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Business War Stories from the Trenches

Battles Relating to Starting, Operating and Ending a Business

UBSS CENTRE FOR ENTREPRENEURSHIP
VOLUME ONE
CASE STUDY SERIES

By Cyril Jankoff and Daniel Bendel

Business War Stories from the Trenches

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Tour of the Book

Be right first and wonderful second.

Maurice Lubansky

Australian business leader and entrepreneur

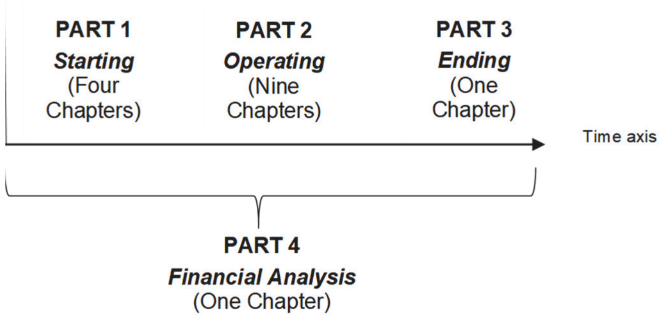
There is a tendency for people to want to be creative and try new things. The need to be innovative is essential but problems can occur if it is at the cost of attention to detail and to business basics.

Battles: Every business, and every person, has had battles, and will have battles in the future. This book is a collection of some of the more informative starting, operating and ending business battles (and accompanying financial issues) which the authors have experienced.

Potholes: The authors seek to help the reader to spot the "potholes in the road" before they hit them and, if they do hit them, be able to mitigate and manage the consequences.

Basics: After you have read this book you will probably think “I have not really learned anything new!” To this we would fully agree, because this book is all about the basics, one of the many being “cash is king”, that is, no cash means no business. We almost see on a daily basis, managers who are not following the basics to their detriment and that of the business. Master the basics and you will be 80% there.

Case Studies: The case studies are divided into four parts comprising fifteen diverse Case Studies: Starting, Operating, Ending and Financially Analysing a business. For a list of the fifteen diverse Case Studies see the Contents page, below.



Dedication

Cyril

To Evlin, Erika and Carl who inspired me in so many ways, and to my co-author (and good friend) Daniel who has shared lots of interesting cases over the years.

Danny

To Sue and Jesse, and to Joshua who is always in my mind.

And Scooter, the kelpie, who helped me think on our morning walks.

And of course, Cyril who is a great friend and colleague.

Authors

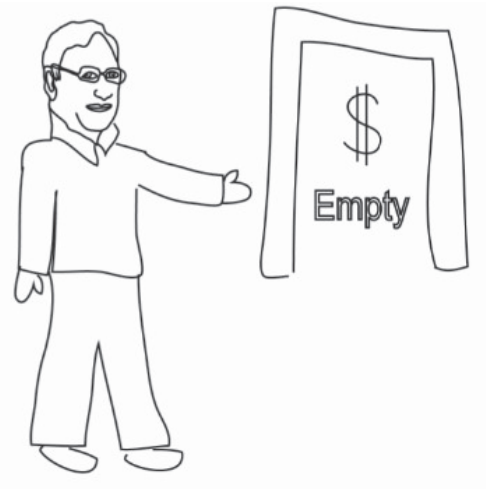
Dr Cyril Jankoff

EdD, MBA, LLB, B Business (Accountancy), Grad Dip Tax, Diploma of Contract Management, Cert IV in Training and Assessment, CPA (Fellow) and AIM (Fellow).

Cyril focuses on business improvement. In his career he practiced as an accountant, solicitor, in-house counsel, business consultant and financial controller in diverse industries and still holds practising certificates as an accountant and solicitor. Included in the above is over 20 years' experience as a forensic accountant and expert witness in the litigation of many commercial contracts, commercial fraud, misleading and deceptive conduct damages cases. He has seen the devastating effects of poorly created and managed contracts on organisations and their individuals. He has worked as the Australia and Oceania manager for a division of a listed UK multinational. He is certified by the International Association for Contract and Commercial Management as an Expert Level Supplier Relationship Management Expert ("SRME"). Cyril has written two books on improving the management of commercial contracts and another one on finance for contracting and non-finance managers. He frequently facilitates business improvement seminars locally and overseas and has taught continuously at universities on a sessional basis since 1986. Cyril's doctorate was in business improvement, family business and the professional development of those who work in, and advise, these organisations.

Daniel Bendel

Bachelor of Business (Distinction), Grad Dip Tax and CPA (Fellow)



Daniel commenced his career in the 1970s as a financial accountant in the corporate world, and later went to work in the accounting profession as a tax and business advisory accountant. Early in his career he was asked to join a large family owned manufacturing company and has been there since. He is now a part owner, a Director and the Company Secretary. Daniel is still involved in the accounting profession and is thus in a rare position to see business from both sides: as an owner/manager and as a consultant advisor. He is also involved in many other business-related activities and has acted for clients in a wide variety of activities including restructuring, forensic work, and business change management etc. He has been involved in the administration of a not-for-profit (NFP) organisation for over 10 years.

Cyril and Daniel

Daniel and Cyril met while they were studying for their Graduate Diploma in Taxation in 1981 and have since worked together on many business improvement projects, a few of which are included in this book. They would have formed a formal business consulting partnership but were impeded by their inability over the years to agree on whose name should come first. Should the firm name be Jankoff and Bendel or Bendel and Jankoff?

Acknowledgements

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UBSS **Emeritus Professor Greg Whateley** – this book was his idea, and without his support it would never have happened.

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The authors also gratefully acknowledge the cartoons by **Jan Harrison** and **Sharon Madder** and **David Hannay's** photography.

And finally, the authors acknowledge the efforts of **Stephen Parker** who assisted with the formatting and layout of the book.

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Foreword

Universal Business School Sydney (UBSS) is an independent higher education provider that prides itself on delivering practical based business degrees at undergraduate and postgraduate levels. The Centre for Entrepreneurship (CFE) was established as a forum to allow students access to entrepreneurs and subject matter experts, to learn and work with the Fellows to further student business education.

One of the ways this access to industry is achieved is through the writing of case studies by our Fellows. It is with great pleasure that the UBSS Centre for Entrepreneurship has compiled Volume 1 of the CFE Fellows Case Study Series. This is the first in a series of CFE Case Studies to be released by UBSS.

We are fortunate and honoured Cyril and Daniel are the authors of Volume 1. Their journeys are long and winding paths through the business world. They bring a comprehensive mix of professional background and real-life experience to these cases. Cyril has considerable expertise and a doctorate in the field of *business improvement*, previously writing two books and lecturing at universities on this topic. Daniel's background, as a practicing accountant and business owner, provides insight into the entrepreneur, having progressed through the whole journey of the entrepreneurial business cycle to divestment of his business.

This volume has been designed to take the entrepreneur through the various stages of the organisation with the use of case studies. These include *starting* the business, *operating* the business, *ending* the business and *financial analysis*. By using a case study format, it may be read as individual case in the academic setting or as a compendium for entrepreneurs to gain insight and build business acumen. This forms an important part of the teaching and learning at UBSS.

As the Director of CFE I wish to sincerely thank Cyril and Daniel for all their hard work and persistence to distill their years of experience and advice into this single volume.

Associate Professor Andrew West

Director, Centre for Entrepreneurship

Universal Business School Sydney

Preface

This book is for *anyone interested in business management*. It is the intention of the authors that the reader learns how to avoid some serious pitfalls from *real life* case studies, and what to do when experiencing these pitfalls and where to look to obtain advice. Remember that truth is often stranger than fiction and you will certainly see this in the attached case studies!

The layout of each case study

Each Case Study is broken into six different individually numbed sections:

1. Brief Overview
2. Background to the Case Study
3. The Case Study Facts – here you will find one or more Case Examples
4. Questions
5. Suggested Responses to Questions
6. Postscript.

Notes for the reader

Each Case Study seeks to provide a background to the topic, and then facts of a Case Example or Examples that the authors have experienced. Try to answer the set questions before reading the suggested responses. The Postscript summarises the Case Study in a short paragraph.

Notes for the facilitator

If this book is used in an education setting, such as a university or an on-the-job training session, the facilitator may wish to summarise the theory and each of the Case Examples before discussing them and use the suggested responses to questions as a springboard to facilitate the materials in class.

Improvements, comments etc

As this case is based on actual Case Examples, we have changed the names, occupations and businesses to protect the innocent and maybe not so innocent. As further protection we have taken careful note of the book "How to Use Real People in Your Writing Without Ending Up in Court". However, if all else fails, any problems that surface will make a great addition to the next edition of this book. If you wish to suggest an improvement to the content or make a comment, then please contact: Cyril Jankoff at Cyril@TheRiskDoctor.com.au

Part 1 – Starting the Business

Figure 1 - Starting the Business

This Part covers the following Case Studies…

1. Choice of Business
2. Business Structure I – People Resource Issues
3. Business Structure II - Capital Purchase Evaluation
4. Family Business

Notes

Chapter

1

Case Study 1 – Choice of Business

Does it make commercial sense?

Cyril Jankoff and Daniel Bendel

1.1 Brief Overview

Below we will look at four individual Case Examples regarding the choice of a business and how they started up. We will consider a number of issues including "why go into business?", "how to get into business?" and "due diligence" evaluation of lifecycle phases. We will also consider several ways to get into business including starting your own, buying an established business and franchising. Remember that a business is simply a process of identifying a problem and finding a way to solve it that benefits both parties to the transaction. The primary reasons for failure of start-ups within three years is usually management's lack of experience and not having enough money when needed. However, we should remember Woody Allen, who once said in an interview about being successful, "80% of success is just turning up". This case study is from the writers' commercial experience and should be only used as general background information and for education purposes. The above and other issues will be discussed in the below Case Examples, but first we will provide a brief background to the case study.

1.2 Background to the case Study

1.2.1 The "why" phase

The reasons why people wish to start a business are quite varied and include:

- Lifestyle reasons, for example flexibility of work
- The feeling of being able to create something new, perhaps an invention or concept
- Dislike of existing employment
- Wanting to help a family member utilise their skills and avoid unemployment.
- The desire to follow a personal passion
- The excitement surrounding entrepreneurship
- The potential to create wealth beyond that which could have occurred as an employee
- The structuring of an income arrangement which has tax benefits for example a computer programmer employee that wants to take on extra clients in their own time.

The above reasons for why we start a business should be considered within a framework of commercial reality. For example, a person may be a talented golfer and wish to follow the well-known Tiger Woods (who is effectively running a business), but for most golfers the reality is they will not profit as much as they hoped to out of the business. This is due to the allocation of prize money being weighted to top finishers in competition, resulting in a highly competitive business, and the large number of good golfers willing to take the risk of earning a low income because of their passion.

However, there is no issue if we accept this. This is similar in many other fields of endeavour, for example acting, music and art.

1.2.2 The "how" phase

Once the decision is made to go into business, then we look at the "how" phase. There is often a common series of logical steps. However, humans are not always logical – in that they may not do all the below or they may perform them in a different sequence. The steps include:

- Filtering the general areas of interest and focusing on a specific target
- Performing basic market research (location, product, price, buyers of product or service etc.)
- Review the competition
- Develop a rough business plan, including a basic financial budget, and a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis
- Prepare a backup plan (called a "Plan B") if the worst happens
- Decide on fellow investors and/or business partners and discuss how this will work, and from this develop verbal, and preferably a written, agreement
- Further refine the business plan
- Make the stop/go decision.

The business plan referred to above is the first step in entering the chosen business. Often just the act of preparing the plan can focus the mind on the benefits of the proposed business and whether it will achieve the financial and emotional goals set. The plan should be kept in an easily accessible location and used to monitor progress. Unfortunately, often a business plan is prepared just for the purposes of satisfying an external party, for example the Bank. If that is the dominant motivation, then often the commitment to it may be lacking.

1.2.3 The evaluation or "due diligence" phase

Once having completed this plan, and decision is made to enter the chosen business, the next stage is the "due diligence" phase, which is the stage before the stop/go decision.

Sometimes the business plan may incorporate aspects of the "due diligence". Due diligence may include the following:

- Checking financial records
- Physically reviewing all assets and liabilities
- Checking asset registers and stock takes
- Checking the intellectual property rights, business names etc.
- Employees and liabilities

- Legal and tax obligations
- Corporate structure
- Registrations requirements
- Review of the documents including:
    - contract of sale of business
    - leases
    - the "Section 52 Statement" (the statement by a vendor of a small business under Section 52 of the Estate Agents Act 1980, Victoria).

The Authors were engaged by a businessperson who wished to buy an existing business. The first business reviewed was a carpentry factory. The Authors conducted the due diligence and concluded that buying the business would be high risk for their client, who fortunately took their advice and did not purchase it. The client then requested the Authors look at a home renovation business, and the Authors concluded from their due diligence that the business could provide the client with sustainable profits and the client purchased it and ran it successfully for over 10 years.

The lack of a business plan or due diligence is considered in Case Example 2.

Figure 2 - Are you doing enough due diligence before making the big decision to start your own business, buy one or take on a franchise?

1.2.4 Choosing a business based purely on your personal interests

This often occurs. For example, an employee, accountant or lawyer on leaving to start a business may enjoy the freedom of dispensing with timesheets, but to make the escape from timesheets as the main reason for leaving the profession is a questionable commercial reason, as it may be more of a personal reason. Your personal interests should be a subsidiary and not a dominant reason for starting a business, and this is illustrated in Case Example 1, below.

1.2.5 Getting into a business by starting your own

Another way of looking at setting up a business is that it is a little like baking a cake. The ingredients could include having the background and skills and enough capital (the two main reasons for avoiding failure), understanding the market, having partners with shared values and trust, conducting the due diligence, and business plan. Leaving out any of these key ingredients increases the risk of overlooking a critical problem or opportunity. Starting your own business is considered in Case Examples 2 and 4, below.

1.2.6 Buying a business

There is no reason why the entrepreneur could not purchase a ready-made business and change it where necessary. Mergers and acquisitions (called "M&A") are a big part of corporate strategy. An example of an acquisition is Microsoft's purchase of Skype to strategically form a business with a broader base. Buying a business will be considered in Case Example 1, below.

1.2.7 Getting into a business by purchasing a franchise

Franchising has become an important part of the business market in which the franchisor has already established a proven business model (think of McDonalds) and the franchisee rents (called "licences") this franchisor's model to run their "own business" for an agreed period, which may be as short as one year, or at the other end of the scale may be granted in perpetuity. Generally, however, most franchises are granted for three- or five-year terms with an option to renew for a corresponding period. Franchises can vary widely from a McDonalds restaurant to a local lawn mowing franchise.

1.2.8 Buying a product or service by subscription

Another way of accessing goods and services is by using subscription services rather by outright purchase. This has become a strong business model in recent years (for example, the use of cloud-based software), and franchising is in effect just a subscription style business. For a regular fee you have a business delivered to you provided you manage it according to the agreed formula, with a Jim's Mowing Service being an example. While franchising has the benefits of producing a reduced risk business model and is often seen as a good way of buying yourself a job, you do not get to own the intellectual property (IP) rights, but just the right to use these IP rights for a limited duration, in limited areas or geographic zones and in limited media (for example the electronic but not the printed version). Care is required as it is still not without some risk and should still be evaluated carefully. Copyright and licencing issues are discussed in Case Study 11 - Intellectual Property II - Copyright and Licencing.

1.2.9 The start of the real work

The real work often only commences once the business starts. It is like a flower - it requires constant care and maintenance for it just to live, let alone bloom. Often opportunities or threats come along after the business has started that were unexpected and must be dealt with using the same diligence shown when starting the business. You will see this in all four of the Case Examples below.

Often it is not the "idea" that fails, but the unsuccessful implementation, that is its commercialisation and marketing, that is the problem. Many people have ideas, but fewer can successfully implement them. Capable businesspeople have skills in both (ideas and implementation) or know how to access them, *and* the necessary funds. Failure issues will be considered in Case Examples 1, 2 and 4, below.

Often a business person who is intending to work with others (for example in some form of partnership or co-investor role) will miss important key people aspects such as how well they trust their colleague(s), how well can they work with them and do they share common values? This will be considered in Case Example 2, below.

1.2.10 Starting a business as a lifestyle choice

In developed countries being in business is often a lifestyle choice, glorified by the glamour surrounding well-known successful entrepreneurs. The reality for most is different, you can generalise by saying that for most new small businesses the founder often works twice as hard, twice as long, with twice as much stress, but with half the salary they were earning before they started their own business. As will be seen in the next sub-section, statistics clearly show that failure frequently occurs soon after commencement. In undeveloped and developing countries there is often a different reason for going into business, and it is survival. That is, no work means no money, and no money means no food. Irrespective of the motivation it is important to know about the "why", "how" and due diligence phases.

1.2.11 Reasons for failure

According to the U.S. Small Business Administration, over 50% of small businesses fail in the first year and 95% fail within the first five years. Other studies around the world have similar results. Different research says different things, but the common answer is, regardless of the industry, failure (especially in the early years) is the result of lack of management experience and insufficient money when needed. These two issues interweave the four Case Examples, below.

1.3 The case study Facts

1.3.1 Case Example 1. Bob Greengrass's café (buying a business)

Bob Greengrass, the sole income earner in his family, was a middle ranking marketing executive in DoDoDo, a reasonably successful company selling office paper. In addition to his sales figures, Bob was evaluated on his inventory management and the accounts receivable recovery, which caused him considerable ongoing stress.

After 20 years at DoDoDo Bob told his accountant, Kim that he wanted to start his own business. Kim analysed Bob's skills and his resources and advised him of the risks and rewards of starting up a business.

Bob said he was particularly keen on finding a business that did not involve dealing with inventory and accounts receivable, as he had enough of dealing with them.

Kim advised that choosing a business mainly based on personal preferences of selected items of working capital may distort the choice of the best business for Bob. Kim further advised that market competition tends to even risks up so that a business that does not require certain items probably will have its own equivalent difficulties and issues.

Bob still insisted on his personal interests, and after reviewing businesses that were for sale, chose a cafe in a trendy Melbourne inner suburb. Bob had no experience in running a cafe.

He bought the cafe and his wife, Jasmine, joined him in running the business. The purchase price was high because it was well set up and profitable. However, it had only been set up two years previously and had little competition. Bob borrowed heavily to buy it. Bob and Jasmine worked hard and ran it well. However, Bob found that expenses (wages of the chef and waiting staff, rent, utilities etc) all cost more than he expected and the return for the long hours invested was low.

Then a new cafe opened next door and copied, and improved upon, Bob's café, and as a result Bob's café lost business, and profits (see cartoon, below).

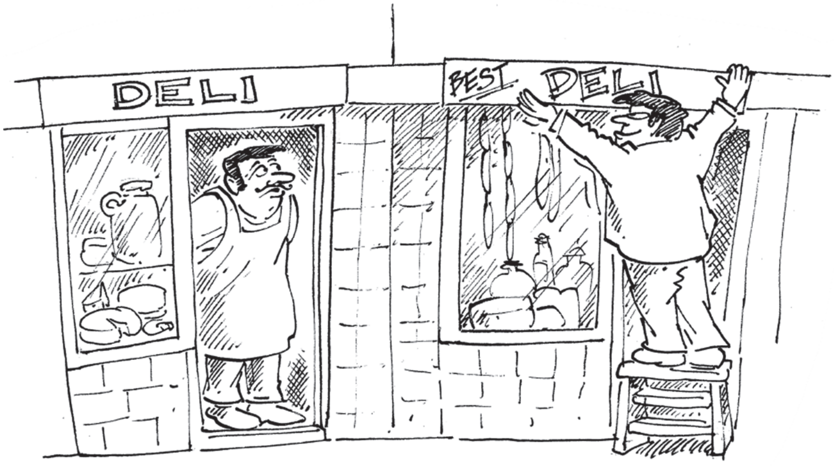

Figure 3 - What are you doing to make up for the competitor who just started up next door?

After a few more years Bob and Jasmine had enough of the long hours and low return and wanted to sell up but only managed to recover half what they paid for it. Bob went back into a sales job similar to what he left to work in the cafe.

1.3.2 Case Example 2: Tommy's product range (adding new businesses to existing business)

Tommy was a trained and experienced electrician and was keen to start his own business. He is ambitious but is also argumentative and not particularly trustworthy. He took on a partner, Patrick. Patrick did not agree with Tommy's unethical business practices and there were many arguments. The business did well and ended up employing a number of electricians and the two partners were able to buy a warehouse and workshop. Patrick did not want to work as a partner with Tommy, so Tommy bought Patrick out. Tommy continued to employ Patrick who needed the employment.

Tommy was always looking for new opportunities. Tommy had a friend that got stuck with a large number of dressing gowns. Tommy purchased them inexpensively. Years later he was still unable to sell them and gave them away.

Tommy then saw an opportunity to expand into solar panels installations. He saw this as a small extension of his existing business, as it has more synergy than random "non-core" ventures such as dressing gowns. Tommy understood the electrical nuances of the business and developed a profitable solar panel business.

Tommy's girlfriend, Debby, was a masseur and Tommy offered to set up a studio employing a number of workers and they leased a studio. Tommy didn't have any expertise in this industry and was too busy and disinterested to learn. Debby had no business experience. The resulting frustrations caused Tommy and Debby to argue. The business eventually lost money and was closed. Tommy and Debby separated.

1.3.3 Case Example 3: Cathy's bespoke food delivery service (refocusing and expansion of an existing business, and possibly franchising)

Cathy was always keen on being self-employed. She tried a variety of businesses, gardening, cleaning with mixed success. Being a trained chef, she decided to set up a takeaway shop in trendy Seddon, an in inner suburb of Melbourne. This was only partially successful, possibly due to the high number of similar trendy take away cafes recently set up in the area.

Cathy had requests from customers wanting very specific changes to the menu options. This made her wonder if a business catering to the fussy Seddon residents could be successful. She then prepared a business plan with input from Joseph, the external accountant, and some experienced business friends.

She converted the takeaway shop into a bespoke on-line kitchen providing home delivery food to fussy eaters with specific requests, for example a vegan wholemeal sandwich with smashed avocado for the school lunches of well-to-do local families.

This was very successful, and the demand grew so much that she had to relocate to larger premises. Eventually Cathy and Joseph put together a syndicate of investors to help the business expand quickly. The reward for Cathy would be that as the existing business expanded it would become more valuable and this would increase her personal wealth.

The business is now "successful" and the investor group is now seriously thinking of replicating the business by franchising it.

1.3.4 Case Example 4: Henry high tech (starting your own high-risk business for personal reasons)

Henry was a reasonably successful businessman. His son, Anton, was a university lecturer in mechanical engineering and was aware of many innovations in his field, particularly a device needed for self-driving cars.

Anton was made redundant due to university funding cutbacks and was unable to find work in his chosen field. Henry discussed with Anton the starting up of a high tech "start up" to develop Widget X, the innovative mechanical device that Anton previously worked on at the university.

People in the industry said the device could be of great benefit and had potentially a wide variety of applications. Henry was enthusiastic about helping his son and the product's potential. Henry did not undertake a formal analysis of the market including such things as an investigation into the competition. Henry put together a syndicate of investors amongst his family and friends, and arranged some highly skilled, but low paid, university post graduate students to assist.

After two years the company had spent the start-up money and there was at least two more years of development before "proof of concept" will be ready to take to a larger company for potential takeover (that is sell the business). The product still appears to have a market, however there are many questions about funding, commercialisation of the product, patent applications and costs which are yet to be answered. The future of the business seems difficult to evaluate.

Henry is now asking friends and family to invest further.

1.4 Questions

1. What do you see as the main "take away" points from (a) each Case Example and (b) all the Case Examples in general? Evaluate these against the main phases and points raised in the Background section.
2. What do you see are the advantages and disadvantages of the three key methods of getting into a business: start your own, buy one or enter into a franchise agreement?

1.5 Suggested responses to Questions

Question 1:

What do you see as the main "take away" points from (a) each Case Example and (b) all the Case Examples in general? Evaluate these against the main phases and points raised in the Background section.

1.5.1 Suggested Response (a): Each Case Example

Case Example 1 - Bob Greengrass

- Bob's motivation was dominated by two things: being sick of his job and thinking the answer is all about escaping from managing inventory and accounts receivable.
- There is nothing wrong with Bob wanting to get better control of his work life. Perhaps he needed to have a more realistic view on starting his business. There does not seem to have been much of a strategy and a back-up plan. Perhaps a franchise may have been a safer option.
- Many advisors also recommend working in a business before investing in your own in order to become familiar with the nuances of the business and how the chosen area of business works. It is often a number of the little things (called "local knowledge") that can make the difference between success and failure. Perhaps Bob could have tried working part-time in a cafe to obtain a better understanding of this industry. Alternatively, he could have gone into business with an experienced cafe owner.

Case Example 2 - Tommy's

- Tommy clearly has both technical and business skills.
- There appears to be an issue with Tommy's ethics and ability to work with others in a shared partnership role. His associates, Patrick and Debby should have considered before going into business with him whether they could work with Tommy, whether they can trust him and have shared values. It is just as important to have these as the

relevant technical skills, when wanting to go into business with someone else.

- Tommy thinks because he has the ability to be successful in the electrical area that this will translate into other areas regardless of whether he has the local knowledge or experience. This is not to say he shouldn't venture into new products and into new markets, but to reduce risk he needs to commit resources (money, time etc) on research and planning. We note that one reason for Debby's business failing is that Tommy didn't have any expertise in her industry and was too busy and disinterested to learn.

Case Example 3 – Cathy home delivery specialised food delivery

- Cathy seems to have followed generally accepted business practice. For example, she used existing skills, carefully evaluated the market and met a market need.
- She is working in an area she is skilled in, enjoys and is prepared to put in the necessary work.
- She was perceptive and flexible enough to change direction after she had started the business to meet consumer demand.

Case Example 4 – Henry high tech

- This is an example of someone whose noble intentions may have affected or influenced his usual process of evaluation.
- Some of the "cake ingredients" are lacking, including ensuring adequate capital, proper review of the market and review of competitive companies' development status in this high-tech area.
- The device may end up being successful, but this outcome, if it occurs, is beginning to look longer term than initially expected.
- We know that in new technology start-ups (often called "bleeding edge") most are not successful and fail. Cochlear is an example of a successful Australian company that developed hearing implant devices.

- We need to be careful about asking for investment from family and friends as they will often have different motivations to those of Henry. There are also legal considerations here (offerings at a certain level require a prospectus and there may be both legal and ethical questions of approaching friends and family with a risky investment), and these need to be considered before approaching friends and relatives.

1.5.2 Suggested Response (b): All 4 Case Examples in general

All four Case Examples demonstrate that a simple desire or enthusiasm to go into business is generally insufficient to increase the chances of success.

The Case Examples show that there are clear benefits in all 4 examples from using a systematic analysis. This could include an analysis of the product, competition, market trends, finance and budgeting.

There are the odd cases of someone acting on just personal feelings ("gut instinct") succeeding. Statistics indicate that this success is usually due to luck and is rare due to the higher risk of going into business without proper due diligence.

These four Case Examples corroborate studies, for example the U.S. Small Business Administration statistics quoted early in this Case, that over 50% of small businesses fail in the first year and 95% fail within the first five years. Research from around the world shows that the common reason for failure regardless of the industry, especially in the early years, is the lack of management experience and insufficient money when needed. These two issues interweave the Case Examples.

Another common theme in the Case Examples is how much influence there is from personal preferences. The benefit of some form of analysis and/or obtaining independent advice is that it can help put these preferences into perspective.

Question 2:

What do you see are the advantages and disadvantages of the three key methods of getting into a business: start your own, buy one or enter into a franchise agreement?

1.5.3 Suggested response:

Start your own

- Advantages
    - Do it yourself the way you would like it
    - No need to pay for assets that you do not need or are not working as they should
    - No need to rely on the profit figures of the vendor.
- Disadvantages
    - Are you capable of starting your own business?
    - Do you have the time and expertise to do it?
    - Having not been in business before you do not know what to expect.
    - May cost more, and take longer (if ever), to set up and become as profitable as expected.

Buy a business

- Advantages
    - Already set up (staff, suppliers, customers, equipment, premises etc) – there is often little still to do.
    - Little down time – the day you walk in is the day you start earning
- Disadvantages
    - May need to pay more than is required to set up the business you desire
    - The business may not have been set up properly, or does not run properly
    - If the business formula is changed too soon then you may lose customers and possibly the business (for example change the menu in a restaurant)
    - The need to pay for the business assets (comprising assets and goodwill), and the larger these assets the more you will need to pay to buy the business

- Vendor may fraudulently inflate profits (increase sales and deflate expenses) resulting in the purchase price artificially increasing.

Franchise

- Advantages
  - Rigorous selection and induction process to increase the chance of success
  - All is provided: marketing, premises, systems etc.
  - Ongoing support is as far away as the telephone/email.
- Disadvantages
  - Greedy franchisors (see press reports).
  - Legal protection of franchisees lacking (see press reports).
  - Contractual obligation to pay high marketing expenses and purchase seemingly useless stock. For example, one of the authors noticed that an American franchise sporting goods retailer was forced to buy and sell ice hockey sticks in tropical Northern Queensland!
  - The equity remains with the franchisor. Franchise agreements vary but the terms are broadly similar to leasing terms. The franchise, like a leasehold, can also be sold but is heavily controlled by the franchisor who will typically charge fees for the sale. Many franchisees make no profit out of the franchise, and indeed lose money.

1.6 Postscript

The four Case Examples validate the U.S. Small Business Administration statistics quoted early in this Case. Worldwide research has shown that regardless of the industry the common reason for failure, especially in the early years, is the lack of management experience and insufficient money when needed. These two issues interweave the Case Examples. The Case Examples also show that personal choice of business preferences can make or break a new business.

Notes

Chapter 2

Case Study 2 – Business Structure I - People Resource Issues

Growing a company is like blowing up a balloon. Your first few breaths, though difficult, produce immediate results. Subsequent breaths expand the balloon proportionally until it nears capacity. Stop too soon and the balloon never reaches its potential. Stop too late and it bursts.

James A. Schriner

2.1 Brief Overview

Once having decided on the choice of business (see Case Study 1 - Choice of Business), one of the main decisions is how do we structure it, that is, will we trade as a sole trader, partnership, company or trust? This requires some forward thinking as once chosen it is often hard to change.

Having made the structuring decision we then move to the decision on what infrastructure is required to run it in order to achieve the goals set by the owners. This applies whether you purchase a business or start a new one (called a "start-up"). Infrastructure decisions apply to many situations including the commencement of a new division of a business, the optimal size of a factory or even the evaluation of a shop.

Often when a business is purchased, many legacy assets come with it, including staff, real estate, plant and equipment, intellectual property, warehousing and distribution. Often one or more of these assets may only be partially useful, or indeed not be useful at all, in the new purchaser's business.

A sensible approach is to thoroughly evaluate the purchased business, or an existing business periodically to determine what is required to run it as if it were a start-up. Often a number of options will present themselves to the new owner. An example is that an evaluation of the warehouse assets indicates that it may be better to outsource the warehouse function to a third-party logistics warehouse ("3PL") than doing it yourself.

It is vital to note that if you are the sole owner of the business and you change to an entity which is owned with others then you will no longer be the sole decision maker.

The above and other issues will be discussed in the Case Examples following, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

2.2 Background to the case Study

2.2.1 Business Structure

Start-up factors to consider

Whether you purchase or start up a business, the decision on how to house the business will depend on several factors. It is vital to obtain competent professional advice here as mistakes can be very costly. The factors include (with some overlapping):

- Tax issues
- Personal liability
- Effect of divorce
- Industry standards (for example, using those that the Bank is familiar with)
- Administration
- Asset protection.

Common structures used for commercial enterprises

The main structures or "shells" you can use to run your business are:

- *Sole Trader*: Here a person trades by themselves in their own or a chosen name
- *Partnership*: Here a group of people trading together in their own names, or a using a chosen name
- *Company*: This is a legal entity separate from its owners (shareholders), and is owned and managed by one or more persons, which may be the same in a small business
- *Trust*: This is an entity that holds assets or trades on behalf of its beneficiaries.

Other structures used for non-commercial enterprises

These include:

- *Co-Operative*: This is a member-subscribed business organisation
- *Incorporated Association*: This is a partnership / company hybrid arrangement that separates the entity from its

members for liability purposes. It is often used for charitable or club type purposes.

- *NGO (Non-Government organisation)*. An NGO is an organisation that works for welfare objectives, including social or public welfare issues. This can be compared to a Not for Profit Organisation (NFP or NPO) that works for a range of objectives, except for making profits. An example of an NPO may be your local sporting club. NGOs usually work on a larger scale projects and examples are Greenpeace or the Red Cross. Often there is a cross over between terms such as Charity, NGO and NFP. They tend to use either the Incorporated Association structure or through a company structure which is "Incorporated by Guarantee" to further limit the liabilities of members. These are all managed by the Australian Charities and Not for Profits Commission (*www.ACNC.gov.au*).

Comparisons

In order to decide which structure to use one needs to consider several key issues including the relative ease of use of the different business structures. These are summarised in the Exhibit below.

Aspect	Business structure			
	Sole Trader	Partnership	Company	Trust
Complexity	Simple	Simple	Complex	Complex
Cost of running	Low	Low	High	High
Asset protection	No	No	Usually	Usually
Tax flexibility	No	No	Usually	Usually

Table 1 – Exhibit 2.1 Some basic comparisons of the Different Business Structures

Other alternatives

An alternative to starting a business, or buying one, is where a company issues shares to new capital investors, with these investors being new shareholders. These companies usually retain their existing corporate structure.

Another alternative is to buy the business and the entity that owns it, usually the company. Normally if you buy an existing business you will purchase the business itself and house it in one of the above structures (usually sole trader, partnership, company, trust), leaving the owner with the shell that used to house the business. This is done so that any problems that the vendor's business faces are not inherited by the buyer. An example of the problems that can occur is where one of the authors advised a builder client against trying to save a very small amount of money by reusing a dormant construction company and that the new multi-million-dollar venture should commence with a new company. The client ignored the author's advice and used the dormant company, and a few months later the recycled company was sued for defective building work on a previous project causing the builder an enormous amount of unnecessary angst, cost and wasted time. Note, however, that some liabilities, such as staff leave, will transfer with the business regardless of who owns it.

2.2.2 Optimum business size

The optimum business size relates to the best configuration of factors that maximises the efficiency and profitability of a business, and this will require a consideration of economies of scale and critical mass.

In many ways this is the more difficult decision than choice of structure because the optimum business size varies with the nature of the business and industry and the changes that inevitably occur constantly within the business and the industry it operates in. It will also vary according to the personal preferences of the owners. For example, the authors know a sole practitioner lawyer who enjoys doing everything rather than hire staff.

Even a growing company may have a difficult decision to make as to what to do with its profits. The company could reinvest the profits and grow the business or alternatively take the profits and invest outside of the industry to spread their risks. This latter option is a common strategy for many smaller business people who use the profits to build a separate property or share portfolio often as part of wealth and retirement planning. The choice between these strategies depends to some extent on the owner's objectives and available options.

Uncontrolled growth can damage a business as much as not having enough business. Imagine a café that suddenly becomes very popular and there is not enough trained staff to handle the influx. Customers will get annoyed quickly and may never return. Another example is when a retailer is frequently out of stock resulting in customers also not returning.

In the case of our sole practitioner lawyer in order to keep good relations with existing and/or future clients the lawyer will need to pick and choose clients as he/she will not be able to service them all, and out of necessity some clients/work will need to be referred to others.

Determining the size of business

The size that the business can grow to is often limited by some common factors, being:

- *Capital available*: This is usually the main limiting factor on the potential size of the business.
- *Human resources available*: A business needs optimal staff and skill levels.
- *Technology available*: A business needs optimal technology and staff technology skill levels.
- *Industry or Market*: Unfortunately, there is no magic formula to calculate the ideal infrastructure. For example, normally the greater the sales the more staff you need. Fortunately, there are some guidelines that you can use, with some noted below;

Business does not operate in a vacuum

It is vital to note that a business does not operate in a vacuum. It operates within one or more industries or markets. Each market has its own peculiarities and requirements. For example, a supplier of free-range eggs will by necessity have a higher cost of operations when compared to the supplier of caged eggs. Therefore, a business owner needs to keep reviewing their cost structure to keep checking whether they are within competitive tolerances.

It is prudent to *continually* look at other successful businesses in the industry and learn what is working and what is not. However, these other businesses should not necessarily be your model, but are used to compare what is happening in the industry and assist you to determine if there is a better way for your business.

How costs move with Income

It is important to understand how costs move with a change in structure. The costs can be:

- *Variable* – these costs change as sales change. Thus, the more you sell the greater the cost due to the increase in direct material cost. An example is the running of a seminar. If you suddenly have five more students, this means that the cost of materials must increase as the organiser needs to purchase five more coursework manuals and five more lunches, however the cost of the facilitator remains the same. The cost increase is easily determined as it is directly proportional to the number of additional students.
- *Fixed* – these costs will not change as sales change. They include rent and management salaries, as these will not change with the increase or decrease in sales. An exception example is where sales increase so much that a new factory/office and manager are required. This is then a "step fixed cost" as explained immediately below.
- *Step fixed costs* – These are fixed costs that change at certain income intervals. Examples include when the demand is so great that you need an additional manager, a new factory or an extra teacher (say when the class size increases to a point when two rather that one classes are required).
- *Mixed (or semi variable)* – These costs are a hybrid of fixed and variable costs. An example is electricity which has a

base charge (the fixed part) and then a usage charge (the variable part).

Evaluate the costs according to your circumstances

When analysing whether to expand or contract the business structure you must consider the above costs, but this analysis must be based on your own current and future circumstances. For example, you may wish to delete a poor performing division but the reduction in income will not reduce the rent unless you move into smaller premises. However, this change may not reduce your accounting department as this department generally is a fixed cost.

2.3 The case study Facts

2.3.1 Case Example 1. Large sole trader

Charles ran a successful sewing machine and accessory business in Melbourne. He ran his multi-million-dollar business as a sole trader.

Charles hired Peter as his new Accountant. Peter reviewed the business and advised that while Charles's structure appeared to work thus far and seemed to be adequate in the past, he was taking a high personal risk in running the business as a sole trader. This is because if he could not pay any invoices due, or he was successfully sued for personal injuries caused by one of his products, he would need to pay the money out of his own pocket. Peter advised that Charles should now run the business through a company.

Charles confirmed that he had previously received that advice but just didn't get around to doing anything about it. Peter pushed the issue and transferred the business into a company structure.

It is indeed fortunate for Charles that he converted to a company as within the next 2 years the business suffered a significant downturn due to poor economic conditions. Trading was so poor that expenses greatly exceeded income and Charles was advised to wind the company up, as it was nearing insolvency. He was advised to do this so that he could retain some personal assets and not have to go into personal bankruptcy. If he had remained as a sole trader, he would have lost all his assets and been bankrupted.

2.3.2 Case Example 2. Constant review and restructuring

Trevally was a toy manufacturer and grew rapidly through the decades from the 1960s to 1990s when imports started making a big inroad and the structure of the market changed from small independent toy stores to major chains and discount outlets.

Trevally operated out of a large building with a large manufacturing and warehouse facilities. As a result of the reduction in market demand Trevally started losing money. It was hard to reduce manufacturing production quickly with a large workforce, and there was a resulting build-up of significant stock levels causing cash flow problems. This hit Trevally hard as by the time it sorted itself out fashions had changed, further reducing its stock value.

The management of Trevally undertook financial modelling to see if the business could be profitable at the existing sales level if the company was restructured. The budget was classified into categories and then into detailed line items, such as motor vehicle costs. This was then analysed using comparisons to available industry standards. The below table summarises the financial analysis.

Category group	Analysis
Current sales	Achievable level
Cost of sales	Using history
Expenses	
Direct	
For example, sales commission	Current rate
Fixed, including:	What is needed to support the sales level?
Selling	
Merchandising	
Warehouse	
Administration	
Computer	
Net profit (which is the resulting figure)	Target 10% of sales

Table 2 – Exhibit 2.2 Financial Analysis Performed on the Trevally Toy Business

The resulting financial plan showed that the 10% target profit was achievable. Based on this analysis Trevally developed a business plan with action items noted and timetabled. It closed its manufacturing and commenced importing and downsized its head office administration. This was successful, and Trevally returned to profitability.

However, over time competition from new entrants into the market, particularly internet-based business, and softening demand all started affecting Trevally again. Trevally overall was only breaking even as some of its divisions were profitable, but others were not. As a legacy from the previous decades the divisions were intertwined and hard to separate. Even the accounting systems were overly cumbersome and expensive to operate.

Trevally undertook a review and it was clear that if the company was to return to profitability, it would have to close one of its poor performing divisions and simplify its cumbersome systems. However, the executives were very comfortable in their jobs and did not want to do this and were happy to continue notwithstanding the above analysis showing an urgency to change.

Trevally sold out to a new director/investor who immediately decided to close the poorest performing division.

2.3.3 Case Example 3. Shop evaluation structure

Veganworld operates several shops in established discount shopping centres. The owners considered opening two new shops – one in a brand-new expensive shopping centre and one in a "strip" street shopping area. Occupancy costs (which comprise rent and associated costs) in this type of retail enterprise in shopping centres and strip streets typically range from 15 to 20% of the total sales. Any percentage significantly above this will start to affect the viability of the business. Both new businesses ended up being failures and were closed. However, the owners continued to be successful by remaining in discount shopping centres.

Below is an analysis of the income and expenditure for the existing typical shop, the new shopping centre shop and the new strip shopping centre shop. Consider the figures and ask yourself why the two new shops did not work.

	Existing typical shop ($)	% of sales	New shopping centre ($)	% of sales	New strip shopping centre ($)	% of sales
Sales	485,000	100.0%	485,000	100.0%	350,000	100.0%
Less Cost of sales	199,000	41.0%	199,000	41.0%	143,000	41.0%
Gross profit	286,000	59.0%	286,000	59.0%	207,000	59.0%
Employee costs	110,000	22.7%	110,000	22.7%	110,000	31.3%
Occupancy	**95,000**	**19.6%**	**143,000**	**29.5%**	**65,000**	**18.5%**
Operating	35,000	7.2%	35,000	7.2%	35,000	10.0%
Total expenses	240,000	49.5%	288,000	59.4%	210,000	59.8%
Net profit	**$46,000**	**9.5%**	**$(2,000)**	**(0.4%)**	**$(3,000)**	**(0.8%)**

Table 3 – Exhibit 2.3 Veganworld Financial Analysis

Notes:

1. Employee costs includes: Wages, superannuation and leave & entitlements
2. Occupancy includes: Rent and rates
3. Figures in brackets are negative.

2.3.4 Case Example 4. Small not-for-profit association

The Help Me is a not-for-profit Organisation (NFP). It had a history of earning a reasonable net profit (called a "net surplus" in the NFP world) and was financially stable.

For some years it was run from a rented office and employed 5 people part time (4 full time equivalent staff). Over many years the NFP had built up a relatively large amount of cash in the bank to be used to purchase its own "home".

The Treasurer of the NFP analysed the figures and stated that the decision to purchase or rent is a complex one and several factors needed to be considered. After careful analysis of this she recommended the purchase of the building. This was done and was very exciting and motivating to all members of the NFP.

Unbeknown to the Board or the Treasurer the NFP then employed an extra person and this has now caused the NFP to lose money. Based on her calculations the Treasurer said this situation of expenses exceeding income must be corrected as soon as possible as the budget does not allow for this loss. Any significant delay may result in the NFP being forced to sell the property to pay debts.

2.4 Questions

Case Example 1. Large Sole Trader

- Question 1. Is a sole trader structure ever appropriate?
- Question 2. Was this a successful outcome for Charles?

Case Example 2. Trevally - Size of business

- Question 3. What were the main factors Trevally used in evaluating their business?
- Question 4. Are there any other factors they should have considered?

Case Example 3. Shop structure Evaluation

- Question 5. What were the main reasons why the two new shops did not work?
- Question 6. Is there any way they could have made these two new shops work?

Case Example 4. Not for profit structure

- Question 7. What should have been done to prevent this excess of expenses over income?
- Question 8. What are the alternative solutions to this problem now?

2.5 Suggested responses to Questions

Case Example 1. Large Sole Trader

- Question 1. Is a sole trader structure ever appropriate?
- Question 2. Was this a successful outcome for Charles?

2.5.1 Suggested Answers

<u>Question 1. Is a sole trader structure ever appropriate?</u>

- There are many situations in which a sole trader would be appropriate, and include one or more of:
    - where simplicity is required
    - there is a low commercial risk
    - where key risks can be covered by insurance cover.
- Based on the above sole traders are often suitable for some tradespeople, consultants and professional providers.

<u>Question 2. Was this a successful outcome for Charles?</u>

- While it was successful to the extent that Charles managed to escape some personal liability, he put himself under unnecessary pressure by not listening to advice on his structure
- The change would have been easier and less expensive when the business was smaller.
- Charles was more concerned with working “in the business” and not “on the business”, that is, his focus was on the day to day running of the business and not looking at the bigger picture. Clearly both are important, but he focused on the former. Had it not been for the intervention of his second accountant he would have been bankrupted and lost everything that he built up over decades.

Figure 4 - Run your business in a business-like way to ensure that you and your family have enough to eat!

Case Example 2. Trevally - Size of business

- Question 3. What were the main factors Trevally used in evaluating their business?
- Question 4. Are there any other factors they should have considered?

2.5.2 Suggested Answers

Question 3. What were the main factors Trevally used in evaluating their business?

Trevally used profitability as the main factor to run the business. Once profits were down it then looked to see what it needed to do to improve profits. Trevally was fortunate that it was able to do this in time and survive. But it would have been better off to have observed the market changes as they were occurring and take immediate preventative action. They are again under pressure and the new owner will implement the required changes.

Question 4. Are there any other factors they should have considered?

Trevally perhaps could have done one or both of:

- used an independent advisor to review its cost structure and compare to competitors and the industry in general; or
- constantly evaluated their business rather than wait and be reactive after living with a festering problem.

Case Example 3. Shop structure Evaluation

- Question 5. What were the main reasons why the two new shops did not work?
- Question 6. Is there any way they could have made these two new shops work?

2.5.3 Suggested Answers

Question 5. What were the main reasons why the two new shops did not work?

First new shop (new shopping centre)

The two main reasons are:

- *Excessive occupancy costs:*
  - The occupancy costs were too high as a percentage of sales (nearly 30%): The new Shopping centre required a higher rent (presumably for a similar sized shop area to the existing shop – incurring a higher rental per square metre).
  - Vegan World should not start new shops unless they can confine rent to around 20% on a conservative turnover. The figures show it was 29.5%
- *Limited sales:* Vegan World appears to be limited in its sales volumes perhaps due to several factors (popularity of brand, general consumer demands, shopping centre foot traffic etc).

Second new shop (strip shopping centre)

The main reason is insufficient sales: Vegan World needs the store foot traffic of a shopping centre. So, when trying a street shop, it should factor in a lower turnover. If it cannot run this shop with less staff (employee costs $110,000 would translate to around 1 full time and 1 casual plus labour on-costs), then this shop option is unsustainable, and should not proceed.

Question 6. Is there any way they could have made these two new shops work?

Yes, there are several ways including:

- *Reduce costs*: Negotiate reduced rents or reduce staffing (note this is a type of step fixed cost, that is, at what turnover do you need an extra person?)
- *Increase sales*: The shop would have to change its operations in a way that would increase its value in the different style shopping centres it wishes to go into. This requires a full business plan including a marketing review that covers its products, demographics of the shopping centre, competitor analysis and other factors. Note that a vegan hamburger chain which was successful in inner city trendy areas of Melbourne opened a store in a low-income demographic outer suburb. This shop failed quickly.

Case Example 4. Not for profit structure

- Question 7. What should have been done to prevent this excess of expenses over income?
- Question 8. What are the alternative solutions to this problem now?

2.5.4 Suggested Answers

<u>Question 7. What should have been done to prevent this excess of expenses over income?</u>

- The NFP has structured itself in a set way to deliver its services, here expenses exceed income. The problem is wages, as they exceed what is a reasonable level relative to income. On this basis the NFP should have had set KPIs (Key Performance Indicators) for the ratio of wages to income locked in by Board resolution. The new staff member started without Board and Treasurer approval, causing this problem.
- No change to this agreed KPI should be made unless the NFP changes its structure, that is, there is a significant increase in funding of the type which allows the money to be spent on running the NFP. This is to be contrasted to project funding which normally is money received to pay for completing a specified project. The problem here is that the project funding money received can only be used to complete that project and cannot be used to cover other operational costs of the organisation, including wages.
- When employing new staff raises any question on the sustainability of keeping the staff member on, then it would be better to have the staff member acknowledge this in their employment contract (either the initial contract or the renewal).

Question 8. What are the alternative solutions to this problem now?

Unless the NFP can obtain additional funding of the type that can be used for operating costs, it faces some unpleasant alternatives where it can do one or more of the following:

- Make one or more people redundant
- Reduce the NFP's services
- Ask all staff to take a short term cut in wages (for example 10%) and keep their jobs and review in 12 months' time. Note this is a voluntary request but this is a common request in times of hardship, particularly in smaller organisations.
- Sell the property and rent premises.

2.6 Postscript

As shown in the Case Examples complacency is the enemy of business. The world, including the market, is constantly changing and moving. In 2009 there was no Uber, iPad, Instagram, and so on. The best businesses are those that constantly review and re-invent themselves and move quickly to meet the market. Part of this constant review is to ensure the business is still structured in the most efficient way to ensure long term success. This Case study, and its four Case Examples, clearly show that you "must move with the times" or be left behind.

Notes

Chapter

3

Case Study 3 – Business Structure II - Capital Purchase Evaluation

Money is always eager and ready to work for anyone who is ready to employ it.

Idowu Koyenikan

3.1 Brief Overview

A core objective of a business organisation is wealth maximisation, that is to increase the wealth of its owners, called "shareholders" if the owner is a company. Investment decisions are a major way that the interests of the shareholders are advanced as future income streams determine the value of the company and its assets. The purchase of capital assets, often called capital budgeting, should thus be made in the context of business strategies. Examples of this include; purchase of land and buildings, plant and equipment etc. Purchase of capital assets should involve an objective form of quantitative and qualitative analysis, in addition to gut feel and intuition. Implementing traditional capital budgeting techniques requires due diligence relating to:

- the requirements of the business
- alternatives available
- a qualitative analysis of the business and industry
- cash flow affordability.

In this case study, and in the Case Examples, we consider how to make the decision to buy or rent, and whether to outsource rather than making or doing it yourself. These decisions are also part of the management of risk. These and other issues will be discussed in the Case Examples, but first we will provide a brief background to the case study. This case study was written from the authors" commercial experience and should be only used as general background information and for education purposes.

3.2 Background to the Case Study

3.2.1 Introduction to traditional capital expenditure evaluation techniques

There are many methods, but we will consider three popular methods:

- *Net Present Value method (NPV) method*: This is where the present values of future net cash inflows are discounted at the required rate of return and this amount is compared to the original investment.
- *Internal Rate of Return (IRR) method*: This is the rate of return generated by a project which equates the discounted future cash flows with the initial outlay, that is at which the NPV is zero. The IRR is the interest rate calculated to equate the present value of future earnings on the investment and is therefore like the Net Present Value method.
- *Payback method*: This is the number of years to return the original investment as determined.

3.2.2 The First Method: The Net Present Value Method

Overview

There are several steps in the net present value (NPV) method:

1. Calculate the current value (called the "present value" or "PV") of all future cash outflows (the money the business expends, including purchases of capital investment, repairs and maintenance etc) and cash inflows (the money the investment will produce, including rent and scrap sale proceeds, if any).
2. The present value of outflows is then subtracted from the present value of inflows to give the "Net" Present Value, or NPV.
3. If this NPV is positive (that is, if the discounted cash inflows exceed the outflow) then the investment is worth undertaking.

The discount rate

The discount rate you use in your calculation is broadly somewhere between the business's cost of money and the owner's required return on funds invested. If the Business has a zero NPV then the project will return no more than the business cost of money/required return on funds. This would be considered a low but still potentially acceptable project. However, it is preferable to have positive rather than a negative NPV. The way the discount rate is determined is discussed below.

Which project to choose?

The rule is that you choose all projects with a positive NPV, and if:

- money is rationed, then choose only the one with the highest NPV
- more than one investment opportunity is analysed, choose the one with the highest NPV.

Advantages and disadvantages of the NPV method

- Advantages
    - It gives a mathematically accurate method of determining which is the best project to choose
    - It cannot make a mathematical mistake.
    - The NPV method is often used in conjunction with the other methods, especially the payback method, and using the two methods together gives the analysis greater depth.
- Disadvantages
    - The NPV calculation is not easy
    - The main difficulties are the:
    - determination of the discount, or "hurdle", rate to be used in the calculation; and
    - cash flows (in flows and out flows, including scrapping cost/proceeds at the end of the project's life)
    - project lifespan.
    - It takes no account of the scale of the project
    - It can be difficult to use where projects have different time scales

3.2.3 The Second Method: The Internal Rate of Return (IRR)

Overview

The internal rate of return, or IRR, also considers the time value of money. However, the approach and calculations differ slightly from those in the NPV method. The internal rate of return on an investment is the discount rate that brings the present value of the future net cash flows to zero. In other words, you must find the discount rate percentage that will make the future cash inflows equal to the upfront cash outflow. In this method, you do not know the discount rate. You must find it by trial and error. The discount rate that makes the future net cash flows equal zero is the internal rate of return on the investment.

Which project to choose?

When you find the rate that results in a nil NPV you compare that rate to your hurdle (target) rate. If the internal rate of return exceeds your hurdle rate, you accept the investment. This method is called the internal rate of return because it is the rate of return that the investment itself produces.

If more than one investment opportunity is analysed, favour the one with the highest IRR value. The investment has only three components to calculate the investment's internal rate of return:

- the cash outflow
- the cash inflows
- the number of the investment years.

The relationship between the NPV and the IRR methods

Another way to look at the relationship between the NPV and the IRR is in looking at Case Example 3 (regarding the Solar Panel Roof). In that Case Example the Net Present Value is approximately $16,000 using an 8% discount rate. The Internal rate of return is approximately 21%. The relationship between them is that the project provides a net 13% (21%-8%) return in excess of the discount rate.

Advantages and disadvantages of the IRR method

- Advantages
    - It gives an accurate method of determining which is the best project to choose (but as will be seen below it has a major disadvantage)
    - It is widely used.
- Disadvantages
    - The IRR calculation is not easy, and it is hard to conceptualise
    - Unlike the NPV method it can make a mathematical mistake. This can occur when comparing mutually exclusive projects selecting one based on a higher internal rate of return may produce the wrong result. Mistakes can also occur with fluctuating cash flows. Consequently, care needs to be taken when using this method. It may be better to use the NPV only, but if the IRR method is to be used it should be corroborated by the NPV method.

3.2.4 The Third Method: Payback Period

Overview

As the payback period method does not consider the time value of money this makes it much easier to "do the numbers" but may produce numbers with a lot less value. The payback period is simply the amount of time that it will take to earn back the original amount invested. The amounts involved are not discounted. In the Exhibit below, showing annual returns, the amount invested is $22 million:

Year	Cash inflows ($)	Cumulative Return ($)
1	2,000,000	2,000,000
2	5,000,000	7,000,000
3	7,000,000	14,000,000
4	8,000,000	22,000,000
5	10,000,000	32,000,000
	32,000,000	

Table 4 – Exhibit 3.1 Payback calculations based on a $22 million investment

In the above Exhibit the payback period is exactly four years. That is, after four years, the original $22 million investment will be exactly recouped. If the payback period fell between any two years, return in the final year of the payback period could be divided by 12 months and pro-rate the return to come up with a period expressed in years and months.

Which project to choose?

The payback method is frequently used in most capital purchase proposals as the main or co-method, especially together with the NPV method. The reason for this frequent use of the payback method is that most businesses want to have their projects repaid within a few years. As risks increase over time businesses seek a lower payback period. If more than one investment opportunity is analysed, the one with the shortest pay back should be favoured. As this method does not discount cash flow over time, or consider returns after the payback period, it is unwise to solely base your decision on the payback method.

Advantage and disadvantages of the payback period

- Advantages
    - It is most useful for short-term investments, meaning those of a year or less, where you can measure the payback period in months. This is because it avoids the disadvantage of having to determine the effect on the cash flow due to the time value of money
    - The method provides a general indication of risk: the longer the payback period the greater the risk
    - The payback identifies when the project investment will be released for possible reinvestment
    - This method can be used for longer-term investments using discounted figures, but not considering returns after the payback period will still be a disadvantage.
- Disadvantages
    - It often distracts management focus from other measures

- It ignores the time value of money
- It does not measure the return on investment.
- It does not consider returns after the payback period. For example, compare two six-year investments (see the below Exhibit) each costing $22 million. Project A pays back in 4 years and Project B in 5 years. As Project A pays back quicker it would be chosen based on the payback method. However, if one takes subsequent receipts into account Project B is by far the best alternative. This error could be catastrophic.

Year	Cash inflows ($) Project A	Cash Inflows ($) Project B
1	2,000,000	2,000,000
2	5,000,000	4,000,000
3	7,000,000	5,000,000
4	8,000,000	5,000,000
5	10,000,000	6,000,000
6	5,000,000	40,000,000
	37,000,000	62,000,000

Table 5 – Exhibit 3.2 Payback calculations based on a $22 million investment

3.2.5 The Three Methods (NPV, IRR & Payback) – A Commentary

Overview

When using any of three methods remember that each method has its advantages and disadvantages. Use them in combination for the best results.

Choice of the Discount Rate in NPV calculations

A fundamental requirement of the NPV method is the determination of interest rate to be used in the calculations. This interest rate is called the discount rate, or the "hurdle rate", and is the minimum rate of return that all investments in an organisation must achieve before a project will be accepted. Ways to determine this amount include:

- *Government interest rates*: An investor clearly seeks a return greater than that which could be obtained in risk free longer-term government bonds. If the bonds are earning a risk-free return of 3% then the minimum hurdle rate will be that amount. This minimum amount then needs to be increased for other factors, including risk, the price the organisation is paying for its capital (both debt and equity) and the return on the organisation's other projects.
- *Performance of existing investments*: If existing investments now bring in 7% return on investment (ROI), the organisation would understandably require future projects or capital investments to earn at least the same. However, if the future investment is new and untested and thus raises the risks the organisation faces then a return above 7% would also be required.
- *Risk*: Normally, the higher the risk the greater the required interest rate.
- *Sensitivity analysis*: We tend to forget that forecasts are always based on assumptions. When doing calculations regarding capital expenditure and forecasted inflows it is always prudent to ask "what if" questions regarding these assumptions. Sensitivity analysis usually is performed by varying the data in the calculation and determining the effect of the variations. Some analysts even prepare three estimated calculations: best case, worst case and most likely case.
- *The essence of capital expenditure*: Capital expenditure is about long-term commitment. Thus, to obtain better decisions you should answer the following questions:
    - Does the proposal make strategic sense?
    - What will the acquisition do for the business, that is does it add value?
    - Have I brainstormed all the possible options?
    - Have I assessed the risks (against which I can judge the returns)?
    - Is the data used in my financial evaluation relevant, comprehensive and realistic? Remember that if you use poor quality information to make decisions then

the result will also be of poor quality. This is called Garbage In, Garbage, or "GIGO".
    - Does the proposal meet the required hurdle rates for the NPV, IRR and Payback methods (if discounting)?
    - If there are competing projects, have I examined the trade-offs?
    - Finally ask yourself the golden rule: if the project meant that I would be committing my own money, would I go ahead with it?
- *Get help*: If you have them seek assistance from your Chief Financial Officer (CFO), finance department or accountant. They should be able to calculate it for you

Examples – from the experience of the authors

- The CFO of a medium sized SME (Small Medium sized Enterprise) was asked how he evaluated the organisation's equipment purchase requirements, that is, does his organisation use NPV or IRR etc? The CFO answered that he had a form called a Capital Requisition Form and the person requesting the purchase needed to complete it to argue their case for the purchase. If the approving manager saw the purchase adding to efficiency, and the organisation could afford it, then the asset would be purchased. Surprisingly, he said that no NPV, IRR, or any other technical method was used. However, a form of Payback return was used to evaluate the request.
- The first job of one of the authors was to maintain a capital expenditure book for one of Australia's biggest resource companies and in this case, there was a limit of $1,000 (back in 1979!) over which one of these techniques as described had to be used. There was often a big question about the accuracy of the data fed in though! He was reminded that he should always remember the quality of information obtained for decision making that is, Garbage In, Garbage Out! ("GIGO").
- One of the authors was asked to advise on a major project. He calculated the payback as 30 years and thus

recommended that the project not proceed due to the risk of not knowing what could happen in the 30-year period.

3.2.6 Conclusion to traditional capital expenditure evaluation techniques

The determination of whether capital should be spent on a project is a vital one. The answer depends on several key factors including the strategic plan, the "hurdle rate" (that is, the organisation's cost of capital) and the accuracy of data (remember "GIGO", above). If such objective methods are not used there may be a misallocation of resources, where higher profit-making projects are passed over for projects which bring in less profit, or even losses.

The reality is that often the payback method is used as the sole determinant as whether the project should be accepted. A reason for this is that it is very simple to use and considers risk. The calculation seeks to forecast whether the project could pay itself off within a given period, say 12 or 24 months. If it does then the project is accepted, and if not, it is rejected. The NPV method could also be used together with the payback method as it considers discounting and receipts subsequent to the payback period.

3.2.7 An example of it all going very wrong

<u>What happened?</u>

In early 2008 the then Mayor of Chicago Richard Daly solicited bids to privatise the City's 36,000 parking meters. The city was in desperate need for cash as it was facing a budget shortfall of about $500 million. In 2007 the city earned about $24 million in parking fees and fines. In late 2008 the Mayor announced that his administration had agreed to lease the city's parking meters to a large consortium for 75 years in return for an immediate capital payment of $1.2 billion.

The CFO who negotiated the deal did not do a business case or any calculation as to how much the parking meter system would be worth over the 75 years. The City Council was not given a chance to discuss or vote on it. The Council could do nothing but rubber stamp the deal. In early 2009 the consortium took over and immediately there were changes:

- more meters were introduced
- parking rates increased
- the hours they needed to be fed were increased.

In August 2010 the consortium valued the expected future flow of revenue at a present value of $11.6 billion, about 10 times the amount the City received for the 75-year lease. This is a profound difference and is a major catastrophe for the City. As the new Mayor takes the office the City is once again facing a significant, and unnecessary, budget shortfall.

Why did it not go well?

It seems that only the immediate budget shortfall, and not the longer-term issues, were considered. Mayors may change but the City is stuck with the problem, in this case for 73 more years!

Reflection

Every organisation needs good governance, and this is particularly important for organisations that handle public money. The preparation of a business case is part of this governance process.

3.3 The case study Facts

3.3.1 Case Example 1 – Steel Bending Machine Co (SBM Co)

SBM Co worked in steel processing and supplied a service of bending and cutting steel for various trade customers, including lintels for builders.

The company depended on one machine which produced all its income. A replacement machine would take 6 months to buy, deliver, install and commence operation. The company's accountant recommended the risk management strategy of buying an extra machine which would provide some spare capacity and as a backup in the case of a breakdown.

The accountant calculated the cost of a smaller backup machine to be around $45,000 plus GST and advised that it could also be used as a supplemental machine during busy periods. The Accountant's advice was ignored. About a month later the machine broke down and repairs took over a month resulting in the manufacturer losing a month's worth of important work and the income and goodwill attached to this loss.

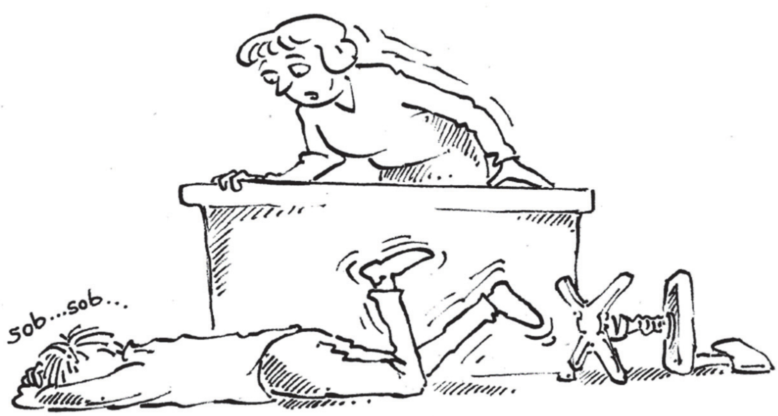

Figure 5 - Actively listen to your professional advisors or you may really regret it!

When the owner purchased the business, the machine was one of the assets which came with the business. The buyer asked the seller of the business for a warranty on the machine, but the seller refused. Later when the machine broke down and it was opened it was found not to have been correctly serviced. The buyer took legal advice. The lawyer advised that for two reasons the current owner had no case against the previous owner. The first reason was that no warranty was provided, and the second reason was the buyer thus took the machine as he found it under the legal principle of *"caveat emptor"* (or "buyer beware") which states that the buyer alone is responsible for checking the quality and suitability of goods before a purchase is made.

3.3.2 Case Example 2 – Which will be Petco's new product?

Petco supplies dog snacks and bakes its product inhouse. If a key Petco customer asks for a new snack for a promotion and it is produced, then this product is expected to conservatively last 3 years before something more appealing is put forward to the market.

Mainly due to time and stock constraints Petco could only invest in one project at a time. It now has three proposals for evaluation. Each proposal had a different pricing and cost structure attached to it and all have a roughly equal risk profile.

Figure 6 - Make sure that the new product excites both the dog and the investors and keep documentation for future reference.

See the Exhibit below for the calculations as to which of the product proposals, if any, should be accepted. Petco's Director said that he was a little undecided as Products 1 and 3 generate the same net profit. The Director continued saying that Product 1 had the shorter payback, however he wanted this evaluated in terms of current dollars and asked the accountant for advice. The accountant then discounted future cash flows to determine the present values and advised that Product 1 provided the highest NPV. He summarised by saying that based on the figures in the below Exhibit he advocated that Petco should proceed with Product 1 as it had the lowest payback period, the highest NPV and the equal top profit.

PETCO CASE		Product		
		1	2	3
		Low price	Medium price	High price
1. CASH FLOWS				
MONEY IN: Expected income generated				
Year 1		5,000	6,000	8,000
Year 2		4,000	3,000	4,000
Year 3		1,000	2,000	3,000
Total inflows	A	10,000	11,000	15,000
LESS: MONEY OUT: Investment required	B	5,000	8,000	10,000
Net Income ("Profit")	(A – B)	5,000	3,000	5,000
2. PAYBACK				
How long to earn the $5000 investment? (years)		**1.00**	**1.67**	**1.50**
3. NET PRESENT VALUE (using 10%)				
MONEY IN: Expected income generated (discounted)				
Year 1 x 0.9091		4,546	5,455	7,273
year 2 x 0.8264		3,306	2,479	3,306
year 3 x 0.7513		751	1,503	2,254
Present Value (PV) of Total inflows	C	8,602	9,436	12,832
Net Present Value (Income – PV outflows) C - B		**$3,602**	**$1,436**	**$2,832**

Table 6 – Exhibit 3.3 Calculation as to which Petco product should be accepted

3.3.3 Case Example 3 – Solar roof for Not-For-Profit (NFP)

A Not-For-Profit (NFP) owns its own office building and operates from it. It is interested in a solar roof on its building and received a quotation. Management is in favour of a solar roof as it shows that the NFP is contributing to less emissions, protecting the environment and it has minimal financial risk. The NFP's Treasurer put together calculations as to the necessary investment, and the proposed savings, to determine whether the proposal should be accepted (see the Exhibits below).

The figures and information were obtained from two sources:

(a) Figures provided by the supplier (using 8% discount rate)

Cost: (net of government rebates)	**$10,108**		
Electricity price increase assumption	3%	4%	5%
Estimated savings over 25 years ($)	58,442	67,484	78,086
NPV: on savings ($)	16,274	18,683	21,440
IRR: investment (%)	21.34%	22.23%	23.13%

Table 7 – Exhibit 3.4 Calculation as to whether the solar roof proposal should be accepted (Supplier Figures)

(b) Figures calculated by NFP's Treasurer

Calculation

	Year 1	2	3	4	5	6
Savings ($)	1,743	1,813	1,885	1,961	2,039	2,121
Accumulated savings ($)	1,743	3,556	5,441	7,402	9,441	11,561

Payback:
As the system cost is $10,108, it will take just over 5 years to pay back the initial cost.

Table 8 - Exhibit 3.4 Calculation as to whether the solar roof proposal should be accepted (NFP's Treasurer)

<u>Notes</u>:

- Solar Installation information from supplier: it is a 7 KW unit; and it is anticipated that 8.07 tons of Co2 will be saved per annum
- The figures in the above Exhibit can be summarised as:
    - The cost of the project is $10,108
    - NPV: The NPV of the project (whether there is a 3%, 4% or 5% expected increase in electricity) is positive and substantial

- IRR: The IRR (whether there is a 3%, 4% or 5% expected increase in electricity) is substantially more than the 8% discount rate
- Payback: Based on the expected savings it will take just over 5 years to payback

3.3.4 Case example 4 – PsychoCo's car purchase

PsychoCo Managing Director has told its accountant that he needs a Porsche as it's important for the business to be seen as successful. The company can't afford to buy one.

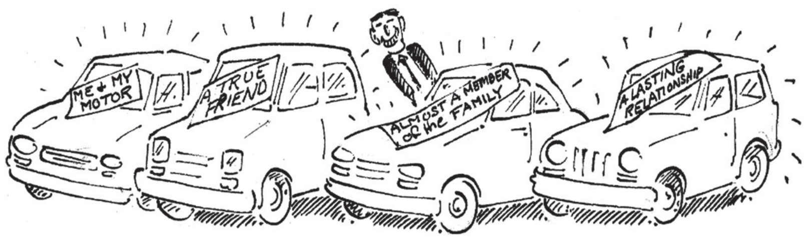

Figure 7 - Know where to get the best value for money deal

3.4 Questions

Case Example 1 - Steel Bending Machine Co SBM Co

- Question 1. What lessons can be learnt from this Case Example?

Case Example 2 - Which will be Petco's new product?

- Question 2. How would you make the new product decision in this Case Example?

Case Example 3 - Solar roof for Not-For-Profit (NFP)

- Question 3. How would you make the investment decision in this Case Example?
- Question 4. How would you interpret the Treasurer's figures?

Case Example 4 - PsychoCo – car purchase

- Question 5. How do you see this Case Example from a financial viewpoint?
- Question 6. How can the MD get the car?

3.5 Suggested responses to Questions

Case Example 1 - Steel Bending Machine Co SBM Co
• Question 1. What lessons can be learnt from this Case Example?

3.5.1 Suggested Answers

Question 1: What lessons can be learnt from this Case Example?

- This Case Example highlights the need to take a holistic approach to capital purchasing, that is the need to understand the whole of the company's needs rather than just the pure financial return analysis on a specific project.
- Clearly, risk management should be applied to all business decisions, including purchasing capital equipment. Risk management was considered in Case Study 7 – Procurement I - Managing Contract Risk and Case Study 8 – Procurement II - Make or Buy?

Case Example 2 – Which will be Petco's new product?

- Question 2: How would you make the new product decision in this Case Example?

3.5.2 Suggested Answers

Question 2: How would you make the new product decision in this Case Example?

- The net income (that is, net profit) looks on the surface to be evenly split between Products 1 and 3. ($5,000).
- However, Product 1 has the:
    - quickest pay back (1 year) which reduces the risk as it brings the money in earlier; and
    - largest Net Present Value ($3,602). Note that this would also mean Product 1 will have a higher IRR than Product 3.
- Everything else being equal (from a holistic business view), one would select Product 1.

Case Example 3 – Solar roof for Not-For-Profit (NFP)

- Question 3: How would you make the investment decision in this Case Example?
- Question 4: How would you interpret the Treasurer's figures?

3.5.3 Suggested Answers

<u>Question 3: How would you make the investment decision in this Case Example?</u>

- This investment can be considered from several angles
    - Investment return
    - Finance/Cash availability
    - Alignment with overall goals and objectives (holistic review).

<u>Question 4: How would you interpret the Treasurer's figures?</u>

- *Source of information*: The figures in tables 7 & 8 (Exhibit 3.4) comprise two different sets of figures, both of which need to be read together. They are:
    - The supplier provided the capex (Capital Expenditure) analysis, which indicates that as the assumed levels of electricity prices increases, the savings (or investment returns) become greater.
        - NPV: Over a 25-year life and using an expected 8% discount rate, the investment will achieve a minimum present value of $16,274, which means it will in present value terms gain $16,274 more than the initial investment.
        - IRR: The investment will receive an Internal rate of return of a minimum of 21.4% which means that is the return on investment that is being achieved. This is related to the NPV by calculating at what rate do the cash flows in and out equalise.
    - The NFP's Treasurer also prepared an approximate payback calculation. While the payback of just over 5 years is slightly longer than ideal, all the other factors

seemed to line up nicely. Thus, the decision to proceed seems sensible.

- *Conclusion*: The supplier and NFP figures seem quite good given other returns available in the economy but depend on several unknown factors (unexpected technical failures, overly optimistic solar generation expectation, maintenance issues, electricity prices etc). It is consequently recommended that the NFP proceeds with the purchase.

Case Example 4 – PsychoCo's car purchase

- Question 5: How do you see this Case Example from a financial viewpoint?
- Question 6: How can the MD get the car?

3.5.4 Suggested Answers

Question 5: How do you see this Case Example from a financial viewpoint?

- From a conservative risk management view the advisor should say no to this request as the organisation cannot afford the purchase.
- If the same question was asked for a luxury work utility vehicle that was more expensive than the basic utility vehicle, the answer may well be different as this vehicle is more work related and has a dual purpose.
- The advisor should state that this request relates to what is essentially a private remuneration matter and should be considered when there is more money available.

Question 6: How can the MD get the car?

Determine whether the car is indeed needed for the purposes described by the MD. If it is needed, perhaps suggest hiring the vehicle or similar arrangement.

3.6 Postscript

Capital expenditure ("CapEx") is normally a strategic investment, as expenditure on items of substance including land and buildings, plant and equipment etc normally has strategic consequences. CapEx should be analysed from a financial aspect where possible, and always from a risk management point of view. A business case can be used to assist.

Notes

Chapter 4

Case Study 4 - Family Business

Leading a family business can be one of the most complex jobs imaginable.

Aronoff and Ward (prominent family business authors)

4.1 Brief Overview

Below we will present two Case Examples to highlight some of the key business issues that distinguish a "family business" from one that is not. The challenge for business families is that family, ownership and business roles involve different and sometimes conflicting values, emotions, goals, and actions. For example, family members put a high priority on emotional capital (the family success that unites them through consecutive generations), owners are interested in financial capital (performance in terms of wealth creation) and executives in the business are concerned about strategy and social capital (the reputation of their firm in the marketplace). Our two below Case Examples will show that the family's influence on a business can be considerable, and follows these three distinctive, yet interwoven, roles. The above and other issues will be discussed in the Case Examples, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

4.2 Background to the case Study

A family Business can be described as *a business where the actions of one or more families determine the fate of the business*. “Family businesses” represent about 70% of Australia’s 2.1 million businesses.

Most people will have had regular contact with a family business: from buying fruit from the local fruiterer to buying a newspaper published by News Limited. Both are examples of businesses whose fate is determined by the actions of one of more families.

There has been considerable research into the dynamics of family business, including the challenges they face and their advantages and disadvantages. There are organisations and associations devoted to providing support and training to professionals working in this sector and to the family members themselves. Examples include Family Business Australia (*www.FamilyBusiness.org.au*) and the Family Firm Institute (*www.FFI.org*).

Family members that work together have an extra “dynamic”, as often they have a heightened sense of commitment and trust which can be compared to a magnifying glass: the good and bad are magnified. That is, when family members work well, they frequently work better than a non-family business, but the bad behaviours are also magnified, as we will see in our Case Examples.

On the positive side family members are also often prepared to put up with difficult conditions. They are often more flexible as they look to the long-term future and family members are often prepared to be paid less to assist the family retain capital. An example is the corner shop employing family.

However, negative things could occur including: the potential for family conflict, unstructured governance (the systems of structures and processes to run the business), nepotism (hiring of relatives regardless of their capabilities) and the lack of succession planning (the continuity of the business through the generations).

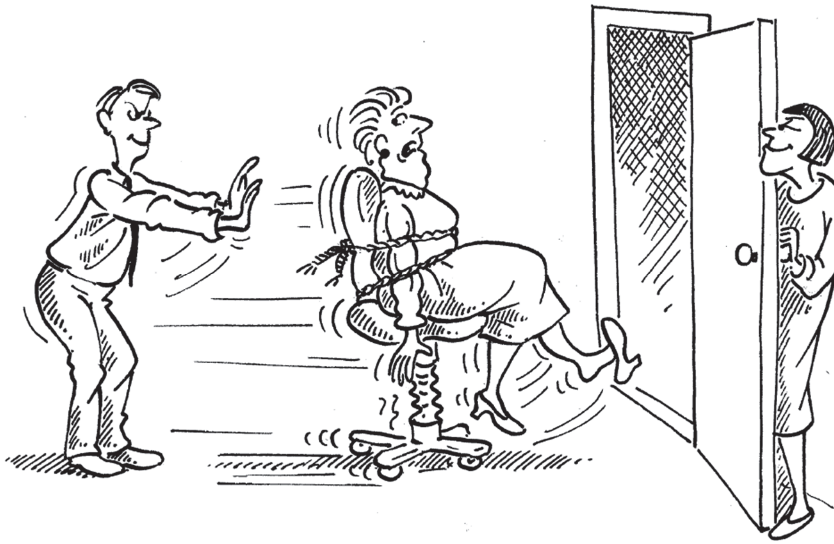

Figure 8 - Can't get the founder/aging CEO out of the business?

Long-term succession can become complex as the family expands vertically and laterally. For example, the well-known Melbourne Smorgon family ended up with a complicated structure due to many family members being involved. The family decided to split up the businesses and distribute the assets to the various family groups, and then let each family group handle how they decided to further split up the assets.

Another example is the Furphy family. It commenced business in Shepparton, in rural Victoria Australia, in 1864 and is known for its iconic cast iron water carts. The Furphy family is still in business but is now very diversified. The family is known for its succession rule where only one branch of the family would run business and other family members would be paid out their financial ownership share.

One main way to take preventative action against potential disputes is to encourage all family members to fully and frankly discuss these issues and make the person aware of which of the three roles (family member, owner and employee) they fit into. A few people, for example, the founder or a senior family member, may hold all three roles.

Another way to take preventative action is to have an agreement, preferably written to minimise misunderstandings. This agreement should encompass all family members working in the business and is often called a family constitution. This agreement should set out key issues that affect both the family and the business, including how the business is to run, how the assets are to be valued and how they should be treated in the event of any family members wanting to join or leave, and what will occur in the case of divorce, death, business sale or dissolution.

Family business faces three key challenges:

- Succession (who is to take over and when). This is about passing of ownership, which may or may not be to the next generation.
- Governance (how decisions are made). This is about how the business is run.
- Professionalisation (how to operate the business in a businesslike manner). This includes issue of nepotism, which is about the hiring of relatives, or friends, regardless of their capabilities.

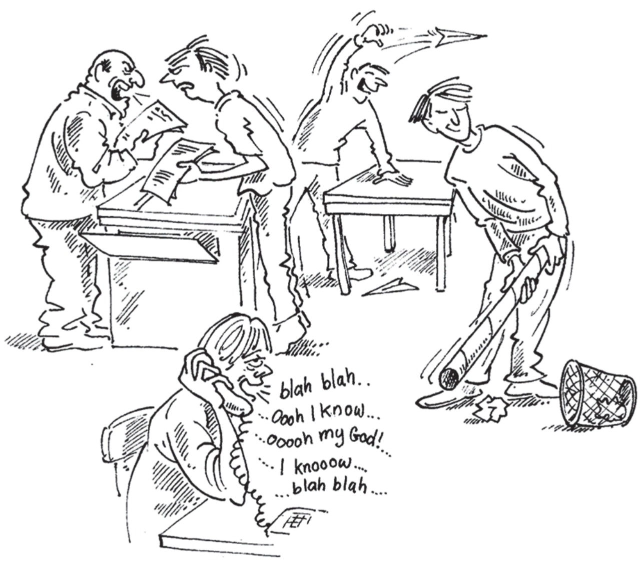

Figure 9 - Family businesses are frequently not run in a business-like manner.

4.3 The case study Facts

4.3.1 Case Example 1 - The Mickey Mouse family

Mickey Mouse and his brother Marcus Mouse established the Disney Cheese Company in 1954 in Sydney Australia. Both were skilful businessmen and entrepreneurs; however, Mickey had an abrasive and difficult side to him. It was a true family business in that brothers Mickey and Marcus were joint CEOs and various other family members worked in various capacities. See the following Exhibit for the Mouse Family Tree.

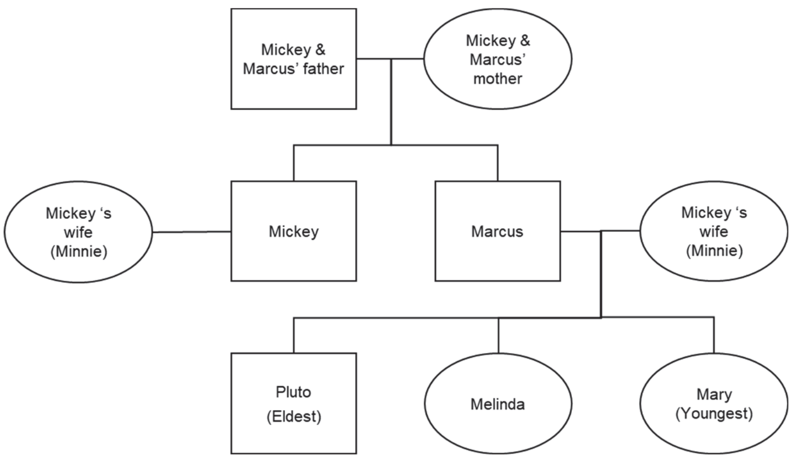

Figure 10 – Exhibit 4.1 Mouse Family Tree

Mickey had no children and Marcus had three children, the first born was his son, Pluto, and two daughters, Melinda and Mary (the youngest). Mickey had a close relationship with Pluto and treated him like a son. Unfortunately, Pluto also exhibited Mickey's abrasive and difficult side.

Mickey, Marcus and Marcus' wife all pushed very hard for Pluto to have a job in Disney Cheese Company. They wanted a male to join the firm, and the other children of Marcus, all girls, were not considered.

Pluto went straight from Sydney University into the Disney Cheese company. Meanwhile the daughters after university were busy with family and various other occupations. Mary, Marcus's youngest child, was very interested in cheese and even did some hobby work on it. In relation to business matters Mickey and Marcus took no notice of his daughters, but only the son.

After many years in the business it became clear that Pluto, although intelligent, lacked common business sense, known as “street smarts”, and worse he had poor “people skills”. Employees, customers, suppliers all tried to avoid Pluto. Despite Mickey, Marcus and Marcus’s wife knowing this, Pluto was continually promoted and ultimately became second in charge and was heir to the family business.

Marcus died and Mickey inherited the business through a buy-sell agreement. This is where Marcus’s wife, the new owner of the shares according to Marcus’ will, was obligated to transfer these shares to Mickey in return for a sum of money paid from the company’s key person insurance policy.

In the meantime, Mary had finished bringing up her children and saw an opportunity to run the Disney cheese outlet shop. She shone in this role and the outlet grew and became very profitable.

It became increasingly clear that the Disney Cheese company was not going to survive if Pluto took complete control. Pluto would severely berate any staff who he felt were not being fully productive. Staff would be apprehensive in dealing with Pluto and were scared to raise problems or errors with him, so to the detriment of the business problems went un-reported or underreported. Pluto kept people waiting for hours in queues and lectured people incessantly.

An example of Pluto’s deficient skills was when he demanded an immediate 10% discount from a key milk supplier and threatened to no longer use the supplier if an immediate agreement was not forthcoming. The supplier, however, immediately walked out stating that she refused to deal with Disney’s extortionate behaviour. Pluto then realised that he had just lost a vital supplier and, in the carpark, begged the supplier to remain one of their key suppliers. The supplier very reluctantly agreed to do this, but Disney had to pay an extra 10% to keep the supplier supplying Disney.

As time passed the overall culture became even more toxic. Mickey wanted to do something about it in order to save the business but his wife, Minnie refused to acknowledge the issue and blamed Mickey on not being a supportive enough uncle and employer.

Mickey eventually took the very difficult decision to terminate Pluto from the company, and this was a source of friction within the family for many years

Figure 11 - Families often employ family members regardless of whether they can contribute to the family business.

Mary was brought onto the board and the company went from strength to strength. Mickey acknowledged that he should have let Pluto go far earlier and brought Mary in earlier as well.

After a number of years Mickey retired at 94, and now Mary was running the business with assistance from non-family and family members. Mickey had spoken about succession many times in the preceding 30 years but could not bring himself to leave the cut and thrust of business which got him out of bed in the morning. In his last 20 years at Disney his judgement was poor, and the business suffered.

Mary now wishes to retire. She had 4 children, but only one, Miles, has shown any interest in the cheese business. Miles has a good job in digital marketing, has good business sense and good people skills. On the other hand, he is a little impetuous, speaks too much trendy marketing jargon and spends money too easily. Mary tried to sell the business without success and the business needs substantial restructuring to recover profitability lost in recent years as a result of many industry changes.

After some discussion, and with some apprehension, Mary and the Board sat down with Miles and explained the costs/benefits of him coming in and the extent of restructuring required. Miles is still keen and wants to continue the family relationship with the company.

4.3.2 Case Example 2 - The Fritz Brothers

Fred and Carl were brothers that went into business together manufacturing pyjamas in a Perth suburb. The business never grew particularly large, but it returned enough profit over the years to support the two brothers and their families, and even provided a couple of small investments for the families.

Fred was the salesman and focused on the sales and marketing. Carl was the production manager and ran the factory well. Together their complementary skills enabled them to run the business efficiently.

After 40 years in the business, the economic conditions were clear that they would have to close manufacturing and import from cheaper overseas sources or close the business altogether. They decided to close the business, sell off the assets and equally split up the proceeds of the liquidation.

Fred's and Carl's children were not in the business, not interested in it and were not particularly close or friendly with each other. Each family suspected the other family of taking more out of the business. Carl's solicitor son was young and aggressive and saw an opportunity to use his legal skills to gain an advantage. For example, he argued for an extra allowance for the extra time his father put into running the factory and less time he took for holidays. He argued that his father should have more superannuation based on a complex earnings calculation. The other side reacted to this and put up opposite arguments. This, and the other demands, escalated to the point that the two families became openly hostile and after additional legal costs they finally equally split the proceeds of the liquidation.

The two families never spoke to each other again.

4.4 Questions

1. What are the main areas in these two Case Examples that are complicated by the effect of family relationships on the business?
2. What could have assisted Mickey and the Fritz brothers to mitigate the family problems?
3. Should Disney Cheese employ Miles?
4. Evaluate these two businesses from a family business planning view

4.5 Suggested responses to Questions

Question 1.

What are the main areas in these two Case Examples that are complicated by the effect of family relationships on the business?

4.5.1 Suggested answer

All businesses have issues, with some being complicated by the family aspect which revolves around the interaction of the family, ownership and business roles and emerge in the business as problems in the overlapping areas of succession, governance and professionalisation. A non-family business may also have these problems, but they are exacerbated in a family business, and include:

- *Succession* (who is to take over and when). Both Case Examples indicate that succession is a key problem. The issues include:
    - The Mickey Mouse family: Mickey should have left many years before to let the next generation take over. It is not that he did not have someone to take over – Pluto was waiting anxiously to take over. By staying in his declining years, he did a big disservice to the business.
    - Fritz Brothers: Management succession was not an issue, but financial succession clearly was.
- *Governance* (how decisions are made, and the business is run). Issues include:
    - The Mickey Mouse family: Decision-making was concentrated in one person, who could not / would not see (and respond to) the problems occurring in the running of the business.
    - Fritz Brothers: The lack of a formalised agreement on how the business would be handled in the case of a close down that ultimately triggered a dispute.
- *Professionalisation* (how to operate the business in a businesslike manner) which includes nepotism, which is the hiring of relatives or friends regardless of their capabilities. The two Case Examples are littered with issues that would not have been tolerated in businesses run by non-related

people, especially those larger than a micro or very small business. These issues include:

- The Mickey Mouse family: For example, staff who are not capable should not be retained. This includes Pluto, but also Mickey as he got older.
- Fritz Brothers: Unfortunately, there was a highly dramatic and unnecessary dispute as to how the half share was to be calculated. This should have been anticipated and agreed upon well in advance of liquidation.

Question 2.

What could have assisted Mickey and the Fritz brothers to mitigate the family problems?

4.5.2 Suggested answer

- The key family members in both Case Examples could have attempted to distance themselves from the potential areas of dispute by having an independent external party (for example a trusted external accountant, or several people working as an "advisory board") provide independent and impartial advice. There are a number of consultants who specialise in family business issues, and one or more of these advisers could have been of assistance.
- While it may have been too late for Mickey once the die was cast in incorrectly employing Pluto, independent professionals could also have assisted in the Case Example of the Fritz brothers.
- In family business there is the consultant who is called the "disposable consultant". This person is solely hired to investigate, write a report, give the bad news, fire staff and then quickly leave. This leaves family managers with the appearance of clean hands. However, note that staff often see thorough this tactic and still blame the employer.

Question 3.

Should Disney Cheese employ Miles?

4.5.3 Suggested answer

- Mary has taken note of the mistakes made by Micky and tried to manage the situation carefully. Better practice is that senior management needs to ensure that any family member seeking to join the business must add value, that is, have most of the required abilities to be successful.
- She seems to have explored other options including the sale of the business and winding up the business.
- Considering all the issues, and if all parties fully understand the risks and put together an agreed strategy plan for the future, then this plan would seem to be a reasonable course of action.

Question 4.

Evaluate these two businesses from a family business planning view.

4.5.4 Suggested answer

- In the Disney Cheese company:
    - Mickey and the family members worked with Pluto much longer than many non-family businesses would have been prepared to do so. The Disney company had been successful for many years with family in the business, so the feeling was it was worth persevering with Pluto.
    - However, the family should not have simply assumed that all family members will have the necessary skills or can be trained and assisted to learn these skills. Sometimes a frank employee evaluation is required, and some difficult decisions may need to be made for everyone's ultimate benefit. This is where a skilled family business adviser can be useful – they can assess the family member's capabilities, and if necessary, deliver the bad news, fire the family member and then quickly leave. As already discussed, the family can then blame the recommendation to fire the family member on the consultant.
    - It could be argued that there is no guarantee that a non-family member would have been any more successful than Pluto given the role of working with Mickey who can be difficult, but one could argue about the length of time Pluto was retained.
    - Perhaps no one could have taken over from Mickey successfully until he retired. He stayed at least 20 years too long, but he just would not leave - to the detriment of the business. A strategic weakness is that he did not have a capable understudy. The whole succession process was handled very badly.
- In the case of Fritz Brothers:
    - This is a good example of the benefits of a family business – trust, cooperation and efficient use of skills. This is an example of a family business where

the "positive factors are magnified", but the Disney Case Example study is an example of where the "negative factors are also magnified".

- The family business worked well for many years – until the end.
- It was the lack of a formalised agreement on how the business would be handled in the Case Example of a close down that ultimately triggered a dispute.
- Having an agreement and / or using an external consultant or advisory board, may have saved the families from this dispute.

4.6 Postscript

We have now seen the practical reality of what was said in the quotation at the beginning of this Case: "Leading a family business can be one of the most complex jobs imaginable." This is because we need not only run the business, but we need to do it with the intrusion of family dynamics, with often the two colliding. In order to run a family business successfully it is thus important to know which of the three roles (family member, owner and employee) a person fits into as this will affect how they will react in a given situation. A few people, for example, the founder or a senior family member, may hold all three roles. Other aspects that always must be kept in mind in a family business are the succession, governance and professionalisation challenges. These challenges are not unique to family business but are often more pronounced than with non-family business.

Notes

Part 2 – Operating the Business

Figure 12 - Operating the Business

This Part covers the following Case Studies...

5. Administration
6. Planning
7. Procurement I - Managing Contract Risk
8. Procurement II – Make or Buy?
9. Procurement III – Unauthorised Variations
10. Intellectual Property I - Trademarks
11. Intellectual Property II - Copyright and Licencing
12. Commercial Disputes
13. Importing and Exporting

Notes

Chapter 5

Case Study 5 – Administration

Drive your business or it will drive thee.

Benjamin Franklin (1706-1790)

5.1 Brief Overview

This case study discusses the very relevant issues of "working on our business", rather than just "working in our business". We will consider two Case Examples which highlight good administration, an aspect of business that is generally undervalued. Many business entrepreneurs consider administration to be a "necessary evil" rather than actively extracting the potential added value that good administration can provide. Poor administration is often a symptom of some fundamental weaknesses in the business, and these weaknesses often result in loss of income, additional costs and reducing the effectiveness of a business' checks and balances. The lack of effectiveness of checks and balances opens the business up for potential fraud. An analysis of the two below Case Examples indicates that without the installation, implementation, monitoring and evaluation of systems, a business will find it hard to "work on their business", which includes the reduction or avoidance of fraud which will also be discussed in the Case Examples, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

5.2 Background to the Case Study

Business is simply "a process of identifying a problem and finding a way to solve it that benefits both parties". Managers in business need to simultaneously focus on two key things: working in the business and working on the business.

The first is working **in** the business. This is where you provide your goods and / or services. Examples include processing timber, selling fish, drilling teeth, building houses etc. To do this successfully you need the necessary capabilities (knowledge, skills and attitudes) with the focus being on employees, customers and the business. Employees are often the forgotten part of this trilogy but are necessary as they are needed to operate the organisation optimally, and if the employees are not looked after they then will not look after the customers and the business.

The second is working **on** the business, the focus of this case study. This is running the business in a proper businesslike manner which requires good "administration" which includes strategic planning, marketing, operations, finance, law etc. Remember the quotation earlier in the book by Maurice Lubansky: "Be right first and wonderful second".

Note that once the business loses its ability to run efficiently the ultimate result often is business failure.

5.3 The case study Facts

5.3.1 Case Example 1 – the successful timber processing plant

Rodney Dangerfield ran a successful timber processing plant in Melbourne. He took pride in providing a good product and employed skilled tradespeople.

Rodney always had a high respect for good craftsmanship. However, he had little time for administration and couldn't understand why the office bookkeeper, Heather, took so long to do the accounts, process pays, process invoices, debtors, creditors etc and believed this administration was a simple job.

Rodney also did not make it easy for Heather and often did not provide her with the required information. Heather would prioritise her work, often before doing Rodney's requests. Rodney's lack of appreciation for Heather's work caused Heather to lose motivation and she finally left the company. A new young person, Lisa was employed. The external accountant, Peter, had doubts about Lisa's skill level, but was prepared to assist and train her.

A couple of months went by and despite spending time with Lisa, Peter was unable to obtain any meaningful reports; the bank reconciliation had not been updated for about two months and information entered seemed misallocated and disorganised.

Peter told Rodney he was very concerned. Rodney was unconcerned and said he had never had a better office assistant than Lisa. Lisa would schedule and timetable Rodney's jobs promptly and would drop everything as soon as Rodney asked for anything.

Another couple of months went by and it was getting to the Christmas break time and still no progress had been made with the lack of bank reconciliations and the financial records in general. Peter was getting very worried.

As a personal favour to Peter, Heather the former bookkeeper, offered to assist Peter over the Christmas break so that together they would work on the accounts.

Together they reviewed the processes and noted many discrepancies. The Bank reconciliation was one of the first areas reviewed and they discovered that many cheques were presented but were not entered into the system, and there was no record of what they were for. They immediately went to the bank to request the cheques, which were made out to unknown people, including Lisa. The cheque signatures were clearly forged. The loss totalled about $100,000. As the police lack resources, they will normally not investigate a fraud allegation unless it is a high-profile case or most of the work is done for them. Peter presented the police with the details of the fraudulent transactions in a user-friendly way and after an investigation Lisa was charged. Luckily the Bank repaid Rodney the money for two reasons. The first is that it did not check the cheque signatures, being a breach of the contract with its customer, and the second is that the bank was negligent, in that it breached its duty of care to its customer when it did not check the signatures.

While Lisa was awaiting her court appointment, she went to work for Company X and this time she had access to the online bank account and fraudulently transferred about $500,000 to her associated parties. In contrast to cheques the Banks will not hold themselves responsible if someone else in the office fraudulently obtains and uses the password with electronic transactions. Thus, the only recourse may be insurance cover, if the company has fraud cover.

In relation to Company X, one may question their administration processes on checking and verifying resumes and references. Poor administration probably cost this second company a large amount of money. This could have resulted in one or more directors losing their homes or even the collapse of the business.

The inescapable conclusion from this Case Example is that without the installation, implementation, monitoring and evaluation of well-thought out systems, a business will find it hard to "work on their business", which includes the reduction or avoidance of fraud.

5.3.2 Case Example 2 – the successful seafood business

Ann Chovie ran "Prawnbrain", the largest seafood business in the country. It was a very profitable business because she was skilled at making profitable deals and she consciously invested resources into obtaining deals, such as those with supermarkets, food manufacturers etc.

Ann had little interest in business administration and while happy to invest in plant and equipment, she neglected to invest in quality financial software, financial training or on hiring skilled administrators/accountants, or working on business systems.

As a result, the business was poorly administered, and its finance and accounting staff were not motivated to work hard. This resulted in incorrect and late invoicing to customers, double paying of suppliers, inventory variances unreported and payroll errors.

Figure 13 - Don't be like these business owners. They cannot afford fishing equipment because they did not run their seafood business in a businesslike manner.

Ann did recognise, however, that due to the lack of good administration she was never sure that the late financial statements and reports were accurate and suspected that this poor administration may be affecting profits and thus the value of her business.

One day she was speaking to her older brother, John, who had worked his whole life elsewhere in an operating capacity and had just retired. After a brief review of the Prawnbrain business John stated that there clearly were areas requiring improvement and Ann invited him to join the firm in a short-term operational role until things were sorted out. This suited John as he wanted to retire permanently.

John's investigations indicated that there was considerable leakage of profit for several reasons, all of which one way or the other related to poor administration practices. They included:

- staff and managers were not working hard nor were there any incentives of any kind for them to work hard
- there were frequent requests for pay rises, but they were not accompanied by any tangible profit or productivity increases; and
- the financial accounts were unreliable and not timely.

John then introduced the following changes:

- an experienced Certified Practising Accountant (CPA) was hired to run the finance section
- more user-friendly, and relevant, software was installed
- all relevant staff were trained in how to use the new software
- new accounting staff were hired, all have relevant experience
- responsibility centres were created. This is where the business was broken up into clear divisions each headed by a responsible manager. If the responsibility was for the division's profit it was called a "profit centre", and if only for expenses it was called a "cost centre"
- budgets are now easier to prepare due to the above improvements
- salary increases or bonuses are only paid to staff upon meeting or exceeding jointly agreed budgets.

Today, six months later, the organisation is becoming the model of a good business. While improvements are still required in several areas, the business is looking far more professionally run and monthly gross and net profits are increasing and the accounts are timelier and more reliable.

The inescapable conclusion from this, and the first, Case Example is that without the installation, implementation, monitoring and evaluation of systems, a business will find it hard to "work on their business", which includes profit improvement, through increasing sales revenue, reducing expenses and the reduction or avoidance of fraud.

5.4 Questions

1. Describe the similarities and differences between the two organisations.
2. Can you think of other effects from good Administration?
3. Can you think of other effects from poor Administration?
4. What could have been done to ensure the fraud in the first Case Example did not happen in the first place?

5.5 Suggested responses to Questions

Question 1.

Describe the similarities and differences between the two organisations.

5.5.1 Suggested response:

Both Case Examples are similar in that they involve the owner/CEO of the business having their own preferences impact on their business. We saw that both willingly invested time and money on the operational side, and how both had a disinterest in administration.

Commentary on this lack focus:

- *The first Case Example (Rodney Dangerfield and his timber processing plant)*: The disinterest is stronger in this first Case Example which ended up resulting in a very costly fraud, and even if the money was recovered, there would be an impact on time and resources in dealing with it and then having someone come in to repair the damage which probably may or may not be fully recoverable by insurance if it is electronic transaction fraud (as occurred in Company X).
- *In the second Case Example (Anne Chovie and her seafood business)*: here the disinterest was not quite so strong as there was some belated acknowledgement that it needed correction and the opportunity of having another trusted person come in was the timely avenue for change. It is questionable whether there would have been such a happy ending had there been no such sibling willing and able to assist. This Case Example shows how fate can significantly affect a business, and consequently an entrepreneur's life, and those around them.

Question 2.

Can you think of other effects from good administration?

5.5.2 Suggested response:

The effects of good administration include:

- *Motivates people* to:
  - be proactive in assisting the company
  - come up with new ideas (innovation)
  - stay longer (see Heather in Case Example 1) resulting in a more stable company
  - assist and train others (lucky Heather was prepared to do so in Case Example 1)
  - help with change
  - be good advocates for the company
  - relate better with external parties, for example customers, suppliers, banks, insurance agencies, government offices.
- *Smoother operations*: Facilitates coordination and control of various office functions
- *Setting up a system of targets*: As part of their job descriptions staff need to achieve defined targets. This requires training of employees such as salespeople to understand their targets, how to achieve them and how achieving them will affect their commissions and bonuses
- *Better use of resources*: good administration helps in more optimal usage of assets (money, people, information, capital assets etc)
- *Minimisation of costs*: productive administration normally results in decreased office expenses
- *Smooth workflow*: good administration results in more proficient and smoother stream of work
- *Efficiency*: Helps in maintaining office efficiency
- *Fraud reduction*: Helps to avoid, or at least reduce, fraud, dishonest, and unethical conduct.

Question 3.

Can you think of other effects from poor Administration?

5.5.3 Suggested response:

The effects of poor administration include:

- *Low company morale*: a manager, for example, who does not relate to staff or shows favouritism can cause a reduction in company morale. This can also result in high turnover of employees and increase the cost of recruitment and training.
- *Reduced employee productivity*: Undefined performance expectations can lead to reduced revenues as the employee does not have a target to aim at; here the organisation is satisfied with any reasonable performance, rather than one that is geared to push the organisation to achieve its stated goals.
- *Decrease in profits*: poor administration can lead to a decrease in profits in two ways (1) by not supervising personnel properly, and (2) not balancing the company budget.
- *Loss of employees*: when employees are faced with poor management, they may spend their time looking for other employment and not focusing on reaching the goals of the organisation. This can also result in high turnover of employees and the high cost of recruitment and training.
- *Ultimate business failure*: once the business loses its ability to run efficiently the ultimate result is business failure.
- *Poor customer service*: poor administration leads to poor customer service due to issues including poor response to customer problems, incorrect invoices, invoices not sent in a timely manner, quotations are incorrect, or information requests not processed.

Question 4.

What could have been done to ensure the fraud in the first Case Example did not happen in the first place?

5.5.4 Suggested response:

One of the many definitions of fraud is by the Commonwealth of Australia: "Dishonestly obtaining a benefit by deception or other means", and could include theft of money, taking (and keeping) bribes from suppliers trying to get work. Most fraud occurs by persons on the inside of the business, that is, by employees and contractors, rather than externally through shoplifting and break and entry theft.

Fraud can often be detected by simple observation of events, behaviour of personnel (in and out of work) and an analysis of management accounts can often detect it. If an unusual transaction is found this should be reported to senior management. The investigator needs only to ask a few simple questions, and the answers may indicate that a closer inspection is warranted:

- Does the company use the good or service?
- Has there been a segregation of duties?
- Is the variance explainable by another reason?
- Is the volume of purchases consistent with the projected volume of purchases?
- Why does a certain employee have an unduly lavish lifestyle and / or is acting "suspiciously"?

Frauds are rarely detected by external auditors, but are mainly detected through internal audit, vigilant staff members and carelessness by the defrauding person(s). Large organisations often also have internal auditors; however, this is not the situation with smaller organisations resulting in a greater risk of fraud occurring. Three weeks into the first job of one of the authors he had to suddenly take over from his manager when an internal auditor discovered the manager had been defrauding the company.

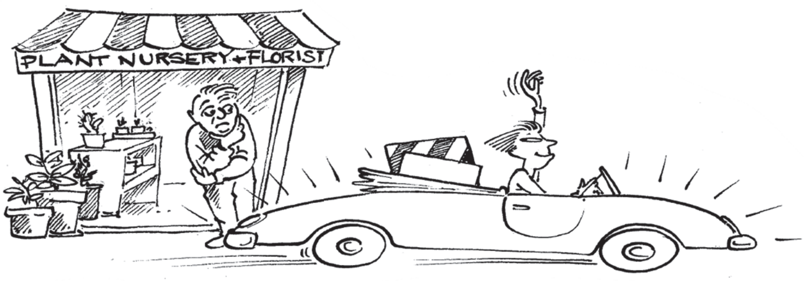

Figure 14 - An employee fraud danger sign is any unduly lavish employee lifestyle. Remember that you may be subsidising their lifestyle!

Fraud can be reduced by knowing that that Fraud = Opportunity + Motivation + Incentive:

- *Opportunity*: Trusted and senior employees have many opportunities to defraud the company. Thus, they especially must follow well designed internal control systems.
- *Motivation*: Not everyone is motivated to take advantage of opportunities, however as time passes the world is becoming more money-orientated, and issues like bankruptcy, divorce, and addictions, especially gambling, provide motivation, often at short notice. Thus, when fraud signs appear, they need to be investigated.
- *Incentive*: However, when you also provide an incentive in the form of high potential gains and a low risk of detection the temptation may be too much to resist.

Other things that can be done to reduce or avoid fraud include taking the following steps:

- Identify factors in your organisation that permit fraud or make it easier for fraud to occur
- Create systems that reduce the possibility of fraud
- Develop and implement effective management and audit systems
- Identify and describe fraudulent practices

- Establish the right culture by informing staff as far as possible of what is acceptable behaviour and what is not.
- Use education and training programs to motivate people to reduce the potential for fraud to take place
- Work with the auditors, especially the internal auditors.

Without the installation, implementation, monitoring and evaluation of systems, a business will find it hard to reduce or avoid fraud.

5.6 Postscript

This case study discussed the very relevant issues of "working on your business" (where the focus is running your business in a business-like manner) rather than just "working in your business" (where the focus is on providing your goods and / or services). The first inescapable conclusion from this case study is that one needs to work both on and in the business. The second inescapable conclusion is that without the installation, implementation, monitoring and evaluation of systems, an organisation will find it hard to work on their business. Successfully working on your business normally results in improving profit, which occurs through one or more of increasing sales revenue, reducing expenses or the reduction or avoidance of fraud.

Notes

Chapter

6

Case Study 6 - Planning

A business plan is a plan, as opposed to the fumbling guesswork that informs most decisions

A Devil's Dictionary of Business Jargon

6.1 Brief Overview

This case study focuses on strategic planning, where the business leaders prepare a strategic plan after the overall strategy has been agreed upon. The plan is then used as the key road map during the implementation of the agreed strategy. In this case study we will not be analysing something that went wrong, but rather we will discuss an example of how the plan assisted the achievement of a defined strategy. These and other issues will be discussed in the Case Examples below, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

6.2 Background to the case Study

6.2.1 Overview

Both business and strategic plans can be very similar and overlap. Business plans tend to be short term and focus on a few specific operational objectives, for example the analysis and financing of a takeover proposal whereas strategic plans are longer term and look at the "big picture" of a business. Business plans are usually externally driven in that they are prepared for reasons including finance applications, grant applications, to comply with bank requirements and various other business proposals. Most business plans are usually prepared to comply only with one of the above requirements and as a result there is often a less than full commitment to it, resulting in it "being left in the bottom drawer" never to see the light of day again. On the other hand, strategic plans are mainly used to implement a strategy developed by an organisation, that is, it is usually internally driven at the initiative of the business leaders, normally the directors, or other senior management.

6.2.2 Planning issues

Much has been written about business and strategic planning, but both are a plan to express how the organisation is to operate in the future. Without a plan, organisations (and indeed any individuals in both their work and private capacities) would be lacking a sense of direction or destination. The plan should be reviewed on a regular basis, and especially when a major event occurs that can affect the organisation, and this could include the death of the CEO, a fire destroying a major manufacturing plant, an important change in the economy or the signing of a prestigious new sales contract. Ensure that the plan is not too complex, otherwise it will again end up sitting in the bottom of the drawer, with the loss of a powerful business tool.

There are four key steps in the basic planning process (see the Exhibit below). These steps are for any organisation whether for profit, not for profit, government etc. The steps are: (1) Where is the business now? (2) Where do we want the business to go? (3) How do we get it there? and (4) Did it get there (and how are we going to keep it there)?

In the third step, "how are we going to get there", there are three interrelated sub-plans to consider, and each sub-plan should work together to achieve the overall plan's objective. They are the marketing, operations and finance sub-plans. In addition to measuring whether the plan got us there, is "are we getting there", which is the determination of the metrics needed to be used to ensure that the plan is on track during the following 2 to 3-year period.

The key benefits from planning include the setting of a direction and a reduction in the probability of nasty surprises occurring. The A Devil's Dictionary of Business Jargon has summarised it well when it defined a strategic plan as "a plan, as opposed to the fumbling guesswork that informs most decisions".

Figure 15 – Exhibit 6.1 A Summary of the Planning Process

Source: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

6.2.3 Succession and nepotism issues

In these Case Examples we will see how Myer, CEO of the Company, by staying on too long, nearly destroyed the company. This Case Example includes issues of "succession", that is when should a CEO, or very senior decision maker, retire and hand over leadership? Leadership tenure is a complex area, with many organisations opting to have a compulsory renewal process, as occurs in democratic political structures. An aspect of Board renewal is to foster consideration of age diversity, in order to ensure that not all Directors are of the same generation and mindset. Many Boards do not have a maximum period a Director may serve, although some specify a maximum of either three or four three-year terms., which totals nine to 12 years). Succession, and nepotism (which is the hiring of favoured relatives or friends irrespective of their knowledge or skills) issues will be discussed in Case Study 4 (Family Business).

6.2.4 Use and do not abuse your plan

Plans are often just created for a specific purpose, for example to get a bank loan, for merger approval etc, but then they are forgotten about. You should be kind to your plan and use it and not junk it.

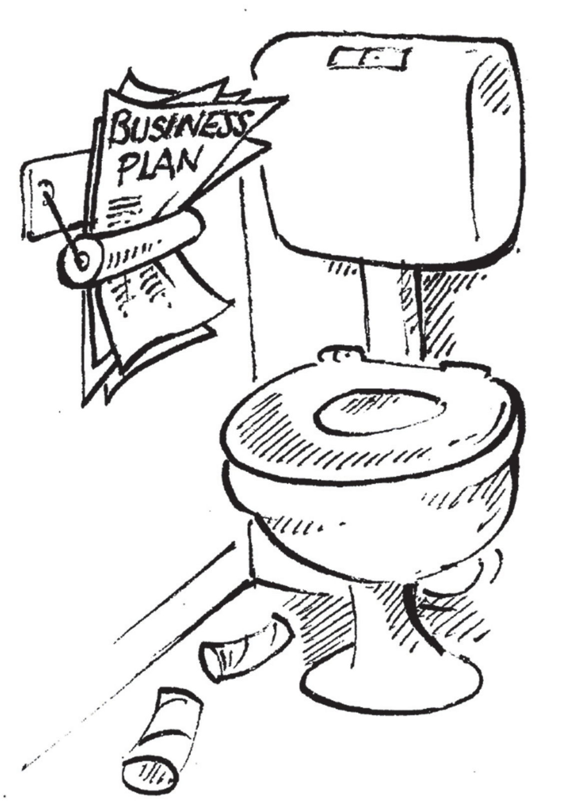

Figure 16 - Use and don't abuse your business plan!

6.2.5 A major planning disaster

See the Chicago parking meters debacle in Section 3.2.7 in Case Study 3 (Business Structure II – Capital Purchase Evaluation). Remember that a strategic plan is a plan, as opposed to the fumbling guesswork that informs most decisions.

6.2.6 Cash is vital

Nothing focuses your attention more that if you are losing money and are running out of cash. Lack of cash will focus you like a laser.

6.3 The case study Facts

Myer Lasky founded the company Curtains R Us in the 1950s with a few other friends and family. He was the driving force behind the company. He is now the Chief Executive Officer (CEO), and sole owner as he owns all the shares in the company.

Curtains R Us started as a manufacturing and wholesale company that sold to independent retailers and department stores around Australia. It initially did not retail. It had a long and successful history right through to the 1990s.

The company grew at a time when resources and manufacturing skills were in short supply, particularly in the decade after the end of the World War II. Myer was a very astute business person and knew how to employ good people, how to use contacts, how to get hold of limited supplies and was able network effectively. He built Curtains R Us into a large and successful business and established manufacturing operations in Melbourne and Sydney. Head office was in metropolitan Melbourne.

The Government was a very keen supporter of local manufacturing and provided several incentives including tariffs and quotas that assisted manufacturing companies, including Curtains R Us. However, over a period, the industry structure slowly changed. The improvement of the world economy after the initial post World War II period resulted in a number of changes including:

- there no longer being any short supply of materials
- more manufacturers came into the market
- Japan then China established their international manufacturing industries
- independent retailers started dwindling as vertically integrated chains started importing product and selling direct to consumers
- governments reduced protection levels and manufacturing support schemes.

Curtains R Us was traditionally a manufacturing and wholesaling company, but then expanded and moved into retailing as well. However, many of its stores were underperforming but they could not be closed as the stores were all needed to support the local Curtains R Us manufacturing plants which were producing more stock than was required. Myer wanted to retain his manufacturing operations, but this decision had unforeseen consequences in that it caused the cash position to significantly deteriorate over time due to the lack of sales causing stock holdings to grow substantially. Over time Myer's former impeccable commercial acumen began to fail him and staff found him even more difficult to deal with, which further exacerbated the demise.

With the passing of time Myer struggled even more to come to terms with the rapidly changing economic environment and the pace of other business methodology changes. The company started getting into serious financial and other difficulties, and these difficulties became so severe that it looked like the company would have to close so that Myer's personal assets were not lost.

Four very senior staff saw an opportunity to revitalise the company and offered to buy the company from Myer, who was then the CEO and sole owner of the company. Myer and the four ("The 4") struck an agreement that The 4 would take over the complete running of the company for three years and would pay Myer an agreed sum at the end of that period. Myer reluctantly agreed as there were very few options at this stage. Myer then bowed out and retired.

With this agreement The 4 owned the company almost equally and the Board consisted of Groucho (Managing Director), Harpo (who was a director and then became CEO - Chief Executive Officer after Myer retired), Chico (CFO - Chief Financial Officer) and Zeppo (General Administration Manager).

The 4 were experienced and worked well together and were supported by a capable senior management team comprising sales and marketing, merchandising, warehousing and distribution, and manufacturing. The 4 developed a strategy to turn around the company. The strategy consisted of:

- Closing local manufacturing and transferring it overseas under a strict quality framework
- Selling off excess stock to raise cash
- Closing poor performing stores to save cash
- Relocating head office to lower rent area to save cash
- Streamlining warehouse operations to save cash

- Cutting redundant staff or asking staff to move to part time when applicable to save cash.

This strategy was supported by a detailed plan with budgets and costs of the changes mapped over a 3-year period and each of the 4 were allocated specific tasks under this plan. As cash was in short supply it would be a tight plan, so it was agreed that all had to implement the plan carefully. It was mandated that each of the directors had to keep the plan on their desk and had to spend time on their part daily. Regular monthly meetings monitored progress against the plan milestones.

All directors worked diligently toward the common goal and had a range of areas for attention assigned to each of them, including specific tasks, including:

- Zeppo (General Administration Manager) oversaw dismantling a very large and complex warehouse racking system. He received a quotation from a local maintenance company that insisted on charging on a time basis which was likely to cost around $80,000 plus 10% Goods and Services Tax. Zeppo contacted a rural engineer who brought a team into dismantle and remove the system in exchange only for them taking it as scrap metal. The dismantlers agreed to provide extra time on the project if Curtains R Us would agree to donate a small amount of money and unused fabric stock to a project the engineer was working on in East Timor.
- Groucho (Managing Director) and Harpo (CEO) negotiated with the retail shop landlords and were able to close without penalty most of the poor performing stores.
- Groucho (Managing Director) and Chico (CFO) worked with a related overseas manufacturer to take over from local manufacturing, which was then closed.
- Chico and Zeppo managed the HR implications of redundancies and changes to staffing.

The above resulted in reduced manufacturing output and the disposal of most of the older stock, both of which brought in much needed cash.

By the end of the agreed three-year period the company had turned around significantly: it was functioning efficiently and there was enough cash generated to not only pay the relocation, staffing and other change costs, but also pay Myer for the purchase of his shares in the company as per their agreement.

This Case Example is a successful example of how a strategy was first created and then implemented with a written detailed supporting “action plan”. Other lessons learnt from this Case Example on strategy development and implementation is the clear allocation of responsibilities and accountabilities to The 4, also linked to clear metrics for each of The 4.

6.4 Questions

1. Did the Strategic plan succeed? Why?
2. What were the key risks in the preparation and implementation of the Strategic plan?
3. Could the Strategic plan have been better managed and how?

6.5 Suggested responses to Questions

Question 1:

Did the Strategic plan succeed? Why?

6.5.1 Suggested response:

- The test of a good plan is whether (1) it was actually used, as opposed to being left in the bottom drawer, and (2) it met the purpose for which it was prepared.
- One could argue that in this case study you can answer "yes" to both questions. We should note that the outcomes may have occurred without the plan. However, the fact that there was an agreed documented road map ensured a higher probability of success. Remember the Devil's Dictionary quotation at the beginning of this Case.

Question 2:

What were the key risks in the preparation and implementation of the Strategic plan?

6.5.2 Suggested response:

There are always both external and internal risks with any business or strategic plan:

- *External risks*: These risks could be general or industry-specific and include political, economic, socio-cultural, technology, legal, economic, infrastructure, demographic and other risks. An example in this case study would be if a favourable government change of manufacturing incentive policy resulting in the realisation that the strategy of closing manufacturing would not be correct.

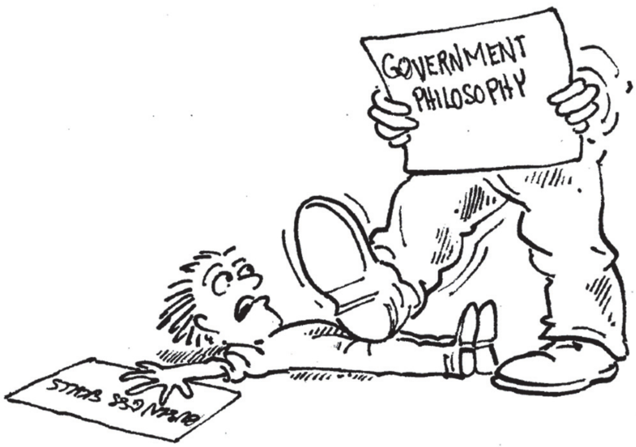

Figure 17 - Watch out for changes in Government policy as they may have an effect on your business!

- *Internal risks*: Perhaps the biggest risk was within the company, that is several of the changes required using up cash reserves in the short term with pay offs coming in the longer term. The required cash would come from the disposal of excess stock. It is important to note that the company was potentially vulnerable during this period.

Question 3:
Could the Strategic plan have been better managed and how?

6.5.3 Suggested response:

- From the Case Example facts we see that the following were all produced and implemented “in house” without outside assistance by the 4 Directors:(1) the agreement struck with Myer, (2) the future strategy and the strategic plan, including a detailed financial plan; (3) the implementation of the plan; and (4) the determination that the plan was successful. In summary, the above occurred without external assistance meaning that any external knowledge, skills, systems or experience that could have been utilised were not taken advantage of. While the plan was successful, the question is had The 4 used some type of external review process Curtains R Us may have reached an even better result and done so quicker or with less effort and risk. Perhaps with the networking and external contacts the organisation may have found a keen buyer of the company or some other benefits, including product store presentation or sales and marketing advice.
- The Strategic plan had some risks. These risks, including running out of cash, did not eventuate, however had they eventuated it would have been very helpful to have knowledgeable external advisors to assist. The analogy is not paying your house insurance and saving the money, and for most people this could well be a positive pay off, but of course who wants to take that risk?

6.6 Postscript

Much has been written about business and strategic planning, but both are a plan to show how the organisation is to operate in the future. Without a plan, organisations (and indeed any individuals in both their work and private capacities) would be without direction. This Case Example is a successful example of how a strategy was first created and implemented with a written detailed supporting "action plan". Other lessons learnt are the need for the clear allocation of responsibilities and accountabilities linked to clear metrics.

Figure 18 - Remember that a business plan is a plan, as opposed to the fumbling guesswork that informs most decisions.

Notes

Chapter

7

Case Study 7 – Procurement I - Managing Procurement Risk

Inspect what you expect

Anon

7.1 Brief Overview

When an organisation purchases goods and / or services there are many issues that it needs to be aware of (see below). In this case study we will focus on two key procurement matters: (a) the buyer needs to be specific with the agreed deliverables; and (b) the need to be aware of, and reduce, risk when changing contractors.

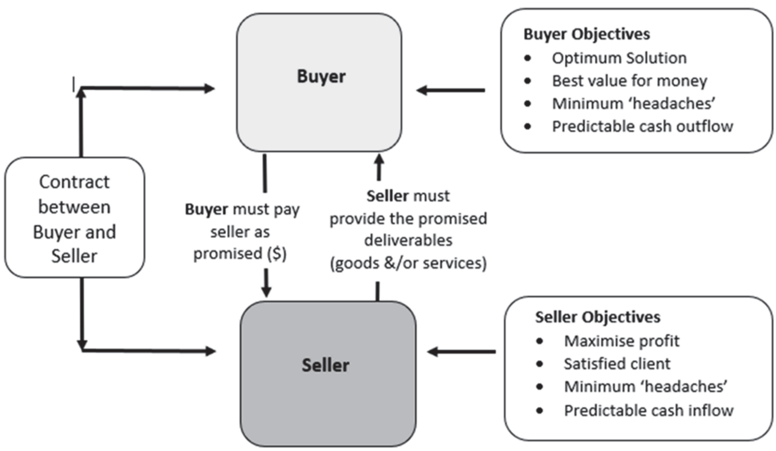

Figure 19 – Exhibit 7.1 A Summary of a Typical Contract

<u>Source</u>: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

As procurement is such an important area of business it will be covered in three parts, with this first Part considering managing procurement risk, the second being make or buy decisions and the final being unauthorised variations.

These and other issues will be discussed in the case examples, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

7.2 Background to the case Study

7.2.1 What is procurement?

Procurement is the act of purchasing goods and / or services to operate the organisation. Examples include, the purchase of staff uniforms, engaging a cleaning contractor to maintain the office, or an internet cabling company engaging subcontractors to install cabling to its customers etc.

Consider a matrix with risk on the vertical axis and cost on the horizontal (see the Exhibit, below). At the low risk / low cost matrix position is the non-essential, or "transactional" purchases and they include the purchase of office stationery, and non-critical software. At the high risk / high cost position are the essential or "strategic" purchases, and these could include critically important computers / software. Procurement in this latter category it is sometimes called "strategic sourcing" due to its importance to the organisation. Peter Kraljic, the creator of the Matrix below said that because of its importance a business would normally spend more resources (time, money etc) on strategic purchases than purchases from the other quadrants, especially the transactional quadrant.

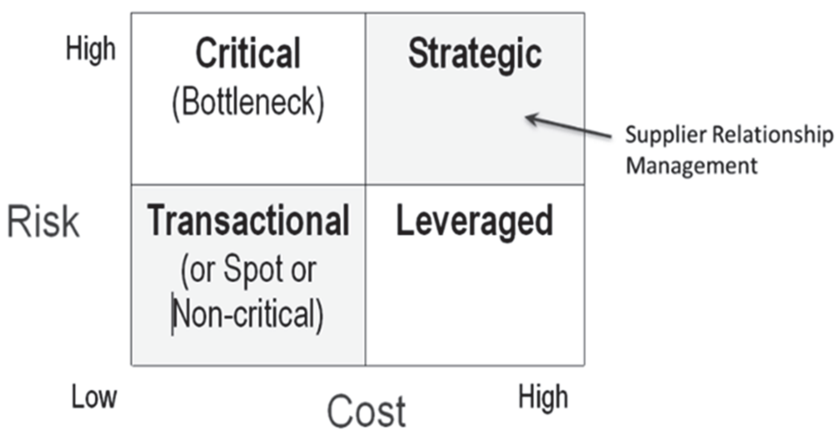

Figure 20 – Exhibit 7.2 The Kraljic Purchasing Classification Matrix

Source: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

Notes:

1. This matrix is called the Kraljic Purchasing Classification Matrix and was devised by Peter Kraljic in the early 1980s and is still used today.
2. The above matrix applies to procurement and not to sales.

7.2.2 Supplier Relationship Management (SRM)

The International Association for Contract and Commercial Management (*www.IACCM.com*) states that when both the buyer and supplier work together in the Strategic quadrant then both can benefit, and this is called Supplier Relationship Management (SRM). The IACCM define SRM as *the function that seeks to develop successful, collaborative relationships with key suppliers for the delivery of significant tangible business benefits for both parties*. Thus, a focus on successful collaborative relationships can result in significant tangible business benefits for both parties.

7.2.3 Some key end of contract clauses

All agreements should clearly state what the rights and obligations are for each party on termination to reduce potential problems or disputes. A common way of expressing this is "if possible, work out what the divorce settlement is before the marriage commences". Two typical examples are:

- *Work in progress*: When the contract finishes there is often an unclear question of what happens to part completed jobs or stock on hand. If the supplier has stock that is held specifically for the buyer, what are the respective rights or obligations of each party? For example, in corporate uniform contracts it is recommended for the supplier to have the right to sell the balance of stock to the purchaser. This is further discussed in Case Example 1, below.
- *The transition* (or "*disengagement*") clause (see Case Example 3, below):
  In contracts that are ongoing, such as facilities management, it is very helpful for the buyer to insert a "transition", or "disengagement", clause, or series of clauses to oblige the incumbent supplier at the end of their contract to assist its successor, preferably in a predetermined way. This is of great importance in highly

technical areas, such as IT facilities management services, where the clause obligates the outgoing supplier to share its site-specific knowledge with the incoming supplier. To make this clause work it is vital that handover clause(s) are predetermined and contain clear details as to what work needs to be done, as well as when, where, how it is to be done and for how much cost. Failure to do this may create serious risk for two reasons. The first is that the incoming supplier will not have a full picture of the organisation. The second reason is that it may leave the buyer in a weak bargaining position if transition assistance services are suddenly required from the former supplier which may demand an unreasonably high fee for assistance, if it will cooperate. Unless there is a clause obligating the outgoing vendor to cooperate then it may refuse to do so, to the potentially significant disadvantage of the buyer. Remember that the successor may be one or more external suppliers and/or the buyer may even bring all or part of the work back in-house.

As has been seen, in contracts dealing with highly technical subject matter the first few months after changeover are very risky because the new supplier will not have fully transitioned into the engagement and may make mistakes that could cause the buyer reputational or financial harm. If there is a possibility of this occurring the buyer could include say a "three-month" transition clause in the contract. In summary it can be something as follows:

- If the changeover date is 1 July then the parties could agree that a month before this, from 1 June, the new supplier can ask questions of the outgoing supplier and can do this for two months after the new supplier has commenced, that is until 31 August.
- The outgoing supplier will need to promptly answer all reasonable questions as to what would be relevant to the new supplier in providing the purchaser with agreed deliverables.
- The outgoing supplier is obligated to hand over an up to date site-specific library in the English language on or before one month before change over date, that is 1 June in our example. This is so

the new supplier can prepare for handover at the end of 30 June. Any updates by the departing contractor should be progressively handed over within a certain time of creation. Documents must be in the English language as contractors working overseas, or overseas contractors with a local presence, may write in another language.

- The buyer will pay the outgoing supplier for its assistance based on a schedule of rates that should be agreed in the original pre-commencement contract. Procurement contracts such as these, and indeed any such contracts, should always be in writing.

7.2.4 Be aware of procurement laws

There are many laws buyers need to be aware of. In Australia, this includes common law (law based on the English legal system which is made by court cases that sets precedents and includes the laws of contract and negligence) and legislation such as the Australian Consumer Law, Goods and Services Tax, intellectual property law, insurance law and modern slavery laws. Failure to be aware of these laws can be very costly from a financial and a reputational viewpoint.

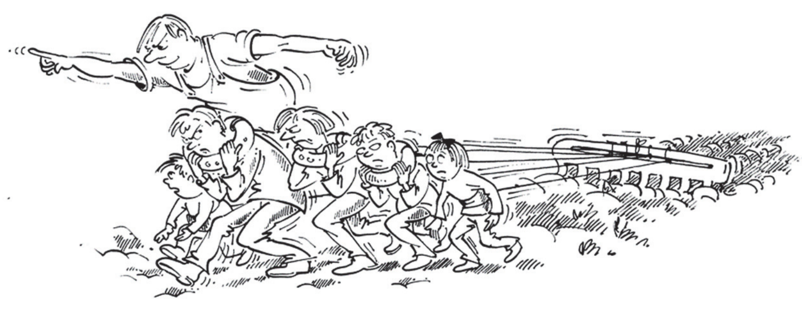

Figure 21 - Take care when buying that you do not to breach the Modern Slavery Laws that now apply to procurement in Australia.

7.3 The case study Facts

7.3.1 Case Example 1: Stock at termination

Corpco supplied corporate clothing to Gorgon, an electricity supplier owned by the State of Gorgonzola.

Corpco held considerable stock of corporate clothing with Gorgon's logo embroidered on the clothing. The contract stated that Gorgon had to purchase stock at the end of the contract for its own needs on a reasonable historic ordering basis. However, the clause should have been clearer and read something to the effect that at the end of the contract Gorgon is obliged to purchase the balance of stock held by the supplier.

The State of Gorgonzola suddenly decided to split Gorgon into seven companies and privatised them (that is, sold the companies to private industry). Each of the seven new companies now needed their uniforms with their own logos, but Gorgon no longer required any stock Gorgon stock still held by Corpco. This left Corpco holding unsalable Gorgon stock. As the clause was unclear Corpco took legal advice which indicated that the contract was indeed unclear and Corpco would need to negotiate a settlement.

The Corpco director in charge of the contract met with the Gorgon's Chief Financial Officer (CFO). The CFO recognised that some suppliers would suffer but said that it was unfortunate there were no funds available to assist. The Corpco director reported this to his Chief Executive Officer (CEO), who was very unhappy about this. Staff stated that they could hear the screaming from the next-door offices. The CEO stated that he intended to fight this decision in the courts and publicly.

The Corpco director went back to meet Gorgon's CFO and relayed his CEO's comments. During the negotiation the Corpco director overheard the Gorgon's legal advisor whisper to the Gorgon CFO "we can use the Terminated Contracts Fund". The Corpco director then insisted on full disclosure regarding this Fund, stating that if he did not obtain such disclosure, he would use the Freedom of Information laws, pursue the matter through the courts and where necessary raise the matter publicly. The Gorgon CFO then reluctantly advised the Corpco director that some money did exist for terminated contracts and that full payment would be made to Corpco for the balance of Gorgon stock held by the supplier.

7.3.2 Case Examples 2 and 3: Vague and Transition (Disengagement) clauses

Both of the following Case Examples relate to the same contract but are treated separately to emphasis separate key issues.

Case Example 2: Supply contract terms are too vague

A medium sized company (the purchaser) hired an IT facilities maintenance company (the supplier) on a three-year contract written by the supplier that included the following clause: “Support will be provided on a best efforts basis - KPIs and penalties will not apply”. The purchaser often complained that the supplier did not provide what the purchaser felt was “best efforts” but still had to pay the agreed fees. Despite this tension the purchaser renewed the contract several times.

Case Example 3: Reducing risk when changing suppliers by using a transition (disengagement) clause

We are following on from Case Example 2, where the purchaser is frustrated with the “best efforts” contract. The purchaser changed IT managers and the new manager noticed that the IT maintenance contract with the difficult “best efforts” supplier was about to expire and decided that it was time to change suppliers. The purchaser engaged a consultant to review the contract. The consultant reported that there was no transition clause to assist the transition from one supplier to another and saw this as a major risk in the early days of the changeover as any new supplier would not initially have site specific experience and knowledge.

The consultant advised that the IT manager needed to determine whether the incumbent would assist in any transition to a new supplier. In an informal off the record discussion with the supplier it became clear that the supplier was not going to assist the purchaser in any transition as the supplier would be very annoyed to lose such a lucrative contract.

This refusal greatly worried the IT manager as this introduced two important risks. The first one was the risk of substandard performance by the new supplier early in the transition, and second is that any lack of IT productivity would hit his salary bonus.

The consultant engaged to review the contract suggested to the buyer that the supplier be given a six-month extension to the contract in return for the supplier agreeing to use the supplier's contract. This contract included the transition clause (the "three-month" clause described in the Background to the Case Study section). The supplier agreed to this.

In the next six months the buyer found several suppliers who were very keen and wanted the work. With this knowledge, the buyer did not extend the contract at the end of the six months, introduced a new supplier and threated to legally enforce the transition clause if the outgoing supplier failed to honour the clear and carefully worded clause. The outgoing supplier did honour its obligations and greatly assisted with the transition to the new supplier with the provision of a site-specific library (written in English) as well as occasional advice as and when required.

After some minor initial problems, the new suppliers performed far better than the outgoing supplier, and all went well. The transition clause was a major reason why the move from one supplier to another was relatively successful.

7.4 Questions

1. How could the problem in Case Example 1 have been prevented?
2. Why did Case Example 2 not go well?
3. Is the Case Example 2 “best efforts” clause ever a valid clause to use?
4. Why did Case Example 3 go well?

7.5 Suggested responses to Questions

Question 1:

How could the problem in Case Example 1 have been prevented?

7.5.1 Suggested answer

- It is hard to anticipate every possible problem that can arise, however out of prudence we need to consider and include possible *key high likelihood and consequence impact* divorce clauses "before the marriage commences". Due to competitive forces the responsibilities for uniform stock have over the years shifted from buyer to supplier.
- In this Case Example a clear "catch all" clause requiring the purchaser to buy the balance of stock in the event of a wind up, liquidation or restructure should have been included.
- It is interesting that after a little well-targeted pushing by the supplier it obtained money set aside by the purchaser to cover restructuring.
- In realty, contracts should be fluid documents in that if it is determined that the current version needs to be improved then the next version should include the improvement. This should be done in an organised way, and normally occurs as part of the organisation's knowledge management process. A part of this process is version control to ensure that the latest fully approved version is always used when drafting a new contract. Another part is the requirement that when writing a contract one should always go to the original version on file, as to reuse one that has been used for a particular contract may be risky as the person working on the prior version may have deleted key clauses that you might need to use.
- A further risk reduction strategy is to have an experienced senior staff member review the legal and commercial parts of the contract for any *obvious* errors. A number of reviewers may be necessary, as a reviewer should only review areas in which they may be experienced, such as the legal part, the technical part, the financial part etc.

- By using the above processes, which are not very difficult to implement, the possibility of errors occurring, or reoccurring, can be greatly reduced. The practical result is the reduction in the likelihood and / or consequence of financial and / or reputational damage. This result can be of tremendous benefit to the organisation.

Question 2:

Why did Case Example 2 not go well?

7.5.2 Suggested answer

There are several factors that caused the problem including:

- The purchaser continued to complain of below standard work but did not do anything about it, continued to pay the agreed fees and renew the contract.
- The contract's quality standard was unspecific and thus would be hard to enforce.
- In law the contract may be seen to be "void for uncertainty". That is, the deliverables are too uncertain for the judge to determine what the parties agreed to, and thus the judge could find that there is no agreement.
- By letting such a contract be signed at all, and by allowing it to be repeatedly renewed, shows that the capabilities of both the organisation's procurement processes and people were lacking.
- With the above in mind Case Example 2 is a good example to show that to be in control the purchaser should (if possible) use its own contract when selling, which is sensible as it is the purchaser who is paying for the goods/services. Powerful and /or large suppliers such as Microsoft, Google etc would rarely agree to do this.
- The other deficiency in this contract, which was described in Case Example 3, is that the supplier's contract put the buyer in an even more vulnerable position as the contract unsurprisingly contained no hand-over (that is, a transition) clause. This will be considered in Question 4, below.

Question 3:

Is the Case Example 2 “best efforts” clause ever a valid clause to use?

7.5.3 Suggested answer

- In Case Example 2 the parties used the supplier’s contract which included the following clause: “Support will be provided on a best efforts basis - KPIs and penalties will not apply”.
- “Best efforts”, “best endeavours”, “reasonable efforts”, and “reasonable endeavours” are commonly used, and perhaps overused, in contracts.
- As can be seen these are vague terms and reliance on them could cause legal problems. Thus, they should only ever be used in addition to clearly defined deliverables, including Service Level Agreements (SLAs) and Key Performance Indicators (KPIs).
- According to the 1984 High Court of Australia case *Hospital Products Ltd v United States Surgical Corporation* [1984] HCA 64 “best endeavours” and “reasonable endeavours” impose similar obligations (that is, mean the same thing), where one must do what is reasonable in the circumstances to achieve the contractual object but no more.
- In Case Example 2 the “best efforts” words will be interpreted to relate to specified deliverables, such as the delivery of IT services.

Question 4:

Why did Case Example 3 go well?

7.5.4 Suggested answer

It went well because the buyer's IT manager was able to:

- with advice from the consultant, negotiate a position in which the supplier agreed to sign the buyer's contract with an appropriate transition clause.
- find alternative suppliers who were happy to replace the poor performing incumbent.
- arrange for the incumbent to cooperate with the new supplier.
- obtain the legal right to pursue the outgoing supplier if it did not honour its contractual transitional obligations.

7.6 Postscript

Procurement staff (being those who work on the buy-side contract prior to signature) and contract management staff (being those who work on the buy or sell side contract after signature) need to understand that contracting is all about pro-actively identifying, assessing and mitigating risk. All commercial contracts, whether procurement or sales contracts, should always be in writing. Furthermore, as much risk as possible should be eliminated before signature, because after the contract has been signed a supplier will not do anything extra without payment.

Notes

Chapter

8

Case Study 8 – Procurement II - Make or Buy?

The OECD's findings showed that companies' boards often played only a very limited role in risk management and that risk management standards were often set at too high a level, with outsourcing and supplier-related risk a key but much overlooked risk.

What Pierre Poret (said at an OECD conference on 12 June 2014)

8.1 Brief Overview

As procurement is such an important area of business it will be covered in three parts, with this second part considering strategic make or buy decisions. The first covered managing procurement risk and the final part will cover unauthorised variations.

We will consider the issues regarding the major make (that is, "insource") or buy (that is, "outsource") decision. In relation to "making" manufacturers face many dynamic challenges (or risks) both externally, which include government policy on tariff rates, quotas etc, and internally, which include the cost of keeping plant and machinery up to date and variation in production levels. In order to survive in a competitive world, manufacturers must continually analyse their operations.

The organisation needs to review its options if any of the above risks start impacting negatively, and decisions will need to be made as early as possible. There are many options to consider, including:

- does the organisation outsource some or all their operations? An example would be to now manufacture through a third party; and
- should the organisation insource some operations that are currently bought externally, and thus become what is called a “vertical operation”? An example would be to now manufacture in-house.

Each decision will have risks which can affect costs and benefits. An example would be where a manufacturer with falling profits looks for ways to reverse the decline. There may be several options including to continue to manufacture but doing so in a lower cost environment or outsourcing the manufacture. It is important to note that when considering the risks, one risk which is often not apparent is the risk of not deciding but keeping the status quo.

The Case Example below discusses in agonising detail such a journey to improve profits, and the attached risks. However, before we look at it, we will look at relevant background issues. This case study was written from the writers’ commercial experience and should be only used as general background information and for education purposes.

8.2 Background to the case Study

First, we start off with "risk", but what is it? According to the Australian and New Zealand Risk Management Standard AS/NZS ISO 31000:2018 "risk" is defined as "effect of uncertainty on objectives", and according to the Project Management Book of Knowledge (PMBOK), "risk" is defined as "an uncertain event or condition that, if it occurs, has a positive or negative effect on a project's objectives".

There are many different categories of risk and risk can be internal and external to the organisation. External risk is usually risk that you cannot control, such as government policy and change in laws, and internal risk is risk you can control and includes implementing an effective internal control system to reduce the likelihood and consequence of employee theft and fraud.

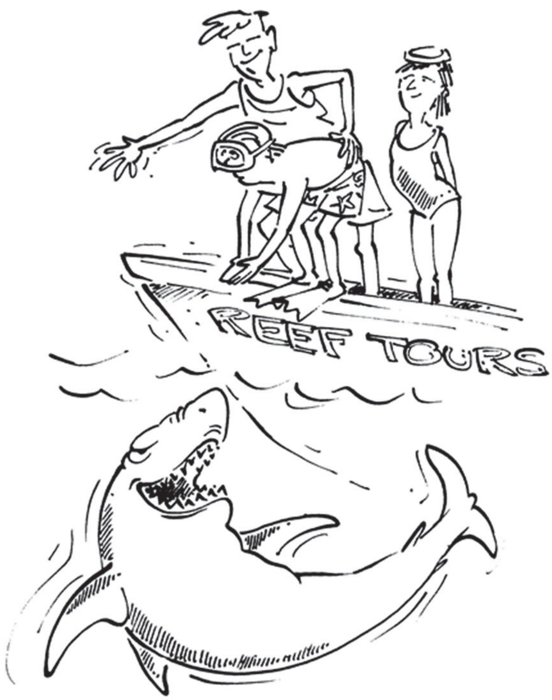

Figure 22 - What are you doing about identifying, assessing and mitigating risk?

Broadly there is strategic risk, which is when something emerges from external environment that's going to have an impact on you and would force a change to the strategic direction. The other broad type of risk is operational risk which is something internal or external that would impact on your ability to achieve the current strategy. Tactical risk is seen to be between strategic and operational risk and is the chance of loss due to changes in business conditions on a real time basis. Tactics differ from strategy in that they handle real time conditions. In other words, a strategy is a plan for the future while a tactic is a plan to handle real world conditions as they unfold. Many people find it difficult to distinguish between the three different types of risk and thus the focus is often on strategic and operational risk.

Next, we need to discuss the vital "make or buy" decision. We have a choice to manufacture our own goods and services (called "insourcing"), and this can be done locally or in our own factory overseas ("offshoring"). Alternatively, we can get others to do it for us (called "outsourcing"). For a number of reasons, we often choose to outsource because there are others who can do it cheaper, faster, better and because we have other more important demands on our resources. In summary, the two key reasons why we outsource are to:

- get the lowest cost (called financially motivated outsourcing); and
- to assist operations and seek strategic and competitive advantage (called strategically driven outsourcing).

Lack of clarity with one or more of the three key parts of the outsourcing relationship, the buyer, supplier and what is being outsourced (see the Exhibit below), can be financially and reputationally costly.

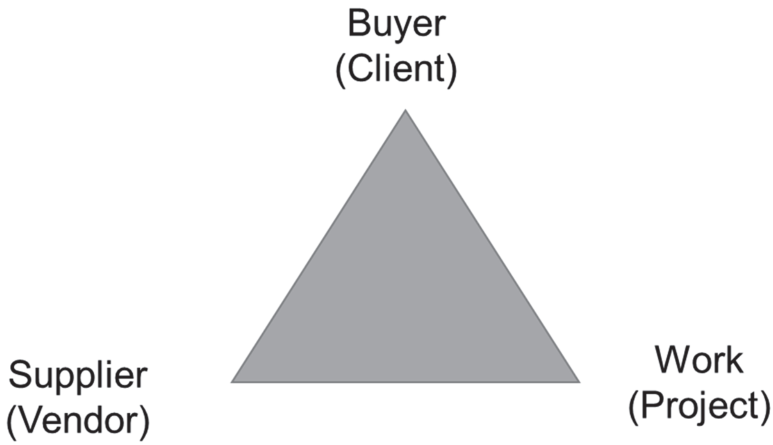

Figure 23 – Exhibit 8.1 The Three Key Parts of the Outsourcing Relationship

Source: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

8.3 The case study Facts

Acme is an old well-established Australian manufacturer of high-quality widgets that supplies the local Australian market. They initially established a plant in Melbourne.

Some years ago, the Government were offering various decentralisation incentives to entice companies to rural areas. Acme decided to set up a second plant in Albury Wodonga using the scheme to assist.

Over time profits were beginning to slip due to rising costs of manufacturing in Australia. These costs included wages, rent and utilities. The cost of local raw materials was rising quickly in Australia, but more slowly overseas, and hence it was better to buy from overseas. Unfortunately, rural costs ended up not being significantly lower than those of metropolitan manufacturing. Thus, something had to be done.

In order to remain competitive and reduce costs, the directors reluctantly closed the Albury Wodonga plant and moved production back into Melbourne. However, costs continued to rise, and in addition, the market that originally preferred "made in Australia" had shifted and customers no longer saw this an important factor when buying. Buyers simply wanted good quality widgets at good prices.

A further feasibility study was made to determine the answer to two key questions. The first was whether the company should continue to manufacture ("insource") or get someone to do it for them ("outsource")? The second question was where should the insourcing or outsourcing manufacturing take place?

In relation to the first question the feasibility group concluded that it would be best to keep on manufacturing, and in relation to the second question it would be better to manufacture overseas ("off-shore") in a nearby lower cost country, with the benefit of the organisation still being able to keep tight control over quality levels, and chose Tonga, a Polynesian country in the Pacific. This was because the Tongan government were providing tax free incentives for manufacturers to set up there.

A building was purchased, and the plant was set up. The venture was successful due to the lower cost of manufacturing, the production of high-quality goods, easy communications (due to same language and culture between Tonga and Australia) and reasonable shipping costs back to Melbourne.

In the meantime, more of Acme's competitors were closing their Australian plants and moving offshore as well, principally to China or India. Ultimately Acme decided to cease manufacture in Australia and produce only from its Tongan plant and has been doing this for many years.

Today the Tongan plant is now ageing, and costs are rising. The tax-free incentives have finished. The costs of transport of raw materials to a Pacific nation and then back to Australia are high and increasing over time. Labour costs in China and Tonga are, however, similar.

A move to China, or India, will necessitate a completely different way of operating. Currently Acme is heavily involved in running the plant. The usual model for small manufacturers operating in China or India is to outsource rather than setting up their own the plant (called "offshoring").

The directors decided to investigate the reasons for and against moving the plant to China or India (or elsewhere) and concluded:

- "For" issues:
    - Reduction in direct unit cost of goods
    - Running the business will become simpler
    - Less management involvement
    - No longer an overseas factory to supervise
    - No property to manage and maintain, ability to sell property and cash up
    - Resources now can be used to concentrate on "core" business.
- "Against" issues:
    - No longer in control of production potentially resulting in longer lead times
    - Less ability to have short runs and/or quick changes to products
    - Does the vendor have the necessary skills?
    - Potential quality issues, as poor vendor quality can affect the brand, causing financial and reputational loss.

- o What reputation does the vendor have internationally?
- o Do we choose a larger vendor with a good reputation? But will we be a "small fish"?
- o Manufacturing now further away resulting in supply chain and logistics issues and longer delivery times and lead times
- o At least one Acme employee needs to travel constantly to check on the plant, production etc.

Ultimately the directors got bogged down in the detail, especially for the director who would have been responsible for the move as s/he would have to do a significant amount of work and eventually stated that it was "all too difficult".

An independent consultant was engaged to provide an opinion on this potential move to India, China or elsewhere, and he urged the directors to strongly consider the move out of Tonga as the higher costs of operating there together with the loss on focus on core business was starting to financially affect the business. The consultant saw that the reticence of the directors was influenced by their personal situations, in that they were all now heading toward a comfortable retirement and were thus avoiding difficult decisions requiring substantial work effort.

The consultant urged the directors to consider the risk reduction strategy of at least starting some manufacturing in India, China (or elsewhere) with a manufacturer with the right quality and capacity to be able to expand quickly if necessary. In addition, this would spread the risk of having all production in just one plant in case of potential problems, such as a plant fire.

The directors did not want to overwork and decided to "take the risk" until they retire.

The consultant provided his advice in writing as he did not want to get sued in case the worst happened, such as a plant fire resulting in a supply chain failure and the business ended up failing.

8.4 Questions

1. What is "risk", what are the different categories and which ones are relevant here?
2. Where are the risks for the different parties and why?
3. Comment on the actions of both the owners and the consultant.

8.5 Suggested responses to Questions)

Question: 1:

What is "risk", what are the different categories and which ones are relevant here?

8.5.1 Suggested response:

- *What is risk?* According to the Australian and New Zealand Risk Management Standard AS/NZS ISO 31000:2018 "risk" is defined as "effect of uncertainty on objectives", and according to the Project Management Book of Knowledge (PMBOK), "risk" is defined as "an uncertain event or condition that, if it occurs, has a positive or negative effect on a project's objectives".
- *What are the different categories of risk?* Risk can be internal and external to the organisation. Internal risk is where the organisation can control the risk and includes staffing levels, marketing, strategy, cash reserves. External risk is where the organisation has no control and includes political, economic, socio-cultural, technological, legal, environmental, infrastructure and demographic risk. Another way of looking at risk is using the four following external risk categories:
    - Supplier risk: risk relating to the particular
    - supplier of the goods/services
    - Project risk: risk relating to the nature of the project
    - Industry and market risk: risk relating to the particular industry and the market
    - Contract risk: risk relating to the particular contract's terms and conditions.
- *Which risks are relevant here?* There are number of risks, but they need to be balanced with the risks of doing nothing but keeping the status quo. The risks include:
    - A strategic risk is where one has all production in just one plant in case of potential problems, such as a plant fire.
    - An industry and market risk are the risks of producing at a higher cost (both in unit cost and management time) than competitors which puts the

company at a disadvantage. This is a risk that cannot be insured against or easily managed other than a change in the method of operating.

- As can be seen from the "Against" issue in the Case Study Facts, above, there are also supplier risks, project risks and contract risks in relocating. Often relocation or change in business will involve high "teething problems". For example, think of the introduction of any new method or equipment where rarely does a major change come without its own challenges, and sometimes a major change can be such a disaster that the change itself can overly impact the organisation. Change is often a short-term headache but is necessary if the rewards could be worth the effort in the long term.

Question: 2:

What are the risks for the different parties and why?

8.5.2 Suggested response:

The parties and risks are:

- *The company* (Acme, including its shareholders): The long-term future of the company and its shareholders is at risk by the directors not properly considering risk, the long-term future and the related succession planning (transfer or sale of business).
- *Directors*:
    - Their financial stake is at risk
    - Their reputation and ability to be directors elsewhere in the future is also at risk. Query if this is a real risk as the directors are all near to retirement and may not be dependent on maximising value from their shares in the company, or income from being non-executive directors.
- *Employees*:
    - Employees in Tonga are certainly at high risk of losing their jobs.
    - Employees in Australia may be somewhat affected
- *Customers*: Perhaps supply is at a risk, but this is dependent on alternative suppliers.
- *Suppliers*: losing a good customer?

Question: 3:

Comment on the actions of both the owners and the consultant.

8.5.3 Suggested response:

- Owner
    - The decision to close Australian plants was in some respect an easy one. However, the decision to close Tonga and move to China/India was a much more difficult one as seen by the many "against" issues, plus the hard work involved in the process of change.
    - It would now appear that the once dynamic company has become stagnant, and indeed over time it may decline to a point where it is not making profits (which is exactly what happened).
    - The lack of action is significantly increasing strategic risk where an unfortunate incident, such as a plant fire could cause the business to collapse overnight.
- Consultant:
    - The consultant seems to have struck a good balance in his recommendations, that is:
        - Commencing manufacturing operations in China/India as well as retaining a scaled down Tongan operation in the short term; and
        - Once China/India plant is well established, then the directors should conduct a further review of the Tongan plant. At that stage many of the "against" issues will have been reduced or eliminated. The Tongan plant could then be closed to reduce costs.
    - The disadvantage in this recommendation is that in the short term the Tongan costs will be much higher due to lower production. However, on an overall risk management and cost/benefit analysis Tonga's closure would appear to provide the optimal solution. The directors, who are also the

owners, disagreed with the consultant's recommendations.

- The alternative is that the directors change their mind and accept the consultant's advice or take up a totally different strategy (sell or close business etc).
- At the time of writing the company is in near collapse due to the inactivity of the directors in relation to the above, and other strategic matters, that were not addressed when they should have been.

8.6 Postscript

Manufacturers face many dynamic risks both in their external and internal environments. In order to survive in a competitive world, manufacturers must continually analyse their operations and work out the best way forward under the circumstances. As has been seen in this case study business failure can easily occur where key risks are not fully identified, assessed and mitigated successfully in time.

Notes

Chapter

9

Case Study 9 – Procurement III - Unauthorised Variations

Until the contract is signed, nothing is real

Glenn Danzig

9.1 Brief Overview

As procurement is such an important area of business it will be covered in three parts, with this third part considering the problematic area of unauthorised variations. We have already covered managing procurement risk and make or buy decisions in the first two parts.

The usual "unauthorised variation" is commonly thought of as a supplier providing labour and/or materials not requested or not needed. Sometimes the quality can even be at a higher standard than requested at a much higher cost. In this case study it is a slightly more nuanced issue – where unauthorised labour and materials are needed and supplied at a high cost. This is a case of the principal ("Government"), the owner of the land, which hired a builder ("DANRIL") to do construction work, and then DANRIL hired a subcontractor ("Trump Brothers") to do the work. The builder sought not to pay the subcontractor for work which it said was unauthorised. The sub-contractor seeks payment for services it believes were validly rendered. The above and other issues will be discussed in the below Case Example, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

9.2 Background to the case Study

9.2.1 Overview

In this Case Example the Government could have contracted directly with its many subcontractors but chose to contract with one party only, here DANRIL. This sole arrangement is normal in such circumstances as Government seeks to outsource the management of the project and thus have only one party responsible if the agreed deliverables are not met.

9.2.2 The contracts

In the English based law of contract, which we have inherited here in Australia, only the participants to a contract, which are the buyer and the seller, are bound by the contract's rights and obligations. This is called the "doctrine of privity". This can be illustrated in the Exhibit below, which explains the two contracts in our Case Example:

- *Contract 1*: Government (the buyer or "principal") has the right to receive the agreed work and has the obligation to pay the seller (DANRIL). The seller has the opposite: it has the right to be paid and the obligation to do the agreed work. However, the Government cannot seek to place obligations on the subcontractor (Trump Brothers) as the Brothers are a non-contracting party. Said another way, in the law of contract there is no "privity" between Government and Trump Brothers, and for the Government to impose obligations on the subcontractor it must do this through its contract with DANRIL.
- *Contract 2*: The parties are the contractor (DANRIL) as the buyer and the subcontractor (Trump Brothers) as the seller.

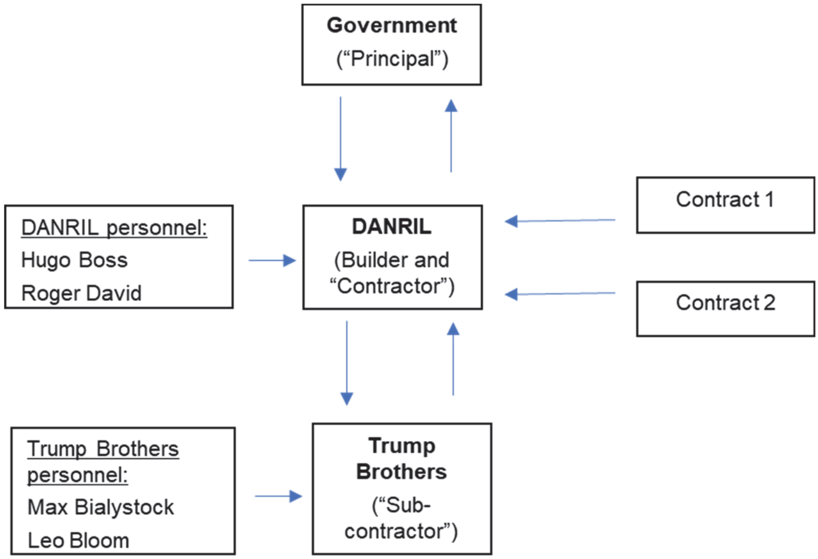

Figure 24 – Exhibit 9.1 The parties, contracts and personnel

9.2.3 Government infrastructure projects

Government infrastructure projects can be run in a number of ways and each has its own positives and negatives. The ways include:

- *Run completely "in-house":* Many years ago, most government projects were managed by government directly, but there were questions as to government's expertise to control and manage contractors. Money was often wasted.
- *Run completely outsourced to private Industry:* This method can work well but there is a potential loss of control by government.
- *Run as a combination of the above:* This is a partnership between government and private enterprise and is called a "PPP" (a Public Private Partnership). The benefit is that the government has access to capital that it would not ordinarily have had. PPPs are thus used to provide large-scale infrastructure (roads, tunnels) and social services (hospitals, prisons) formerly considered the remit of government. PPPs theoretically enable government to control the project while utilising private industry expertise. A disadvantage is the increased cost in that in addition to

the government contract supervision staff there are also a number of management levels on the private industry side that require a margin, and include the head contractor, major sub-contractors, minor sub-contractors. Another disadvantage is that PPPs in Australia are dominated by service-payments, for example the private enterprise party will build the freeway be able to collect the freeway toll (where previously there was no toll) for say 30 years and then hand back the asset to the government. In conclusion. PPPs can work well but need careful monitoring. Examples of PPP failure include Sydney's Cross City Tunnel and Sydney's Lane Cove Tunnel. The private contractor in a PPP model does not have an incentive to make the infrastructure last much longer than the period of its legal involvement, which may be the revenue collection period, and in the above freeway toll example this is 30 years.

9.3 The case study Facts

The government of Freedonia needed to complete an urgent infrastructure project, being the rail and road separation and installation of a new station at the main street of Moamma, a suburb of Freedonia. This needed to be completed by a set date due to:

- the program of rail/road separations was an election promise and it needed to be completed by set milestone dates against which it is being measured; and
- road users were being greatly inconvenienced by every day there is a delay.

The government employed the well-known builder DANRIL, as the head contractor on a complex pricing mechanism in which provable variations are paid subject to a comprehensive review process. DANRIL then hired several subcontractors to do the work.

There was a small local builder, Trump Brothers, known for good quality service and workmanship in supplying and fitting steel and glass components. Trump brothers has worked for DANRIL on occasional projects and has a reasonable relationship with DANRIL. Trump Brothers tendered for and was awarded the $400,000 (plus 10% Goods and Services Tax) contract for the supply and installation of some of the steel and glass components for the Moamma project and a detailed contract was signed, including the requirement for proper authorisations of variations.

Many of the sub-contractors were working overnight every day to meet the Government's announced milestone targets.

In this environment Trump Brothers became aware of some areas of the project that were not being properly addressed promptly by other contractors. This included clearing of rubbish, quality checking, more and better handrails not initially specified for the project etc. These issues were causing DANRIL a few headaches.

The General Manager of Trump Brothers, Max Bialystock, was well versed in seeing opportunities wherever there is chaos or stresses in hierarchical organisations. Max started to "help" out the DANRIL site Manager, Roger David, with small things at first, which grew substantially as Max identified opportunities over time.

For example, Max would point out the benefits of higher-grade steel and glass than was specified in the contract. Max would kindly offer, with a big friendly smile (as he would be making a lot of profit) that while he was there at 2 am on site it would be more productive and efficient for his people to install other rail station components so that the site would be ready in the morning for the next tradespeople. This accumulated quickly to a substantial amount of work for Trump Brothers.

Max took Roger out for coffees and built up a strong relationship. As each "extra" job was completed, the job detail was emailed to Roger to keep him up to date. Roger was happy because it enabled the project to be completed on time and with good quality solutions to issues that kept cropping up. Basically, Max always made sure he was making Roger's job and life easier.

At the end of the contract Trump Brothers sent DANRIL an invoice for an additional $450,000 (plus GST) for all the above variations. The $450,000 was heavily loaded with overtime and penalty charges since much of the work was performed late at night and on weekends, even though the actual employees doing the work were on a fixed rate.

Roger was very worried as he realised that while the works were of a very good standard and made for a more efficient project it had come at a much higher cost than he expected. He approached his manager, Hugo Boss, who said DANRIL was going to have problems getting the Government to pay this extra amount as it was an unexpected and quite a large amount, and DANRIL may have to pay some of this overrun.

DANRIL strongly rejected the invoice on the basis that the works were not properly signed off. They requested a meeting with Max Bialystock. Max had his accountant, Leo Bloom, carefully review the files and prepare detailed costings sheets and other financial documentation for the meeting.

A meeting was then held between DANRIL's site manager, Roger David, Hugo Boss, Max Bialystock and Leo Bloom. At the meeting many of the variation jobs performed by Trump for DANRIL were reviewed and Leo had all the information at his fingertips and presented evidence about DANRIL's push for urgent completion of the work. Max and Leo were well prepared. For a further discussion on disputes see the Case study 12 – Commercial Disputes.

Hugo said that the reason for non-acceptance of the variations was that they were (1) not submitted in line with the contract, (2) they were not properly quoted, and (3) they were not authorised. Max explained that due to time pressure there was no time to have a quote sent and then authorised, and that in reality the contract was verbally agreed and also variations were accepted by the actions of the parties (by the work being done without complaint) and in the end, Max was just focused on getting the project done well and on time for their benefit.

Max argued that DANRIL, the Government and the public were getting value for money considering the conditions endured to get the job done on time at a high-quality standard.

After much discussion and some small concessions on the $450,000 + GST variations invoice, DANRIL authorised a payment of $430,000 for the variations (on top of the initial $400,000 contract sum). It is ironic that Trump brothers made much more profit on the variations than it made on the original contract. Note that this is often what happens with variations and is the reason why contractors often seek to “find” variations, and if there is a choice of projects, they will take the one where they can make more money out of variations.

9.4 Questions

Do you think this was a fair outcome for all involved, and why?

As a taxpayer, has the Government spent your money wisely?

What should change and how?

Figure 25 - If you want to avoid being walked all over, as happened to Hugo and Roger, then ensure that variations are properly authorised.

9.5 Suggested responses to Questions

Question: 1:

Do you think this was a fair outcome for all involved and why?

9.5.1 Suggested response:

The key parties are:

- *Government*: it was conflicted as it must satisfactorily complete the project, and answer to the public on cost overruns. However, it must act in a fair and reasonable manner. It paid a part of the Trump Brother's claim, which when looking at the facts was not a fair outcome for Government.
- *DANRIL*: it did suffer as it paid far more than what it should have paid. The work performed would have had to be paid anyway but it paid more than it should have paid had proper procurement processes been followed. Thus, it was not a fair outcome for DANRIL
- *Trump Brothers*: it used misleading and deceptive conduct to obtain higher payment that it should have obtained otherwise. How was this done? DANRIL has the responsibility to manage several contractors, but it allowed one of its subcontractors, that is Trump Brothers to manipulate the situation to take on DANRIL's duties and responsibilities and profit by this. Thus, this is an unfair advantage obtained by Trump Brothers.

Question 2:

As a taxpayer, has the Government spent your money wisely?

9.5.2 Suggested response:

- If the cost of longer installation time and lower quality is higher than the extra cost of the variations by Trump Brothers, one could argue that the money was spent wisely BUT it sets a very bad precedent that in other cases could go awry.
- What would happen if the extra cost cannot be afforded by Freedonia and other important social welfare services must be cut as a result?

Question 3:

What should change and how?

9.5.3 Suggested response:

- Site management needs to have all required documentation submitted by suppliers, reviewed, and approved before work commences. Payment should not occur until all deliverables have been reviewed for fitness for purpose. All this needs to be performed by an experienced contract administrator / manager. A policy should be implemented that all correspondence between suppliers and site management must be copied to the contract administration person. That may have been a warning sign that there was a problem.
- The site management, if necessary, can require urgent action, for example, issuing warnings to suppliers, issuing Notices of Non-compliance and even suspension if suppliers fail to obtain proper authorisation. All DANRIL employees should be made aware of the dangers of being put into a conflicted position. Suppliers attempting to manipulate buyers has always existed and will continue to exist with obvious examples including suppliers corrupting buyers with pay offs etc. However, it is not always obvious and can be quite subtle, as occurred in this Case Example.

9.6 Postscript

Anyone who has ever worked in contracting (procurement, contract management and sales contracts) knows the problems caused by variations and especially unauthorised variations. Contracts must be managed carefully by all involved on both buy-side and sell-side to avoid such problems.

Notes

Chapter

10

Case Study 10 - Intellectual Property I - Trade Marks

Every trademark you build adds to the financial value of your business, much more than your tangible assets

Kalyan C. Kankanala, Fun IP, Fundamentals of Intellectual Property

10.1 Brief Overview

An area of business that frequently leads to lively discussion is IP (Intellectual Property) rights. IP represents creations of the mind or intellect that can be legally owned and include trademarks, patents, designs and copyright. IP laws allow for protection of ideas and unique creations that exist in every business, and almost every business has some form of IP that they need to protect. IP is important for long term financial success and can make your organisation more competitive than your rivals. As IP is such an important area of business it will be covered in two parts, with this first part covering trademark issues, and the second part covering copyright and licensing issues.

The Case Examples will consider trademarks which are a device brand, heading, label, name, signature, word, letter, numeral or combination of these used in relation to goods or services indicating a commercial connection between goods or services and the registered user of the mark. Examples include the McDonald's golden arch and the Coca Cola logo. We first provide a brief background before we discuss the Case Examples. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

10.2 Background of the case Study

10.2.1 Overview

Intellectual property (IP) represents creations of the mind or intellect that can be legally owned. Almost every business has some form of IP that they need to protect. This is an important asset of a business and fits into the business asset structure as in the below Exhibit, with IP being classified as an intangible asset, that is one that is not tangible like land and buildings, plant and equipment.

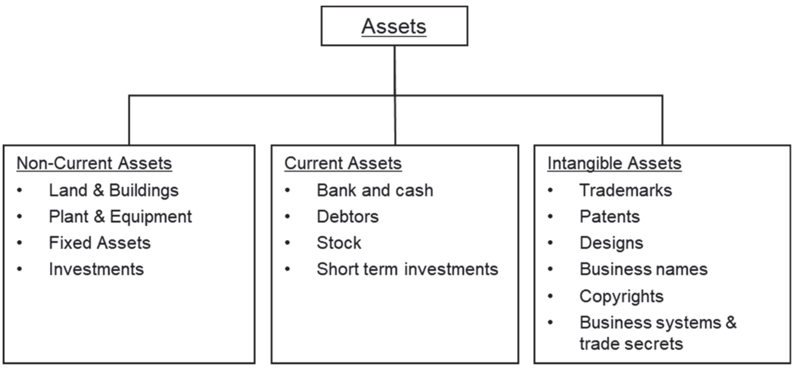

Figure 26 – Exhibit 10.1 Assets of a Business

For a further analysis of the IP categories and how IP protection can be obtained see the Exhibit below. An example is a photographer who uses a unique logo to identify their business. The photographer would own the logo (under the Australian law of trademarks) and any photograph taken. This would be owned under the Australian law of copyright discussed more fully in the next Case Study, Case Study 11. The photographer as the owner can choose to licence (that is, rent) or sell (that is, assign) the logo and/or the photo. Licencing and sale will be discussed in Case Study 11.

10.2.2 Intellectual Property basics

IP laws allow for protection of ideas and unique creations that exist in every business. They're important for long term financial success and can make you more competitive than your rivals. We will discuss below how you can stop competitors from copying your most valuable asset. IP in Australia is subject to Australian law and the detail can change quickly due to court interpretations and legislative changes. This case study is written from the writers' commercial experience and should be only used as general background information.

10.2.3 How to get IP protection

Intellectual property can be classified into that which needs to be registered to get protection and that which does not (see Exhibit below):

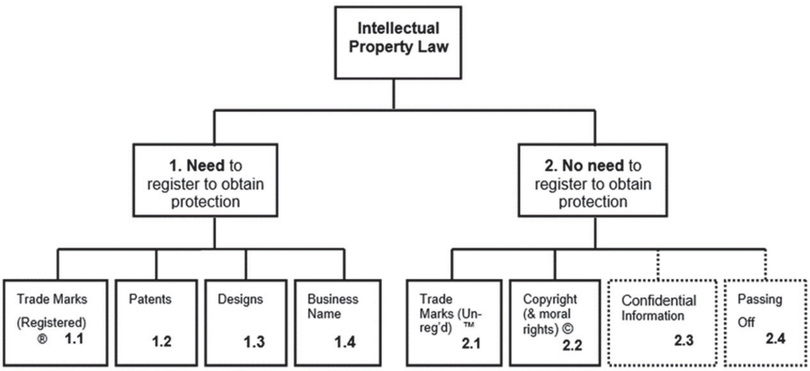

Figure 27 – Exhibit 10.2 The Two Types of Intellectual Property

Source: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

Note: For issues relating to sale and licencing of IP see Exhibit 11.1, in Case Study 11, below.

10.2.4 Categories of IP and protections similar in nature to IP

We will now briefly discuss each category of IP.

- *Trademark (see Box 1.1 in the above Exhibit):* A trademark is a device, brand, heading, label, name, signature, word, letter, numeral or combination of these used in relation to goods or services indicating a commercial connection between goods or services and the registered user of the mark. Examples include the Harley Davidson and IBM logos. It can also be a colour or a sound, for example the Harley Davidson "rumble". Infringement allows the registered owner to sue the party breaching the owner's IP rights for damages, for an accounting of profits (share of profits made by the illegal use of the IP), or for a court order to stop the breach (called an injunction). If the trademark is registered then the registered owners can use the ® symbol, however when unregistered only the ™ symbol can be used. Registration provides the owner of the trademark advantages that the unregistered owner will not have when pursuing someone who is unlawfully using the trademark. Trademarks are subject to Commonwealth of Australia legislation. The duration of a trademark registration in Australia is 10 years and continues indefinitely if the renewal fees are paid. Trademark protection is Australia specific, and if protection is sought in an overseas jurisdiction then the trademark needs to be registered there as well. Trademarks will be discussed in the two below Case Examples.

- *Patent (see Box 1.2, above):* The holder of a patent has the right to make, use, exercise, sell or otherwise deal with an invention. A patent will only be issued for a new manner of manufacture. It is not enough to have an idea; the applicant must create a way in which that idea can operate. Applying for a Standard Patent is an expensive and time-consuming process. As with trademarks (see above) and designs (see below) an infringement of a patent allows the owner to sue for damages, for an accounting of profits, or for an injunction. Patents are subject to Commonwealth legislation where a standard patent confers monopoly protection to 20 years from the date of filing of the patent specification. A few well-known companies began or gained their success with a patented invention, and they include Facebook, Google, Apple, Dropbox and Groupon. An Australian government agency, CSIRO, owned a patent dealing with electronic transfer protocol and in 2010 it successfully sued ten companies, including Apple and Microsoft, for breach of the patent, because these companies were using CSIRO's patented invention without permission. CSIRO received, $1 Billion in damages! This win only occurred because a CSIRO employee in the early 1990s thought that it would be sensible to patent the invention. Patent protection is Australia specific, and if protection is sought in an overseas jurisdiction then the patent needs to be registered there as well.

- *Design (see Box 1.3, above):* The effect of registering a design is that the owner of the registration receives protection of the shape of the article. Infringement allows the registered user to sue for damages, for an accounting of profits, or for an injunction. Designs are subject to Commonwealth legislation. Registration is for a maximum term of 10 years. Examples include the shape of a coffee pot, a car, furniture, a radio etc. Patent protection is Australia specific, and if protection is sought in an overseas jurisdiction then the design needs to be registered there as well.
- *Business name (see Box 1.4, above):* Rather than using the corporate or individual names of the owners most businesses register a name when they commence trading. The business names legislation is a system to provide information as to who is the underlying owner of the business that is using a business name. It does not aid in obtaining intellectual rights or protection to the user of the business name. To own the name, you need to trademark it (see Box 1.1 discussion, above). If you do not use your own given names you need to register the name as a business name. As a result, all states enacted similar uniform business names legislation and Australia-wide registration commenced in 2012 and is handled by the Australian Securities and Investments Commission (ASIC). An example is Jane Smith, an engineering consultant who wants to call her business "Honest Jane's Engineering Consultancy". She will need to register this name as it goes beyond her given names. She can register it for one or three years and if it is renewed it has an indefinite duration. Protection is Australia specific, and if protection is sought in an overseas jurisdiction then the name needs to be registered there. The simple use of a business name may assist the owner who wishes to obtain Intellectual Property rights via an unregistered trademark (that is, under the

"default" or common law rights - see next paragraph), but it is not a good substitute for trademark registration.

- *Unregistered trademarks (see Box 2.1, above):* These are trademarks that are not yet registered, and have a weaker common law (that is, judge made, but not legislative) protection. As these trademarks are unregistered, they have an indefinite duration except if they are successfully challenged by another unregistered trademark or more usually by a registered trademark. See commentary on trademarks, above.
- *Copyright (see Box 2.2, above):* In Australia Copyright is created automatically without the requirement to register when a copyrightable work is created. Copyright is created when something that can be copyrighted, for example a photograph, a written document, a cartoon, text to a book, musical lyrics is dispersed, published, or made available to the public, even to a single member of the public. Copyright is subject to the Copyright Act (Commonwealth) 1968. There is no need to use the "©" symbol, but it helps to use it to tell the world that you are claiming copyright. Copyright is more fully described in Case Study 11 (Intellectual Property II - Copyright and Licencing).
- *Confidential information and trade secrets (see Box 2.3, above):* These are an aspect of intellectual property and only remain valuable while they are kept secret. The courts protect confidential information and an injured party can sue the party infringing their rights for damages, an accounting of profits or obtain injunctions. Protection can be indefinite depending on the agreement.
- *Passing off (see Box 2.4, above):* This is not technically intellectual property. It is where a party represents their goods, services or business as those of the party suing, often using a similar mark or get-up. An example is the accidental purchase, by one of the authors from a local market in Melbourne, of fake Duracell batteries. The fake batteries looked like the real Duracell batteries and used "Dinacell", a very similar name (see images in the below Exhibit). The normal remedy awarded to a successful owner in a passing off action would be an injunction, which is a court order requiring the other party to stop offering

the goods for sale. In addition, the plaintiff, who is the injured party, may be entitled to an award of damages or account of profits made by the defendant, the liable party, during the period of passing off. It may also be seen to breach of trademark and / or copyright.

Figure 28 – Exhibit 10.3 The Real and Fake Battery

- Goodwill: It is a type of a non-physical asset which is often confused with other Intangible assets. Goodwill represents those assets that cannot be sold off separately from the actual business itself, unlike physical assets such as land and buildings, and intangible assets such as registered trademarks and patents that can be. Goodwill is a type of intangible asset that is basically linked to its reputation and related aspects such as customer and employee relationships. An example is a restaurant. The owner seeks to sell their restaurant for \$150,000, and for this the buyer will receive \$50,000 worth of tangible assets (tables, chairs, ovens, kitchen appliances etc), with the \$100,000 balance being goodwill, an intangible asset. It is this goodwill that enables a business to earn a higher return than otherwise investing the assets in some other way. The more customers you have regularly buying from the business the greater the goodwill. The benefit of building up a successful business is the related increase in its goodwill value, although goodwill is not usually valued until the business is purchased or sold. Goodwill is not the same as intellectual property but there is a strong relationship between them, as intellectual property assets will protect and assist in the business goodwill. Many small businesses will combine Intellectual property and goodwill in its valuation.

10.2.5 Unregistered trademarks on sale of business

A recent Federal Court of Australia case confirmed that an unregistered trademark cannot be transferred separately to the sale of the business. This is because the common law usage rights of an unregistered trademark are gained by the continual use of the unregistered trademark by the business itself. The case is *Kraft Foods Group Brands LLC v Bega Cheese Limited* (No 8) [2019] FCA 593.

10.2.6 An organisation should safeguard its IP as it may have great value

Intellectual property rights can have tremendous value, and examples include the McDonalds, Coca Cola and Harley Davidson logos. Over time the percentage of an organisation's intangible IP value is rapidly increasing, and that of the tangible land and buildings, and plant and equipment etc is reducing. An example is the content owned by Disney and Netflix. They also need to be kept safely as IP is easier to manipulate and transfer than traditional assets such as land and buildings as much IP can be transferred simply via email. As such IP should be treated as any other valuable asset, and an IP Register can assist.

10.3 The case study Facts

10.3.1 Case Example 1 – ABC clothing (ABC) and Famous company (Famous) Trademark case

ABC is an Australian company which owns the IP rights to its name "ABC". Sam Shapiro, a director of ABC, received a call from the Australian Regional Manager of Famous Company (Famous), a well-known European company, who wants to meet with Sam and discuss an IP issue. Famous wants to register a high-priced clothing line called Famous ABC, but the trademark office blocked registration because of the prior registration of "ABC". Famous was happy to arrange a compromise with ABC.

Sam didn't see an issue and thought there could be an opportunity, particularly considering that Famous was a high-priced luxury good. Sam took this to both of his CEO and the Managing Director (MD). They both took a different view and instructed Sam to reject the request from Famous.

Famous then legally pursued its case for registration of Famous ABC, causing ABC to defend its position. ABC engaged a lawyer who stated that there is a general principle that you cannot use someone else's trademark by simply adding your own name to it (that is, by adding the word Famous to ABC), and as ABC owns the registered trade mark ABC was on *very strong grounds.*

Figure 29 - "Trust me, I'm your lawyer. You are on very strong grounds …"

After over a year of negotiation, considerable time and legal fees spent on this matter Sam met the barrister (the lawyer who argues cases in court) for briefing prior to the court case at the Federal Court. The barrister said that ABC's case was reasonable, better than 50/50.

Sam was shocked, as this is not the advice he was originally given and asked about the trademark registration certificate and the trademark principles. The barrister explained that the certificate and the trademark principles are of only limited relevance at the Federal Court, where the fundamental question will revolve around whether the person in the street (the reasonable person) would be confused by the two products.

This late legal advice made the directors of ABC very nervous and it was at this stage they concentrated on retreating with a mutual use agreement with each party bearing their own legal and other costs. Both parties agreed to what Famous had asked for in the first place, however, by this time a very large amount of time and money had been spent, and worse still … wasted.

10.3.2 Case Example 2 – ABC versus Frente [Trademark case]

Just when Sam had recovered from the above action, he received a letter from the trademark attorney for another famous sportswear company Frente, a registered French company.

ABC had many labels in its stable and the ABC CEO enjoyed creating new product names and ABC ended up with hundreds of them, all of which were trademarked, and one of which was "Frente", which coincidently was the name of the French company. The CEO's desire for accumulating names required considerable management time, and together with trademark registration fees, it was a very expensive exercise.

Frente had undertaken a specialised fashion market search, known as FBI (Fashion Bureau Index) which was used by people looking to see what names were being advertised in the various fashion journals.

According to Australian trademark law if Sam's firm did not use the trademark in the last 3 years another party could make an application for removal of the trademark from the register, and then apply for it themselves.

ABC did its investigations and realised that it had used the Frente name as a product name from time to time mainly some years ago. There was very little use in the previous 3 years. Frente warned they were intending to issue a removal action and offered $2,500 for the purchase. ABC refused and Frente launched a removal action.

Sam gathered together as much evidence of use as possible and presented his case to the ABC trademark Attorney. The case was then heard in the Trademark Administrative Appeals Court. Although the court found in favour of ABC, Frente continued to attack and intended to appeal the matter to the Federal Court. After long and exhaustive negotiations, Frente agreed to pay $400,000 to ABC to purchase the trademark. Because Frente did not intend entering the market for some time, Frente agreed to licence it to ABC royalty free for a few years in order to keep usage going. At the time of writing, many years after the $400,000 payment, Frente has still not entered the market. Sam by this time had enough of this IP stress and left his job, however luck was not with him as he became entangled in more IP issues, and these are discussed in Case Study 11 (Intellectual Property II - Copyright and Licencing).

10.4 Questions

1. How could the parties have protected themselves?
2. What is the broad-brush lesson we learn from the two trademark Case Examples?

10.5 Suggested responses to Questions

Question 1:

How could the parties have protected themselves?

10.5.1 Suggested response:

<u>Case Example 1 – ABC versus Famous trademark dispute</u>

- This is a difficult situation as although ABC/Sam did get legal advice, it should have been double checked as the matter gained momentum and considering what was involved. Often these areas of law can be considered "grey" where there is no right or wrong answer, but only a good or bad one.
- The decision to compromise was a good one
- However, the CEO and MD did not appreciate the realities of dealing with well-resourced companies and the need to be practical in many of these "greyer" areas. They should have given more thought to Sam's proposal, or at least discussed options with Famous before refusing the request.

<u>Case Example 2 – ABC versus Frente trademark dispute</u>

- Some businesses are very keen on having multiple names, logos, trademarks etc, and there is nothing wrong with this if it is not overdone.
- The administration of the trademarks in this Case Example took an enormous time, cost, and effort to keep them all used actively. Failure to do this, as we have seen, will result in them being lost after three years of non-use.
- How do we protect ourselves when we have so many trademarks? There is a lot of tracking to do. One must ask the question "are we confusing the public with different trademarks?". However, note that some large well-resourced companies use multiple product names to expand their market. They even use different names to sell virtually identical product, an example being Surf and Omo owned by Unilever.

- It is sometimes advised that in order to get the best value for its marketing spend, organisations should focus on a limited number of brands.

Question 2:

What is the broad-brush lesson we learn from the two trademark Case Examples?

10.5.2 Suggested response:

We learn:

- Think things through carefully, never assume the law and get advice where necessary, and if it is a matter of high consequence get a second opinion. Many people use specialist IP advisors and/or specialist lawyers. This is especially the case in one or more of the following:
  - the amounts of money are large
  - mistakes can have a serious effect on the organisation
  - you seek international protection; and
  - where you are new to an area of business
- Disputes can waste an extraordinary amount of time, effort and money.
- IP can be a very valuable asset – treat it as any other asset. Traditionally most valuable assets were tangible, and included land and buildings, plant and machinery etc and were hard to steal or manipulate. Today intangible assets in the form of intellectual property rights often form much of the value of an organisation and are far easier to lose than tangible assets. An example is the theft of intellectual property rights by email (for example the emailing of a photograph or document), or the accidental non-renewal of a trademark, for example the McDonalds trademark.

10.6 Postscript

Intellectual property rights can have tremendous value. Over time the proportion of value of an organisation's intangible assets is increasing, and that of the tangible assets (such as land and buildings, and plant and equipment) is decreasing. Intellectual property rights need to be kept safely as they are easier to manipulate and transfer than traditional assets such as land and buildings. IP should be treated as any other valuable asset, and an IP Register should be used.

Notes

Chapter

11

Case Study 11 - Intellectual Property II - Copyright and Licencing

We protect monopolies with copyright

Peter Thiel

11.1 Brief Overview

Intellectual property (IP) laws allow for protection of ideas and unique creations that exist in every business, and almost every business has some form of IP that requires protection. IP is important for long term financial success as it can make you more competitive than your rivals. In Case Study 10 we focused on trademarks and mentioned other types of IP such as patents and designs, and in this Case Study we will focus on key copyright and licensing issues. Before providing Case Examples we will first provide a brief background. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

11.2 Background to the case Study

This background will focus on copyright and licencing in Australia. IP in Australia is subject to Australian law and can change quickly due to court interpretations and legislative changes.

11.2.1 Copyright

Copyright is a legal right created by the law of a country that grants the creator of an original work exclusive rights for its use and distribution. This is usually only for a limited time. The exclusive rights are not absolute but restricted by limitations and exceptions to the law of copyright, the *Copyright Act* (Commonwealth) 1968. In Australia copyright is created when something that can be copyrighted, for example a photograph, a written document, a cartoon, is dispersed, published, or made available to the public, even to a single member of the public. Copyright is created automatically without the requirement to register when a copyrightable work is created. There is no need to use the "©" symbol, but it helps to use the symbol to tell the world that you are claiming copyright, and to a lesser extent when it was created. Copyright will be discussed in the last Case Examples below. In Australia, copyright in published works generally lasts for the life of the author plus 70 years. For unpublished works copyright duration is set by whether the work was made public in the creator's lifetime. The duration of copyright in subject matter other than works (films and sound recordings for example) is more variable, but generally is 70 years from the end of the year of first publication. There are variations from these general rules. Before 1 January 2005, the term of copyright in Australia was life of the author plus 50 years for published works, and 50 years after publication for audio-visual items. The extended term of 70 years applies only to material that was still in copyright on 1 January 2005. If the copyright had expired by that date, it stays expired. Crown Copyright refers to material made or first published by state, territory or commonwealth government. The term of copyright for these works is generally 50 years after date made. For copyright disasters see below and the website catastrophe in Section 14.2.4 (Case Study 14 – Ending the Business).

11.2.2 Licencing

You can either own IP or borrow it (called licencing) from the owner. Licencing is like renting an office (which will be for a certain duration, for a defined part of the building and for a given rent). For example, if you have written a training manual, or you have a desirable trademarked name/symbol, then you can rent the IP (that is, "licence") to a person who wants to use the book or the name/symbol (see Exhibit below). Indeed, this is what a franchisor, like McDonalds, does. Thus, clearly there is a significant difference between licencing and ownership.

It is often the situation that a buyer of a service or product will insist on a standard agreement (known as a boiler plate agreement) and contains clauses that are unsuitable for the particular contract being negotiated. For example, a Government department that frequently tenders for building works using that tender document for the supply of corporate clothing. In most situations this will still work, but the danger is that an unsuitable clause can leave either, or even both, parties in a vulnerable position if things go wrong. Case Example 3, below, is an example of the buyer suffering.

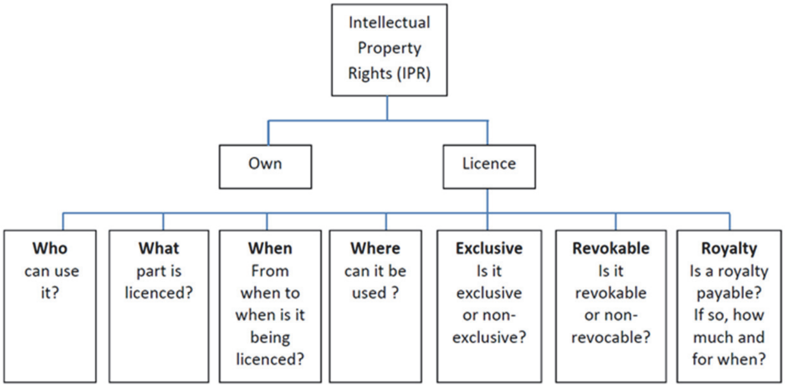

Figure 30 – Exhibit 11.1 Intellectual Property Licencing

Source: Jankoff, C (2015) Manage Your Contracts – A Practical Start to Finish Guide for Contracting Professionals, (4th edition) Melbourne, Business Education and Consulting. Reproduced with permission.

11.2.3 An organisation should safeguard its IP as it may have great value

From a risk mitigation viewpoint, it is important to understand the general rule in copyright law: generally the person who creates the IP will be the owner of the IP, and examples include an IT contractor who is contracted to write IT code, or a graphic designer who is contracted to design a new logo for a business, for example Nike's swoosh. The exception to this rule is made under the Section 35(6) of the *Copyright Act* (Commonwealth) 1968 which states that if an employee does this type of creative work, then the employee's employer will own the IP rights. However, by contrast, contractors will always own the IP rights unless this has been agreed to the contrary, and is the subject of Case Example 1, below. Thus, organisations should have a policy regarding work performed by independent contractors and employees, and it should note the following:

- *Contractors*: Subject to any agreement to the contrary the default situation for the buyer organisation should always be that it owns the intellectual property rights created under a contracting agreement.
- *Employees*: If you know that an employee will be working on a specific piece of work of significance, it is better for the employer to be specific about the project in the employee's contract of employment than just rely on a general IP clause.

From a risk mitigation viewpoint an organisation should set up and maintain an IP register as its IP may have great value and it should thus treat the IP like any other valuable tangible or intangible asset.

11.2.4 Ownership of IP created by the contractors, and that used to create the new IP

We have just discussed how the creator is the owner of the IP rights, subject to legislative intervention. However, we need also remember that a contract should *always* specify who owns IP created (called "new" or "foreground" IP) under the contract and who owns IP used to create it (called "existing" or "background" IP). Clarity is important as ownership of new and existing IP can cause major disputes. Generally, new IP should be owned by the buyer and existing IP should remain with their respective owners. An example of ownership of new IP is the Nike "Swoosh", mentioned above. It is a corporate trademark created in 1971 by Carolyn Davidson, while she was a graphic design student at Portland State University. She met Phil Knight while he was teaching accounting classes and she started doing some freelance work for his company, Blue Ribbon Sports, later Nike. She sold, that is "assigned" the ownership right for $USD 35. The Swoosh logo must now be worth billions. Lucky that Knight got her to legally transfer the IP rights in the logo to his company! It is important to keep written evidence of this transfer if one is ever challenged.

11.3 The case study Facts

11.3.1 Case Example 1 – Loss of IP rights to a major design improvement [key issue here is Copyright]

Sam, our hero from Case Study 10 (Intellectual Property I - Trade Marks) found a new job and joined XYZ Ltd, a major Australian mining company, which needed improvements to the design of equipment vital to the organisation's mining activities. Sam was the staff member in charge of the purchase, and spent much time ensuring that all relevant deliverables and other key terms to the deal were included in the contract with consultants. The price demanded by the consultants was very high, but the promised benefits greatly exceeded the cost.

Sam did not approach XYZ's legal department for two reasons: (1) he felt that lawyers overcomplicate matters, resulting in deals taking considerably longer to finalise than they should; and (2) he wrongly assumed that it was the buyer who owned the IP rights, as happens in an employment situation, where the employer owns the IP rights created by their employee.

The agreement was made by an exchange of emails. The consultant provided what it promised - a new design that was very helpful in improving the life and output of the machine. The mining company paid the consultant's fee.

Sam later saw its competitors using the same design and he investigated. The consultant advised that because it owned the IP rights to the improvements it could use the IP as it saw fit. Sam disputed this. The consultant then showed him the email agreement which was silent as to who owns the IP rights. The consultant stated that under Australian copyright law unless there is something to the contrary in the agreement it is the creator, and not the buyer, who owns the IP rights. He was also advised that the situation with employees is a specific statutory exception to the rule (see Section 35(6) of the *Copyright Act* (Commonwealth) 1968). After seeing his legal department Sam, to his horror, realised that he had misunderstood the law.

The result is that not only did the purchaser lose the intellectual property rights to the improvements purchased, but it also allowed competitors access to its improvements. Sam was fired.

Figure 31 - If Sam had obtained legal advice regarding his IP rights, he would have preferred to go to the gym instead of a therapist!

11.3.2 Case example 2 – Threatened loss of a trainer's IP rights [key issues here are Copyright and other remedies]

Sam is now self-employed and is keen to share his knowledge (and get paid for it) and suggested to Superior, a training company, that Superior runs a new course regarding a hot new area of business and suggested a course he felt very capable of delivering. He wanted to name it "IP procurement mistakes".

Superior was quite enthusiastic and for a period of about a month much was discussed including the content, delivery, audience, learning objectives and a draft syllabus was produced. From the very beginning it was agreed that Sam would present the course, and as a result he happily shared his knowledge, expecting as he is the author of the draft syllabus, he would naturally own any IP.

All went quiet for several months as Superior was reorganising its courses and during the period Sam periodically asked if the course would be going ahead and he was repeatedly advised that his two-day course was of great interest, that it would go ahead, and that Sam would present it.

On a Wednesday Sam presented a 45-minute version of the course at a conference, and the presentation was attended by Superior's key executives. After the presentation the executives congratulated Sam on the course content and delivery. Sam then asked the executives when they would like to start offering the course. They advised that they still needed to think about it, and they would get back to him. This worried Sam, as Superior previously had been so enthusiastic about it.

The next Monday the presenter received a standard mass email "flyer" from Superior about several courses and it included Sam's course to be held in about 8 weeks and to be taught by Smiley, one of Superior's favourite presenters. The Course content was almost identical to that what Sam had proposed to Superior.

Sam is unsure of his legal position. Can he stop the course from proceeding?

11.3.3 Case Example 3 - The buyer wanting it all [key issues here are licencing and copyright ownership]

Sam thought that he would look for other work in the training area as he felt that it was easy and well-paid work. Over time he created several well-researched training documents. He saw a tender for a two-day "Avoiding Procurement Disasters" course sought by a large metropolitan council. He felt that as he was experienced with procurement disasters and the costs of running his business were low, he would have a good chance of getting the contract on his low bid.

He applied for, and was sent the tender documentation, which included a lengthy contract. The following clause concerned him:

Clause 17: Intellectual Property Rights.

The Council will own the Intellectual Property Rights of materials used by the Contractor to provide its services under this Agreement.

In the documentation Sam received there was a statement that if the contractor disagreed with any of the contract's terms in its tender response then the contractor's tender response would be treated as "non-conforming" and the response would be rejected.

Sam rang the enquiry officer stating, "I do not think that you understand, that according to the IP clause in the contract I will for two days' pay be giving you ownership of my training materials (manual, workbook, PowerPoint slides) which took months of hard work to write, and I will not be able to work anymore in the future with them because you will have ownership." The officer quickly responded, "I do not think that YOU understand, if YOU want to be in the running for the work then YOU need to agree to the contract by signing the tender response documents (including the contract) and lodging them by the due date." Sam was shocked by this attitude, and then thought about it. He then offered the officer a licencing arrangement where the council could use the training materials at work as it sees fit , it would be royalty free (that is, at no charge) and in perpetuity (that is, forever) as long as Sam continues to own the materials that took him so long to write. The officer then said, "If you want the work then you put in a tender application acknowledging that you would deliver a two-day training program and give ownership of all your training materials to the Council."

It was all too much for Sam – he wanted a quiet life and then and there at the age of 35 he decided to retire from real work and decided to work as a politician, and hopefully become a future Prime Minister of Australia.

11.4 Questions

1. How could the parties have protected themselves in the three Case Examples?
2. What is copyright and how can we best protect our copyright?
3. Describe the concept of ownership and licencing in Case Example 3, and what you would have done had you been the council officer?
4. What are the broad-brush lessons we learn from the Case Study 10 trademark AND the Case Study 11 copyright and licencing Case Examples?

11.5 Suggested responses to Questions

Question 1:

How could the parties have protected themselves in the three Case Examples?

11.5.1 Suggested response:

<u>Case Example 1 – Loss of IP rights to a major design improvement</u>

- Sam could have avoided this costly problem (which got him fired) by:
    - not assuming laws
    - using a standard procurement contract, which normally has the buyer owning the IP
    - demanding an intellectual property clause in the contract.
- Once the contract has been signed it is too late to change the terms of the contract, unless it is varied by agreement by the parties.
- The above is a reason why intellectual property clauses, stating that the buyer owns the IP rights, are normally found in standard form agreements prepared by the buyer.

<u>Case Example 2 – Threatened loss of a trainer's IP rights</u>

- Sam should not have provided valuable IP rights or confidential information until the Superior had signed an enforceable NDA (Non-Disclosure Agreement) which is also known as a confidentiality agreement. It should also have clearly agreed remedies for breach.
- Sam does have an action but in the absence of documentation, it will be difficult to pursue his claim. Sam will now need to threaten Superior with breach of IP rights, breach of contract, and other remedies such as misleading and deceptive conduct and breach of confidential information. Will Superior defend? In the interim the parties are wasting a lot of time and money which could have been used on core business.

Case Example 3 – The buyer wanting it all

- Sam should have escalated to a senior manager and pointed out how uncommercial the clause was – that no contractor would voluntarily surrender its IP right without reward.
- Sam needs to point out to the council that their IP ownership procurement practices will result in a reduction, if not elimination, of tenderers. No capable trainer would like to lose the ownership of their training materials. In reality those who do apply will probably lack capability and / or will probably provide little or no training materials with both of these likely outcomes affecting the quality of the training, possibly significantly.
- Sam could argue that the tenderers could for an extra fee write customised materials

Question 2:

What is copyright and how can we best protect our copyright?

11.5.2 Suggested response:

- *What is copyright?* Copyright is a legal right created by the law of a country that grants the creator of an original work exclusive rights for its use and distribution. This is usually only for a limited time, with exceptions. Normally the copyright owner is the creator, but if created by an employee it will be owned by the employer according to the "in pursuance of the terms of his or her employment" copyright rule in Section 35(6) of the *Copyright Act* (Commonwealth) 1968 (see Case Example 1, above). The creator can sell the copyright, or licence it, so that another can benefit from it.
- *How can we best protect our copyright?*
    - *First know the facts*: What have you created? It may be, for example, a book on business improvement.
    - *Then apply the law to the facts.*
        - *Ownership*: Normally the author owns the copyright which the law will protect, however you will not have copyright if:
            - you are an employee and you have written the book because your employer has asked you to write it (here the owner will be the employer), or
            - you are a contractor but have agreed in writing that the party paying for the book will be the owner.
        - Advising the world: By law no advice, or use of the © symbol, is necessary, but you can warn the world that you own copyright by using the © symbol, or writing the word "copyright", the year and then your name and perhaps a method of contacting you.

Question 3:

Describe the concept of ownership and licencing in Case Example 3, and what you would have done had you been the council officer?

11.5.3 Suggested response:

- *Describe the concept of ownership and licencing in Case Example 3*: You can either own IP or borrow it (called licencing) from the owner. Licencing is like renting an office (which will be for a certain duration, for a defined part of the building and for a given rent). If you own and then sell (called "assign") the IP, then you no longer own it and thus you cannot use it unless you agree otherwise with the new owner.
- *What you would have done had you been the council officer?* The council did not need to own the IP, as it could have taken a licence. Indeed, by seeking ownership it may have scared all genuine bidders as no vendor would like to permanently lose IP of significance for what really is only two-days' pay.
- See comments under Question 1 that relate to this Case Example.

> **Question 4:**
>
> What are the broad-brush lessons we learn from the Case Study 10 trademark AND the Case Study 11 copyright and licencing Case Examples?

11.5.4 Suggested response:

We learn:

- Think things through carefully, never assume the law and get advice where necessary. If you can use a specialist IP advisor and/or a specialist lawyer, and do so especially in one or more of the following situations:
    - the amounts of money are large,
    - mistakes can have a serious effect on the organisation,
    - you seek international protection; and
    - where you are new to IP and / or an area of business.
- Disputes can waste an extraordinary amount of management time and be very expensive.
- IP can be a very valuable asset – treat it as any other asset. Traditionally valuable assets were tangible, and included land and buildings, plant and machinery etc. They were hard to steal or manipulate. Today intangible assets, such as IP, are far easier to steal (for example the emailing of a photograph or document). Valuable IP examples include the copyright to construction of a building, a famous hit song, or an academy award winning film.

11.6 Postscript

Intellectual property rights are statutory monopoly rights and include copyright and licencing and can have tremendous value. As such they should be treated as any other valuable asset. However, they also need to be kept safely as they are easier to manipulate and transfer than traditional assets such as land and buildings. As intellectual property is forming a bigger part of an organisation's asset pool the likelihood and consequence of IT problems will increase over time.

Notes

Chapter

12

Case Study 12 – Commercial Disputes

If you win your legal dispute you lose. But if you lose the dispute you are really in trouble!

Anon

12.1 Brief Overview

Disputes are a normal result of human relationships where misunderstandings or differences of opinion arise. Good contract management usually limits these disputes, but It is likely that at some stage in your commercial life you will be faced with the possibility of an unresolved dispute. In this case study we will consider several disputes and what has, and could have been done, to resolve them. Remember that a contract is a legally enforceable agreement and a negotiation is everything that leads up to the creation of the contract. The above and other issues will be discussed in the Case Examples, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

Figure 32 - Try to act professionally when resolving your commercial disputes.

12.2 Background to the case Study

12.2.1 Overview

In most advanced legal systems of the world once a party has validly entered into an enforceable contract, they cannot change the terms and conditions (T&Cs) unless both parties agree. If there is a unilateral (one sided) change then if the innocent party suffers loss it can sue for compensation, that is if it loses $100, it will be able to claim *up* to $100 and get paid most of its legal costs. The innocent party cannot profit from its loss, that is it *cannot* obtain compensation in excess of $100. However, under the English legal system that we inherited in Australia the party winning will still not be fully compensated for two reasons. The first is that the winner does not get all their legal fees paid, and the second is that no allowance is made for the loss of management time taken away from core business. Thus, one should always prepare a "business case" as to whether the organisation should proceed with the dispute or settle the matter once and for all. Remember that you may win your immediate dispute, but an important relationship may be irretrievably damaged in the process causing loss far in excess of what was in dispute. This can be seen in the Case Example 3, below.

12.2.2 Use an experienced adviser

It is prudent to have a list of advisers that can assist with problems that occur. An experienced commercial lawyer is an invaluable source of assistance and can help in managing potentially stressful, financially and reputationally damaging disputes.

12.2.3 Cause of disputes

Disputes usually revolve around:

- The quality of product or service delivered
- Quantity delivered or Price being charged
- Timeframe of delivery
- Cancellation
- Variations
- Other Contract terms.

12.2.4 Unfair contract clauses

The Australian Consumer Law, which is part of the *Competition and Consumer Act 2010*, protects against unfair clauses in consumer contracts, and extended to cover unfair "small business contracts". The information below refers to the Small Business Unfair Contract Terms law that commenced Australia wide on 12 November 2016.

<u>Meaning of "unfair"</u>

Ultimately, only a court, not the Australian Competition and Consumer Commission (ACCC), can decide whether a term is unfair. In deciding whether a term is unfair, a court must consider how transparent the term is, as well as the overall rights and obligations of each party under the contract. The court may also consider other relevant matters. To be "unfair", a term must:

- cause a significant imbalance in the parties' rights and obligations
- not be reasonably necessary to protect the legitimate interests of the party advantaged by the term, and
- cause financial or other detriment (such as delay) to a small business if it were relied on.

For a small business to obtain protection from the court under this legislation it needs to answer "yes" to all of the following:

- Is it a "small business contract? This requires a "yes" regarding several issues including:
    - one of the parties needs to be a "small business", that is it has less than 20 employees; and
    - the contract's value is less than $300,000 if its duration is for a year or less, and if over a year the value is less than $1,000,000
- It is an "unfair" term? – see commentary above.
- Was the contract offered to the party on a "take it or leave it basis"?

If you can answer "yes" to all three of the above questions then the court will remove the contractual term from the contract, that is, the term is made "void". There is currently a move to also have penalties imposed if the term is ultimately found by the court to be "unfair" in order to prevent unfair terms being repeatedly used against weaker parties, where it is difficult or impossible for smaller parties to be able to afford the cost and disruption of the litigation to prove that the term was "unfair". For further information see *https://www.accc.gov.au/publications/unfair-terms-in-small-business-contracts* (viewed 24 April 2019).

12.2.5 Commercial aspects of Disputes

It is vital to detail the history of a dispute and keep a thorough file of all correspondence. This is for a number of reasons:

- Assists management and the lawyer to understand the case
- Prepares the case for litigation
- Provides all key correspondence in a logical order and convenient place

- Assists in the creation of a chronological history (note that often just the process of listing and reviewing of all relevant events may present a solution). See Exhibit, below for a sample of a chronology.

Date	Event	Document	Doc No.
19 Feb 2020	Contract signed	Contract	1
22 Feb 2020	First delivery	Delivery docket	2
23 Feb 2020	First delivery: goods considered faulty	Receiving department report	3
24 Feb 2020	Advice that goods were faulty and request that they be replaced	Email of 24 Feb 2020	4
3 Mar 2020	As no response to 24 Feb 2020 email call to Mr X. Not in, left a message	Diary note	5
3 Mar 2020	Email confirmation of 3 March 2020 call sent to Mr X	Email of 3 Mar 2020	6
6 Mar 2020	Call from Mr X who said that it'd be rectified in 24 hours	Diary note	7
12 Mar 2020	As no response call made to Mr X	Diary note of 12 Mar 2020	8
12 Mar 2020	Email confirmation of 12 March 2020 call sent to Mr X	Email of 12 Mar 2020	9

Table 9 – Exhibit 12.1 Sample Chronological History

12.2.6 What lawyers love to hear

It is an old adage that the sweetest words a lawyer will hear from his client is "this is a matter of principle". This is code for the client being prepared to spend a lot of money regardless of the cost/benefits of the litigation. It is important to understand the motivations behind people who litigate, as an understanding of these motivations may help in presenting a solution.

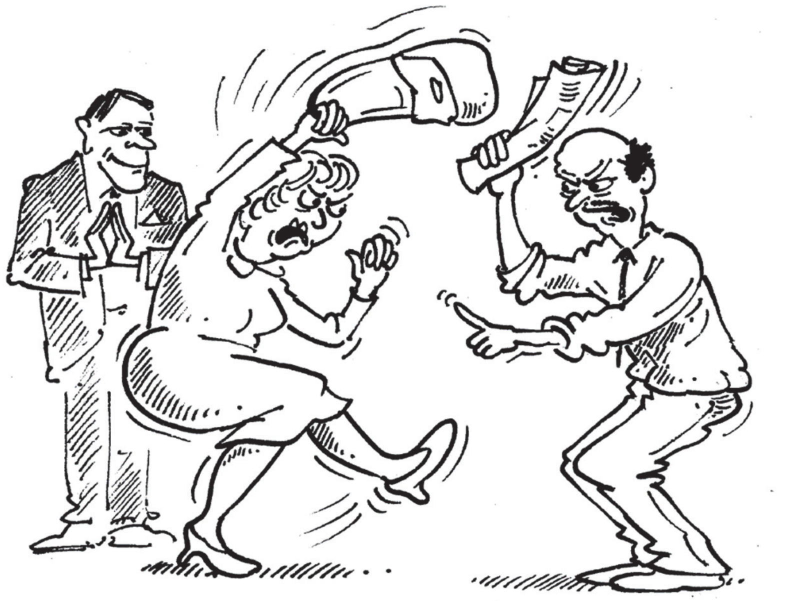

Figure 33 - I'll gladly help you with your "matter of principle" …

12.2.7 The use of a forensic accountant

Once the dispute starts the lawyer will often request an independent expert (often called a forensic accountant) to quantify the loss, and this may include valuing assets such as the business before and after the alleged event relating to the dispute. A good forensic accountant can sometimes add great value to the case.

12.2.8 Other issues to be aware of

- Australian courts follow the British legal model and work on an adversarial (argumentative) approach rather than an inquisitorial (inquiry driven) approach followed in continental Europe. Thus, in Australian dispute resolution there will be considerable antagonism, and this takes resources (time, money and energy) to resolve.
- The uncertainty of litigation – rarely will you have an "open and shut case".
- You will have a huge amount of lost management time as you will not be able to concentrate on core business as you need to prepare for the court hearing.

- Reputational loss is a distinct possibility. Litigation in the court room is open to the public and especially the press and thus nearly anything said in court may be reported in the press. This may be a reason for requiring the dispute resolution process to be mediation or arbitration, rather than litigation, as mediation and arbitration proceedings are expressly agreed to be confidential and held behind closed doors with no press access.

12.2.9 Vexatious Litigation

- Some people in business use the bullying approach to make money. One way this occurs is by being a "vexatious litigant", that is a person who begins a legal action without sufficient genuine legal grounds for doing so. Vexatious proceedings include cases that are started or pursued to abuse the process of a court or tribunal, to harass or annoy, to cause delay or detriment, to extort a favourable settlement or for another wrongful purpose.
- One must be prepared for such litigants. They are normally motivated by making money quickly and unfairly. To do this they make themselves as powerful, obnoxious, time consuming or frustrating as possible so that the other party decides in desperation to pay or do what is demanded. This nearly happened in Case Example 5, below.
- Remember that this is normally a simple commercial exercise:
  - the *vexatious litigant* will only invest its time, and money (usually in legal fees to harass the victim) if they can get significantly more back, and
  - the *victim* of such attention will decide that it is less expensive to pay the demanded amount (or do the demanded action) than to resist. Remember that attending to paperwork, spending time meeting to determine the facts, seeing lawyers etc all costs money, as usually it involves large amounts of executive time, and this needs to be factored in when doing the cost / benefit calculation. This "surrender" often incurs with insurance claims, where the insurance company sees that it is cheaper

to pay rather to fight the claim. The authors were involved in one such claim where fraud was strongly suspected, but the insurer took the easy way out and paid the claim.

12.2.10 Problem solving methodology

Whenever you have a problem you may wish to use the below five-step methodology. When writing a report, you can use the five steps as headings with an executive summary at the front. An example which both authors worked on is whether company ABC should continue to manufacture and/or does it buy (that is outsource)? The steps are listed below.

1. What is the *problem*? Make or/or buy, as described above?
2. What are the *facts*? Use the Chronological History (see the Exhibit, above, for an example) to summarise the relevant facts in chronological order supported by the necessary documents. In our example of continuing to make or to outsource the facts would include reports as to the cost of manufacturing, the cost of buying, who could we be buying from, the advantages and disadvantages of manufacturing versus buying, the different outsourcers etc.
3. What is the *applicable law*? For example, check the law on the liability of both the buyer and seller for goods that are not fit for purpose, dispute resolution clauses in agreements etc.
4. What *option(s)* do we have? For example, the above three steps could be applied to the case study in Section 8.3 and may point to two options
    a. Option A: Close the factory completely and outsource to one of supplier X, Y or Z, with Y being the suggested choice for specified reasons; or
    b. Option B: Keep the factory producing 50% of the current output and outsource the balance (to one of supplier X, Y or Z, with Y being the suggested choice for specified reasons).
5. What is the *recommendation*? The recommendation may be to choose Option B. The reason for the choice of a particular option should be stated in detail.

12.2.11 Methods of dispute resolution

- *Dispute resolution term in the written agreement*: The written agreement may provide a process for resolving disputes between the parties to avoid costly litigation. Possibilities include:
    - Parties are in control of the decision-making process:
        - *Informal meeting*: Most disputes are best resolved through negotiation and compromise. The dispute may need to be escalated through the organisation, however it is recommended that is does not escalate to the CEO, as CEOs are normally too busy to concentrate on such issues for any length of time. Thus, the matter can go to the CEO for final decision, but normally not be negotiated by the CEO.
        - *Mediation*: Mediation utilises an independent person whose role is to encourage the parties to find ways to come to a resolution
    - Parties are not in control of the decision-making process:
        - *Arbitration*: This approach utilises an independent person as arbiter and involves less formality than a formal court hearing. It can be described as a private court case behind closed doors.
        - *Litigation*: This is the bringing, maintaining, or defending, a lawsuit before a tribunal or court:
            - a tribunal includes the Victorian Civil and Administrative Tribunal (VCAT)
            - a court includes the Victorian County Court, the Victorian Supreme Court, the Federal Court of Australia or The High Court of Australia.
        - *Independent expert*: An independent expert can assist the parties when trying to resolve

a dispute between themselves, or in mediation, arbitration or court litigation. This often occurs with discrete technical issues requiring an opinion and where the parties agree to be bound by the expert's opinion.

- *No dispute resolution term in the written agreement*: If the written agreement is silent as to the method of dispute resolution then the normal method of dispute resolution, subject to any legislation or binding requirement elsewhere, is to informally meet to negotiate a settlement and if this does not settle the matter then one would go direct to litigation, either in to tribunal or court.

12.2.12 Choosing your battles - knowing when to stop

The celebrated Chinese general, military strategist, writer and philosopher Sun Tzu (545 BC - 496 BC) wrote in his book *The Art of War*, that if a battle cannot be won, do not fight it, that you have to pick your battles wisely and not every conflict is worth turning into a major battle. In business we need to do the same. Both authors have been involved in disputes which should not have been litigated. Indeed, one of the authors worked with a person whose ego meant that he saw every conflict as a major battle he had to win.

Needless to say, this attitude took resources away from core business, and the business' results suffered accordingly. It is very easy for us authors to advocate "pick your battles", but if someone has done you wrong there is a psychological temptation to seek revenge. Both authors have seen this, and both have had this happen to them, where they resisted the temptation (it was not easy) to retaliate as it would have been uneconomic to litigate as only the lawyers would have won!

12.2.13 Emotional Intelligence (or "People Skills")

EQ (or EQ for Emotional Quotient) is "The capacity to be aware of, control, and express one's emotions, and to handle interpersonal relationships judiciously and empathetically", and is the key to both personal and professional success"

Every negotiation is comprised of two major components: the people taking part in the negotiation and the problem those people need to address. Roger Fisher, William Ury and Bruce Patton introduced the idea of separating the people from the problem in their book *Getting to Yes: Negotiating Agreement Without Giving In*. When we turn our negotiating counterpart into the enemy, we tend to lose focus on resolving the problem. So, work professionally and collaboratively with the other party to resolve the dispute. Dale Carnegie said that the worst way to change someone's mind is to aggressively say that your counterparty is wrong.

We will now consider three examples from the authors' experience;

- *Personal negotiation*: Peter Wiley who went to a resort on a golf package which was advertised "*every room booking gets two free games of golf*". Peter booked a room for him and his wife and after they played one game and went to book a second game, they were advised that they had already used up their entitlement of free games. As Peter and his wife wanted to play another game, they paid for it. Later he went to the office and courteously, but firmly, spoke to the manager and explained that the advertising was ambiguous and assumed it was two games per person as most room bookings are made for two people. The manager listened and refunded Peter the cost of the extra games that were charged to his account. Would this have worked if Peter was belligerent? Maybe, but at what cost. See next case
- *The corporate tender*: A company had a large customer. The customer wanted to take their business to tender. The vendor's Managing Director (MD) argued with the customer and the relationship became damaged. The customer eventually moved to a new supplier. But this is not the end of the story. When the company applied for other tenders, new potential customers did their due diligence on previous customer relationships. The end

result was that the vendor lost a lot more business that the one customer. The MD would have been better to try to keep a good relationship for future potential.

- *Emotional Intelligence in the employee relationship*: Another interesting example is one where in one company, George, the cost accountant had made a small error. In the morning, the Chief Financial officer (CFO) said to George in a courteous voice, "Hey George, can you correct the cost of the widget?" George was positive in response and said "of course, no problems". In the afternoon, the belligerent Managing Director who did not know the CFO had spoken to George, came over and said in an extremely aggressive tone "Hey George, can you correct the cost of the widget". George cowered and timidly said "of course, no problems". In both cases the persons used very similar words but with different results.

Interpersonal communication via our body gestures (that is, body language) and voice tone can make a huge difference. One of the best managers the author ever knew was a softy spoken petite female. She had the classic "iron fist in a velvet glove", which is a disguised firmness, being a gentle demeanour concealing a resolute personality. Perhaps taking this style to an extreme is the character "Miranda Priestly" in the Hollywood film "*The Devil wears Prada*", with Meryl Streep as Miranda Priestly, a fashion editor, believed to be based on Anna Wintour.

12.3 The case study Facts

12.3.1 Case Example 1 - Con and looking at creative ways to resolve a small dispute

Con had a dispute with his landlord, Leon over $3,000, a relatively small amount of money for the parties. The dispute was adjudicated at the Victorian Administrative Tribunal (VCAT). Con didn't care about the money but believed Leon was wrong in principle.

Con advised he was only fighting the matter on principle and presented to the adjudicator (the VCAT Member) an offer for both parties to pay $1500 as a donation to the Children's Hospital to settle the matter.

Faced with a moral dilemma, Leon was put in a position that he couldn't easily refuse. This enabled Con to take the higher moral ground which is what Con was after. Both paid the $1500 as a donation, and the matter was settled.

12.3.2 Case Example 2 - Mary and the unfair subscription renewal clause

Mary was the merchandise clerk in a clothing company. The company had a subscription service which her employer asked her to cancel. The subscription had an automatic renewal clause that if the agreement was not cancelled within a specific time the agreement automatically rolled over.

She cancelled this but the subscription company stated that her cancellation notice was ineffective as the cancellation had to be given more than 90 days before the renewal date. The following year the same thing happened, and she was quite upset. Mary asked her employer's company secretary, Donald, for advice.

Donald carefully prepared the file with a detailed event chronology similar to the one in the above Exhibit. In preparing the chronology Donald noticed that the cancellation notice provided in the previous year could be used to cancel for the current year, that is:

- Subscription year 1 - 1st July 2017 to 30th June 2018
- Subscription year 2 - 1st July 2018 to 30th June 2019

The clerk gave notice on 1st July 2017 attempting to cancel Subscription year 1, but because it did not refer to any particular year Donald reasoned that it could be used to cancel subscription year 2. The subscription company was advised and had to accept this as the subscriber followed the terms and conditions surrounding the subscription contract.

This is a good example of the problem with automatic renewals. This is where sellers are very keen to get buyers to subscribe with automatic renewals, knowing that may organisations do not diarise renewal cancellation dates. This issue is growing as over time more business is done through subscriptions rather than purchase, for example the use of the cloud in IT. Both authors have experienced the negative effects of such clauses and recommend against them reasoning that the vendor will always remind the buyer of their need to renew, and thus an automatic renewal is superfluous and increases, and does not decrease, risk.

12.3.3 Case Example 3 - The retailer and the shopping centre forensics case

Martin ran a women's wear shop (Martini), in the Volt Shopping Centre (Volt). Volt rented a space to the Jolly Juice kiosk shop outside Martini.

The juice company was very popular, and queues formed blocking the Martini's shop entrance and window (see Exhibit, below). This enraged Martin who maintained this was affecting his sales. After many arguments and discussion, ultimately Volt offered to pay him $5,000 and review the Jolly Juice kiosk configuration.

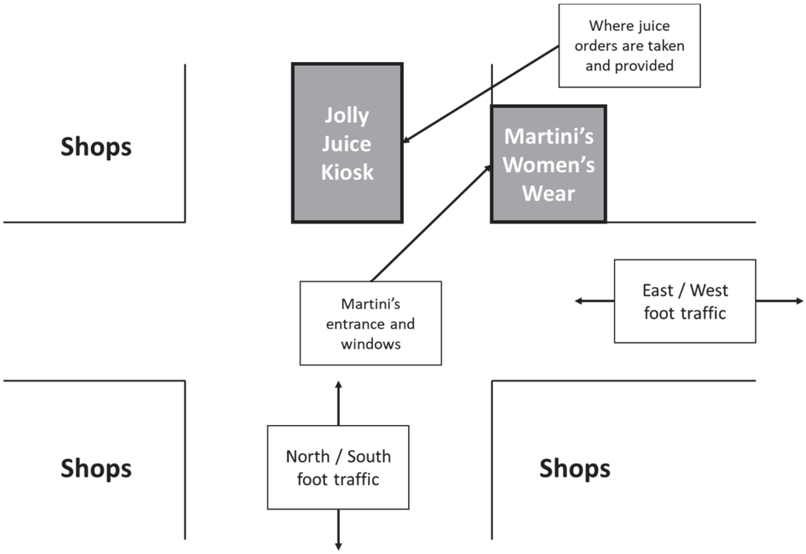

Figure 34 – Exhibit 12.2 Shopping Centre Layout

Martin was a difficult and obstinate person who rejected this and demanded $100,000 and a complete reconfiguration. Volt refused this and withdrew its previous offer. Volt maintained that there was no loss in sales as a result of Jolly Juice.

The dispute escalated and was headed to court. As preparation for the court case, Volt engaged a clever forensic accountant (Dante), to analyse sales figures who determined there was no loss of income to Martini.

Martin engaged a few experts, including internal and external accountants who couldn't find any losses. This enraged Martin even more, and he was beginning to think that he should have taken the $5,000 settlement sum as it was becoming a reality to Martin that if he now wanted to drop out of the negotiation, he would have to pay the other party's costs, which was beginning to add up.

Finally, Martin engaged Carl who was a Forensic Accountant and was prepared to do an in-depth investigation. Carl carefully analysed Dante's (Volt's Forensic Accountant) Report. Carl saw that Dante had compared all the sales figures to a base month and that the chosen base month was when the shop was undergoing some renovations and closed for a week, and thus this base month's sales were well under Martini's normal sales level. Carl had unearthed a clever statistical manipulation.

After adjusting for this it became clear that the sales for Martini after the introduction of the Jolly Juice kiosk had not increased but actually slightly decreased when compared to a more typical sales base. This meant that the Martin now had a case and more importantly was less likely to pay for Volt's legal costs.

There was then a follow up mediation and Volt quickly reinstated their original offer which was quickly accepted by Martin. Unfortunately, Volt then refused to renew any of Martin's leases in any other Volt shopping centres confirming the saying "*If you win your legal dispute you lose. But if you lose the dispute you are really in trouble!*"

This bitterly fought dispute created a change in shopping centre procedure. All shopping centres now require the tenant agree to a casual mall licensing clause that gives more rights to the landlord. It is another example of risk management, and in this case, it was instigated by the landlord. If you are a shopping centre executive, or lawyer for the shopping centre, do not forget this clause – see cartoon, below.

Figure 35 - The poor shopping centre executive stutters… "I forgot to include in the lease (sob sob) a casual mall licensing clause (sob sob) …"

12.3.4 Case Example 4 – Jasmyn and the public service - Unethical legal practices

Jasmyn worked for Simply Corporate, a corporate clothing company which also had a factory outlet. Simply Corporate provided corporate clothing for many customers including a branch of the Government department, Department X. The Outlet shop carried garments with an embroidered logo for the Department and was under a contractual obligation not to supply garments with a logo to anyone except Department employees

For an unknown reason the Department orders for uniforms significantly declined. Simply Corporate tried contacting the Department, however this was without success.

One day a person came into the factory outlet and requested a blouse from the Department's corporate clothing range. Jasmyn explained she could not sell without some form of ID otherwise she would have to remove the logo. The customer did not have any ID and said it was ok to remove the logo. As Jasmyn started unpicking the logo the customer said she was in a hurry and would unpick the rest herself. Jasmyn said she could not do this.

The customer insisted and said she had an emergency to attend. Jasmyn reluctantly allowed the customer to take the blouse. One hour later the company secretary of Simply Corporate, Steve, received a 3-page detailed letter from the lawyers for the Department terminating the supply contract due to a breach of the clause requiring security of supply to the Department employees.

Simply Corporate was very upset to be treated in this manner and took legal action for breach of contract. At the compulsory mediation the Department was forced to provide relevant emails. These emails proved very embarrassing for the Department as it detailed the Department's unethical plan to move suppliers.

Based on the above emails Simply Corporate felt that it had a good legal case, but it knew that it had to prove to the court what loss it has sustained due to the Department's breach. It would be this provable loss, plus legal costs, that the judge would order to be paid to Simply Corporate. To get a formal estimation of loss Simply Corporate hired a forensic accountant. Unfortunately, the forensic accountant could not provide much assistance as orders had been low, meaning that there had not been much loss of profit.

However, the lawyer representing Simply Corporate was a lateral thinker and argued for compensation for the potential loss due to the conspiracy of not ordering.

Simply Corporate was now very determined to proceed to court due to the Department's unethical behaviour and knew that the Department would not go to trial, as it had to avoid the negative publicity. Eventually before trial the Department, probably fearing the expected public relations disaster, offered a 6-figure compensation sum and also to purchase all back stock on hand. Simply Corporate accepted the offer and the case was settled without taxpayers finding out how much money their unethical public servants had cost them.

12.3.5 Case Example 5 – Vexatious building owner and the Not for Profit (NFP)

Mr Vexatious purchased a building and decided to use its own property management agency to handle the property rental collection rather than the one that the vendor was using. Under the original lease the tenant, a small not for profit organisation (NFP) paid a bond of $3,000 to the original property management agency.

Unfortunately, the original agent had poor bookkeeping and did not issue statements, and the new agency stated that the bond, if paid, would have been simply credited against rental payments. This was only an assumption.

The NFP had always paid every month's rent on time and stated that all rent was paid as and when required and thus considered that the bond still had to be refunded to NFP. Notwithstanding this information Vexatious still insisted it had not been paid.

NFP through its clever Treasurer stated that the lease required the bond to be held separately by the property management agency, and thus the rental was an issue between the vendor and purchaser and not the tenant. NFP considered that the property settlement statement between the property seller and buyer should show this, and consequently Vexatious is suing the wrong party. That is, Vexatious should be the suing the previous owner, the previous agency or perhaps their lawyer for not checking the lease, but **not** NFP, the current tenant. NFP produced substantial documentation to show all payments were fully made and recorded.

NFP was finishing up their lease and relocating to new premises. The advisor to NFP stated the only way of getting the bond back would be unfortunately to withhold the amount from the last rental payment otherwise it would have to take Vexatious to court. The advisor also stated that legally one is not permitted to offset bond against rental payments.

Vexatious ignored all the facts and requests and continued to batter the tenant with strong demands to pay and even stronger threats of litigation. This caused considerable distress to the NFP staff as $3,000 was a lot of money for it, and despite suggestions from the NFP staff to "just pay it", NFP stood firm, and it illegally withheld the last month's rent knowing that it was the only way to stop the loss of the $3,000.

Vexatious then took the NFP to the Victorian Civil and Administrative Tribunal (VCAT) to obtain the $3,000. Vexatious' application documents were poorly drafted and deficient in several respects, while the NFP's documents were detailed and professionally presented.

Prior to the hearing the VCAT Member rang representatives of both sides. The NFP Treasurer explained:

- that Vexatious was bullying NFP, proceeding against the incorrect party, the claim against NFP clearly was a fraud and NFP was not backing down.
- That NFP had taken legal advice and was advised that NFP has the legal right to claim costs because the Vexatious case had no merit and wasted NFP's time and money. The VCAT Member was requested to advise Vexatious that if it continued Vexatious would (1) lose the case as NFP had conclusive evidence that the rent had been paid, and thus nothing was owing; and (2) NFP would press for payment of its legal costs.
- Not long afterward VCAT advised that Vexatious had dropped the case.

12.4 Questions

1. What are the key takeaways from the Case Examples?
2. What factors should one consider when taking legal action.
3. What could go wrong when one takes legal action?

12.5 Suggested responses to Questions

Question 1:

What are the key takeaways from the Case Examples?

12.5.1 Suggested response:

Case Example 1 – Con and looking at creative ways to resolve a small dispute

This Case Example highlights the importance of understanding the motivations behind the various parties. It shows that there are often alternatives to what sometimes can appear to be intractable positions.

Case Example 2 – Mary and the unfair subscription renewal clause

- This is an example of the importance of good record keeping and going through the history carefully to find evidence for an argument to resolve the dispute.
- Note that Automatic renewal clauses may be considered unfair under the Small Business Unfair Contract Terms legislation (which is Sections 23-26 of Schedule 2 to the Commonwealth's Competition and Consumer Act 2010).

Case Example 3 - The retailer and the shopping centre forensics case

- This is an example of the danger of being blinded by principle and the lack of being commercially reasonable.
- This is also an example of the benefits of using an expert who knew how to find the information needed to enable Martin to argue from a position of strength and mount an effective retreat. It seemed that the expert for the shopping centre set up a smokescreen to take away the attention from the weakness in the shopping centre's argument.
- It also shows that you should not antagonise your landlord – the tenant will never be able to rent from that shopping centre landlord again.

Case Example 4 – Jasmyn and the public service - Unethical legal practices

- Unfortunately, there are many unethical people in business ready to take advantage, but you do not expect this from your public servants.
- This is an example of when sometimes principle may be an important issue to fight for and getting an experienced lawyer to assist.

Case Example 5 – Vexatious building owner and the Not for Profit (NFP)

- There may well be times when a payout is warranted on a cost/benefit basis. Insurance companies do this if it is cheaper to pay out the claim due to the high legal costs involved in pursuing the "morally right" course of action.
- However, there are other times, as in this Case Example, which warrant resistance to pressure. To do this it is very helpful to have time, energy and strong independent evidence to back up your argument.

> **Question 2:**
>
> What factors should one consider when taking legal action.

12.5.2 Suggested response:

- The cost/benefit of any actions should always be analysed, particularly where legal costs can escalate quickly. This is not dissimilar to preparing a business case regarding a commercial decision. Business cases are mentioned in Case Study 3 – Business Structure II - Capital Purchase Evaluation.
- Also, determine the estimated resources (including time and money) needed to invest in mounting a strong case, remembering that every minute that you fight a case is a minute that you are not devoting to your core business. Any case should be carefully evaluated on the basis of:
    - What are the merits of the case?
    - What are merits of the opposing party's case?

Question 3:

What could go wrong when one takes legal action?

12.5.3 Suggested response:

- The legal system is unpredictable, and matters may arise that are unexpected. For example, there is always a possibility that during the case the other side uncovers that you, or a since departed associate, wrote a letter, sent an email etc that you have forgotten about but is very damaging to your case.
- Because of the adversarial approach, you must depend on your lawyer's ability to argue the case. Normally the better the lawyer, the higher the fee you need to pay. There are two types of lawyers if you litigate in court:
    - Barristers: A barrister is a lawyer who appears for a client in court and may give advice on complex areas of law. In 2019 a Melbourne senior barrister, called a "Queens Counsel", "Silk", or "Senior Counsel", charges from $5,000 + GST to $12,000 + GST per day. Some top QCs in the tax area can charge up to $30,000 + GST per day as do some top QCs in the public company competition law arena. The rule of thumb is that the junior assisting the QC, called "junior counsel", charges two thirds of the QC's rate, but this is not always followed, particularly with the very high-priced QCs.
    - Solicitors: A solicitor is a lawyer who does the out of court paperwork in preparation for a court case. These fees must be paid in addition to the above barristers' fees.
- There is also the possibility of having costs awarded against the losing party, increasing their costs. When considering the above barristers' and solicitors' fees this can be a significant burden.
- You never know what "dirty laundry" will appear. So, if there is a possibility of this occurring then ensure that arbitration (which is closed to the public) rather than to litigation (that is open to the public) is pursued.

12.6 Postscript

Disputes are a normal result of human relationships where misunderstandings or differences of opinion arise. One of the many causes could be substandard contract drafting where the intention of the parties and their agreed deliverables are ambiguous. Good contract management usually limits these disputes, but It is likely that at some stage in your commercial life you will be faced with the possibility of an unresolved dispute. As has been seen in the above Case Examples you should try to resolve the dispute as quickly as possible as a prolonged dispute costs more to resolve and relationships may be damaged. Keep it simple and keep egos out of it. Etch into your mind the quotation at the beginning of this case that "If you win your legal dispute you lose. But if you lose the dispute you are really in trouble.

Notes

Chapter 13

Case Study 13 – Importing and Exporting

If we can't export the scenery, we'll import the tourists

William Cornelius Van Horne (President of the Canadian Pacific Railway, 1888)

13.1 Brief Overview

Australia has one of the most open economic markets in the world. It is therefore likely that most people involved in business in Australia will be presented with opportunities to import and/or export finished goods, services or raw materials for further processing. These opportunities present an exciting method to innovate and to be competitive in an open market. Australia has been reducing trade barriers and entering into free trade agreements since the early 1970s.

The downside of this change is that many local high labour cost manufacturing industries have lost competitiveness and have therefore closed or moved manufacturing offshore to lower cost countries. However, the positive is that new Industries have opened or expanded due to the open nature of the global economy, for example education, medical technology, pharmaceuticals, wine and sophisticated knowledge-based technology. Australia is a country of choice in many product areas due its reputation for its educated workforce and high-quality control, for example infant milk formula.

A business starting to import or export for the first time will need to be aware of the key aspects of international trade which make trade more complex than local purchases/sales. There are thus many issues and traps that one must be aware of, and we will highlight some of these in the Case Examples, but we will first provide a background to importing and exporting. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

13.2 Background to the case Study

13.2.1 Advisors

Whether importing or exporting it is vital to obtain a good reliable set of advisors that help guide you through the process. These include:

- Private sources:
    - Accountant – Advising on costing and pricing, as well as any taxes, which may include withholding tax, GST/VAT (value added tax/goods and services tax) etc.
    - Customs Broker – Handling documentation with Australian Customs (now part of the Australian Border Force, ABF, which is a part of the Department of Home Affairs: see *www.abf.gov.au*).
    - Customs Consultant – may be required for more complex issues including Tariff problems.
    - Forwarding Agent – To arrange international transportation.
    - Shipping Manager – Employ part/full time if possible
- There are also various government support agencies that encourage commercialisation and innovation, for example Austrade (*www.austrade.gov.au*) and there are also a number of tax incentives available.

13.2.2 Importing

Certain items purchased from outside Australia (imported) must be cleared by Australian Customs which now is part of the Australian Border Force, ABF, which is a part of the Department of Home Affairs: see *www.abf.gov.au*. There are many different costs, and include clearance fees, customs duty, goods and service tax (GST). Some goods may require special clearances for either importing or exporting, for example foodstuffs (particularly meat or dairy), chemicals or items requiring quarantining.

13.2.3 Exporting

Selling to overseas customers (exporting) requires substantial care to ensure necessary regulations and risks are managed, which include getting paid, managing the legal, foreign exchange, political, and shipping risks. As with importing Australian Customs must clear certain goods for export.

13.2.4 Decisions to make - Security of payment and trust

The first key decision to be made relates to the security of the transaction. For exporters this means ensuring you are paid, and for importers it means that you receive what you have paid for. Success here includes how well you trust the other party and/or how well they trust you.

An exporter may gain added security by insisting on a letter of credit, which is a document issued by a bank on behalf of a customer authorising payment to a supplier when the conditions specified in the document are met. The importer also gains some security in that it does not need to pay until their bank has documents indicating that its shipment is on its way. It does not, however, ensure that the contents are what was ordered, or of good quality, unless the letter of credit calls for a certificate of some kind from an independent authority with expertise in the commodity in question. In the absence of a letter of credit, "sight draft" terms, which also can be obtained through a bank, may at least ensure that documents are only passed to the buyer against payment, but if the buyer has changed its mind it may reject the draft leaving the exporter with goods arriving in a foreign country with no buyer. Unscrupulous importers may refuse a draft in these circumstances as a tactic to gain a discount.

If there is a high level of trust, often the simplest payment process is electronic funds transfer (EFT) direct to the supplier around the time of shipping and based on a verified supplier invoice.

13.2.5 Beware of corrupt suppliers and con artists

Caution is always required when dealing with any supplier, but especially when dealing with new overseas suppliers. Start by communicating with them as much as possible; call them regularly, visit the factory unannounced and always ask for product samples. If there is a problem with the goods, it is common for an overseas supplier to allow a discount of the following order rather than pay refunds. Whenever possible, meet the supplier face-to-face and arrange quality checks. Confirm and double check all details including bank accounts. There are fraudsters who specialise in hacking (obtaining access) to suppliers' emails and then pretending to be the supplier (see Case Example 4, below).

Figure 36 - Beware of corrupt suppliers and con artists

13.2.6 Terms of Trade

The next thing to be decided are what each party needs to do for the other and are called the "terms" of the transaction. These include who will pay, what are they paying for, how much they will be paying, when is payment due and who will pay for the many charges incurred between leaving the exporter's premises and arriving at the importer's door. There are a large range of terms, ranging from "Ex Works" (where the buyer pays for everything once the goods have left the seller's premises) to "Delivered Duty

Paid" where the seller pays for the lot. This latter term can be problematic if the country of destination has a goods and services tax, or "GST", as occurs in Australia (often elsewhere called a value added tax or "VAT") the importer may be entitled to a refund of the tax paid, but not the overseas exporter.

Among the most common terms are "FOB" (Free on Board) in which the exporter pays for all costs in its country up until and including the goods are loaded on the vessel; the importer pays the rest, including the ocean freight and marine insurance. But if an importer is new to international trade and is dealing with an exporter which ships constantly to the importer's country, it is likely that the exporter may be able to gain a much better freight rate, so terms of "CFR" (Cost & Freight) may be preferable. "CIF" (Cost, Insurance & Freight) may offer the same advantage with the marine insurance, but the importer should tread carefully here and ensure that a reputable insurer of substance, with reliable agents in the importer's country, is used. This is discussed in Case Example 1, below.

13.2.7 Security of goods

The document known as a "bill of lading" (*not* "loading") as well as being an agreement by the ship's agents for carriage of the cargo, is also usually a *title document*. This means that whoever first arrives at the offices of the shipping agent at the destination port with a valid *original* bill of lading (there are usually two or three originals issued to allow for contingences including mail going astray) is entitled to take delivery of the goods. A risk is that the Bill of lading can be transferred to another person who is not mentioned on the Bill of Lading. Consequently, *original bills of lading should be treated as if they are cash to the value of the cargo*. As many things can go wrong in the transportation part of the deal it is vital to have good relationships and use reputable agents.

13.2.8 Marine Insurance – and General Average (GA) Insurance

It is customary to insure for 110% of the CIF value – to allow for costs incurred in the event of a claim. It is also important that a reputable marine insurer be used, that is re-insuring with an insurer such as Lloyds. On occasions, albeit rarely today, an event may give rise to a "general average" being declared, and in such a case the cargo-owner may find themselves liable to pay compensation to other cargo-owners.

This practice dates to the days of sailing ships when many sea voyages ended in tragedy. Each voyage was considered an "adventure" undertaken jointly by the owners of the ship and those with a pecuniary interest in the various cargoes it would carry. When rough seas were encountered, it might sometimes be necessary to jettison certain cargo in order to save the ship and the remaining cargo from peril. In such a case all parties involved whose property had been saved by the sacrifice of certain cargoes were required to contribute to a fund to reimburse those traders whose cargo had been abandoned – in proportion to the value of their interest in the venture, be it ship or cargo. This provision, currently known as the *York-Antwerp Rules* 2014, remains as part of the Law of the Sea and is printed on every bill of lading. See Case Example 2, below.

13.2.9 Other risks to consider

One risk not commonly considered is the capacity of the exporter to meet a large order. The inability to supply in times of high demand, such as Christmas, can hurt the buyer as much as delivering inferior product. Consequently, you need to have all necessary systems in place to ensure quality and quantity at all times.

Exchange rate risk is also an issue as any profit can be wiped out by a negative movement in the exchange rate. Often you cannot transact in Australian dollars when buying or selling internationally and this raises the risk of currency fluctuations, and thus it may be prudent to take out some insurance, called foreign exchange hedging. However, this can be expensive.

There is also the danger of having your valuable intellectual property (IP) stolen, for example your product is illegally copied overseas. One of the authors purchased a new pair of sport shoes in Bali, and when he inspected them in the hotel, he noticed the top of the shoe was marked Adidas and the bottom Nike! While it is common to manage your own IP in Australia, when dealing with overseas it is recommended that a specialist be retained. See Case Studies 10 and 11 on Intellectual Property issues.

13.2.10 A list of the main *exporting* risks and how they could be mitigated

Risk: Getting paid

Mitigation:

- Get paid in advance
- Use letters of credit
- Use a buyer who you have a good relationship with.

Risk: Adequate sales prices

Mitigation:

- Obtain all relevant facts (all the different costs, the overseas market, what competitor and substitute products are selling for etc)
- Know the gross profit margin you seek
- Where necessary use an experienced accountant to determine how much you need to sell the goods for.

Risk: Quality – Need to obtain the agreed quality

Mitigation:

- Ensue that you clearly understand what the buyer wants especially with customers from non-English speaking countries.
- Send a quality check – that is a small quantity of goods, say 5% of the total contract, to get the buyer's approval before sending the bulk to the customer

- Where necessary use experienced professional assistance (see list above).
- Use a customer who you have a good relationship with as they are more likely to work with you.

Risk: Damaged goods

Mitigation:

- Use the appropriate lower risk method of transport, and a reputable logistics company
- Use appropriate packaging that will help protect goods in transport.
- Insure the goods using a reputable insurer of substance.
- Where necessary use experienced professional assistance (see list above).
- Use a buyer who you have a good relationship with as they are more likely to help with the claim.

Risk: Late delivery - This is a real problem as our customer may not pay us at all (or pays only in part) if we deliver late as they may have missed a key period of demand, such as Christmas

Mitigation:

- Have systems in place to monitor process and advise the customer as soon as possible if there appears to be risk of late delivery.
- Insure the goods using a reputable insurer of substance.
- Have a force majeure clause in the contract
- Where necessary use experienced professional assistance (see list above).
- Use a buyer who you have a good relationship with as they may be able to assist in rearranging their affairs to reduce the effect of a delay

<u>Risk: Lack of trust with the other party – this is where the other party will try to use loopholes, or vague parts of the contact against you</u>

Mitigation:

- Change customers – this is easily said but hard to do. However, if possible, choose a customer where there is a better relationship, as they are more likely to work with you
- Where necessary use experienced professional assistance (see list above). An experienced adviser, or Austrade (www.austrade.gov.au), may be able to refer you to better customers.

<u>Risk: Quantity – our lack of capacity to meet a large order</u>

Mitigation:

- If our customer needs a large order, then do one or more of the following: (1) choose a supplier in advance, which may be one of your competitors, to increase supply at a short notice; or (2) ask for the customer to give us sufficient notice.
- Where necessary use experienced professional assistance (see list above). Advice may include how to deal with the customer or identify other suppliers.
- Use customers, and other suppliers, who you have a good relationship with as they are more likely to work with you

<u>Risk: Contract – inability to enforce your contract</u>

Mitigation:

- Seek payment before, or simultaneously, with delivery
- As it is hard (and costly) to litigate outside of Australia choose to make the law of the contract where it is easier to get judgment, for example Singapore, however, payment may still be a problem.
- Specify in the contract that disputes are to be resolved using arbitration under the "New York Convention" (1958) rather than litigation as arbitral award may be easier to

satisfy than a court judgment (see The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, known as "The New York Convention" (1958))

- Sell to a customer which you have a good relationship with as they are more likely to work with you, and thus there will be a lower likelihood to litigate
- Where necessary use experienced professional assistance (see list above). They can assist you to reduce the likelihood and consequence of problems that may lead to the need to litigate

<u>Risk: Exchange rate gains / losses</u>

Mitigation:

- Hedge the contract through a financial institution (but this may be costly)
- Build "rise and fall" clauses into the contract
- Where necessary use experienced professional assistance (see list above).
- Sell to customers who you have a good relationship with as they are more likely to work with you, and where necessary assist in the structuring of payments

13.2.11 A list of the main importing risks and how they could be mitigated

<u>Risk: Quality – Need to obtain the agreed quality</u>

Mitigation:

- Trust between the organisations
- Ask the supplier for a sample check. This could be 5% of total quantity of goods sent to check the quality.
- Need clear communication and "triple check" all specifications so the supplier is sure of what is required, especially with manufacturers from non-English speaking countries.
- Where necessary use experienced professional assistance (see list above).

Risk: Adequate purchase cost

Mitigation:

- Obtain all relevant facts and costs to determine how much you should pay (this is just another procurement, but as it is from overseas, it is one with more risks)
- Know the gross profit margin you seek
- Where necessary use an experienced accountant to determine how much you need to pay for the goods.

Risk: Damaged goods – This means we cannot meet our commitments

Mitigation

- Use the appropriate lower risk method of transport, and a reputable logistics company
- Use appropriate packaging that will help protect goods in transport.
- Insure the goods using a reputable insurer of substance, and where necessary make a claim.
- Having a good relationship with your supplier helps – you may not get a refund, but you may get a credit on the next shipment.
- Where necessary use experienced professional assistance (see list above).

Risk: Late delivery:

- This is a real problem. If we are a:
- retailer then we may have missed the peak season, say Christmas.
- wholesaler then we may have missed our customer's peak season meaning they may (1) refuse to pay, or (2) they will pay us, say, 50% of the agreed fee, or (3) sue us for the loss of profits they may have made.

Mitigation:

Regularly follow up

- Where necessary use experienced professional assistance (see list above).
- Insure the goods using a reputable insurer of substance.
- Use a supplier who you have a good relationship with as they may be able to assist in rearranging their affairs to reduce the effect of the delay

<u>Risk: Lack of trust with the other party – this is where the other party will try to use loopholes, or vague parts of the contract against you</u>

Mitigation:

- Change suppliers – if possible, get one that where there is a better relationship, because you cannot detail everything in an agreement (assuming you will be able to enforce it)
- Where necessary use experienced professional assistance (see list above). The adviser may suggest a more appropriate supplier.

<u>Risk: Quantity – lack of capacity of the exporter to meet a large order</u>

Mitigation:

- If you feel that you need a large order, then do one or more of the following: (1) choose a supplier who can increase supply at a short notice; (2) give sufficient notice; or (3) have another supplier ready to do this, which is a reason why some importers have more than one supplier.
- Where necessary use experienced professional assistance (see list above).

Risk: Contract – inability to enforce your contract

Mitigation:

- Pay after, or simultaneously, with delivery, but unless there are exceptional circumstances the general rule is never pay a supplier before delivery.
- As it is hard (and costly) to litigate outside Australia choose to make the law of the contract where it is easier to get judgment, for example Singapore, however, payment may still be a problem.
- Specify in the contract that disputes are to be resolved using arbitration under the "New York Convention" (1958) rather than litigation as arbitral award may be easier to satisfy than a court judgment (see The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, known as "The New York Convention" (1958))
- Buy from a supplier which you have a good relationship with as they are more likely to work with you, and thus there will be a lower likelihood to litigate
- Where necessary use experienced professional assistance (see list above). They can assist you to reduce the likelihood and consequence of problems that may lead to the need to litigate

Risk: Exchange rate gains / losses

Mitigation:

- Hedge the contract through a financial institution (but this may be costly)
- Build "rise and fall" clauses into the contract
- Where necessary use experienced professional assistance (see list above).

13.3 The case study Facts

13.3.1 Case Example 1 – Joe and terms of trade

Joe was the shipping manager for DEF Pty Ltd and arranged for goods to be imported into Australia from Organisation X in the newly created X Republic in eastern Europe. Joe advised his General Manager at DEF Pty Ltd that it should be done on an FOB (Free on Board) basis, where the exporter pays for all costs in its country up until and including the goods are loaded on the vessel; the importer pays the ocean freight, marine insurance and all charges at his end. Joe's reasoning is that it would be better for DEF to be in control of any insurance claims.

The DEF General Manager, however, insisted on using CIF terms (Cost, Insurance & Freight), where the insurance was provided by the exporter. Joe reluctantly agreed as it appeared to be a cheaper option for DEF Pty Ltd because the exporter agreed to cover the insurance for no extra cost.

The goods were exported from the X Republic but were water damaged upon arrival. The insurer was an arm of the X Republic government. After 18 months of fruitless correspondence with the insurer it became very clear that the insurer had no intention of paying what was clearly a valid claim.

By chance Joe found himself chatting to a lady at *Phantom of the Opera* concert, who introduced herself as the new X Republic Consul-General. Joe seized the opportunity to politely tell the tale of woe. His influencing skills were working well that evening because DEF received a full settlement within 10 days! Without this chance meeting Joe's company, DEF, would certainly have not recovered the money.

13.3.2 Case Example 2 – Joe and general averaging

Over the years Joe was involved in five general average (GA) cases. For an explanation of GA see Section 13.2.8, above. A recent example is the vessel "*YM Efficiency*" which lost 80 containers overboard due to bad weather.

The vessel which caused Joe the most stress, however, was called the *Golden Orchid Junior*, carrying 172 containers of paper from South America. This vessel was damaged by fire not once but twice, resulting in *two* "general averages" being declared.

One of the containers jettisoned to save the *Golden Orchid Junior* vessel was rumoured to contain gold bars; certainly, the compensating charges to the other customers not affected, including Joe's company, seemed to support this theory. While some of Joe's containers were jettisoned in the first fire to stop the ship from listing, in the second outbreak Joe's goods were kept safe by the sacrifice of others' cargo, making him a nett beneficiary of one GA and nett contributor to the other. Over the next three years, the legal documentation arising from this shipment grew to the point where a vacant office had to be found to contain it. True!

Experienced importers/exporters normally recommend the management of such a case using an insurer with expertise in marine matters. However, a surprising number of importers and exporters seem to take risks by incorporating their marine insurance under a "catch-all" policy with an inexperienced insurer or one that does not have a good reputation in the industry, for example the insurer in Case Example 1, above.

Figure 37 - It is not always best to do things yourself…

13.3.3 Case Example 3 – Fanny and the export pricing

Fanny had a business of selling papier mache artwork to local businesses.

She contacted an agent that was able to put her in touch with a potential export market for her to sell in China. She knew she needed 54% Gross Margin to make enough profit to cover all her costs and to give her a return on her time, and the working capital invested.

She had eight different products. The overseas agent advised using one price for all eight items to keep the export negotiations simple, however as each of the eight products had different costs this meant the gross margins would vary from 35% to 70%.

Fanny's accountant, Tom, disagreed with the agent's advice and suggested that from both a longer-term marketing view and potentially competitive aspect Fanny should group the products into categories that will broadly achieve the gross profit targets. By grouping the 8 products into 3 categories, the gross margins all ended up being approximately 54% with only a small variance.

Having one product that has added or better features than another product but both selling for the same price can be confusing to customers as they may wonder if the first product is too cheap or the second one too expensive. Thus, grouping the 8 products into 3 categories was beneficial as it provided a consistent message to customers.

Tom also noted that many of Fanny's costs needed to be adjusted as they did not properly allow for overheads, such as freight and duty, agent's fees etc. Fanny took note of all this advice and changed her costing and resulting prices. The result was very beneficial for her.

13.3.4 Case Example 4 – Joe (again) and the bank account

Joe received an email from a supplier stating the supplier bank account had changed and requested payment on an invoice.

The email address had one letter different to the normal email and Joe thought that it would be prudent to ring the supplier to check that all details were correct. It is lucky that Joe was vigilant as the supplier stated that they had not changed the bank account. That is, someone had hacked (accessed) the supplier's email account, copied the supplier's invoice and sent this to the buyer with the new bank account details. Had Joe not checked this, his company would have lost $100,000. Whilst this can also happen locally there is more risk with overseas transactions due to more potential communication difficulties.

13.4 Questions

1. What are the main risks in each Case Example and how could each be mitigated?
2. What are the main benefits from exporting and importing?

13.5 Suggested responses to Questions

Question: 1:

What are the main risks in each Case Example and how could each be mitigated?

13.5.1 Suggested response:

Case Example 1 – Joe and terms of trade

- Risks:
  - Not a reputable insurance company of substance
  - Thus, claiming may be hard or impossible.
- Mitigation:
  - All terms of trade, foreign exchange and freight choice need to be carefully reviewed before entering into contracts, this includes the insurance clause and the choice of insurer.
  - Experienced professional assistance is invaluable.
  - Use a reputable insurance company of substance.

Case Example 2 - Joe and general averaging

- Risks: You may not lose cargo but if others lose valuable cargo then you may need to make a large financial contribution.
- Mitigation
  - Use the services of an experienced insurance agent that understands how marine Insurance works.
  - Use another way of insuring your cargo
  - Use a reputable insurance company of substance.

Case Example 3 - Fanny and the export pricing

- Risks: Incorrect pricing of your exports will affect your revenue received, your profits and even may result in insolvency.
- Mitigation:
  - Export pricing may be complex, and all direct and overhead costs need to be carefully calculated.

   - The pricing structure also needs to be set with knowledge of what is likely to sell overseas in the overseas market.
   - When pricing it is often prudent to compare your local price with an international product. Remember that due to currency fluctuations pricing for a particular profit is more difficult when one uses non-local currency, for example the US Dollar. This is why a McDonalds Big Mac burger has in the past been used as the default for this purpose. This is where you compare your local price to that of a local burger and do so again when looking at the price of a burger in the foreign market. However, today it is more accurate to compare to a product within your industry, so perhaps checking to see what a local papier mache product also sells for in the chosen export market would be useful.

<u>Case Example 4 – Joe (again) and the bank account</u>

- Risks: Insufficient care to even the smallest detail could be very costly.
- Mitigation: Be extra vigilant, and especially so when dealing with overseas transactions. Check everything! This scam should be noted and any requests for change of bank account be thoroughly investigated.

Question 2:

What are the main benefits from exporting and importing?

13.5.2 Suggested response:

<u>Exports:</u>

- The ability to expand the range of customers from the local to international brings many additional opportunities.
- The larger the pool of economic activity, the larger the potential for smaller players to carve out a niche for themselves.
- This is particularly valuable when developing a new and innovative product where there may be more customers overseas. Government programs can also assist.

<u>Imports:</u>

- To remain competitive, you may need access to lower cost supplies, and this is more possible now due to easier access to suppliers in low cost countries.
- The ability to expand the range of suppliers from the local to international may provide access to higher quality supplies or supplies not able to be obtained locally. This results in a competitive advantage.
- Each country often has its own strengths and expertise, and if possible, a business should take advantage of them.

<u>Note:</u>

See Section 13.2.10 for the main exporting risks and Section 13.2.11 for the main importing risks.

13.6 Postscript

Importing and exporting can greatly benefit an organisation, however there are many traps for those who are starting off. Careful planning is a critical issue, and where necessary use competent assistance, including insurance advice.

Notes

Part 3 – Ending the Business

Figure 38 - Ending the Business

This Part covers the following Case Studies...

14. Ending the Business

Notes

Chapter

14

Case Study 14 – Ending the Business

Always the last day of anything is the first day of something new

Paul McCartney

14.1 Brief Overview

All businesses inevitably go through some form of exit, be it via succession, sale, merger, takeover or close. As with the starting and operating a business, which we have already covered in detail, our preparation will affect our success in the exit stage.

A business owner normally likes to run their business how they want, for as long as they want and then sell quickly and easily when they want for a very large price. However, the reality is often that the best exit may be at a time that is not convenient to the owner, the exit process is more complicated than expected, it takes more time to exit and the money received in the exit is less than expected.

Albert Einstein wrote "A man should look for what is, and not for what he thinks should be", and we can paraphrase this by saying that the owner should see the business as is, not what the owner thinks it should be. The reasons for this will be explored in the below Case Examples and in understanding the exit process the owner should be better prepared to avoid common pitfalls and gain greater value out of the exit process. First, we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

14.2 Background to the case Study

14.2.1 Overview

Usually the more control the owner has when exiting, the higher the value extracted, and conversely loss of control often results in higher unavoidable costs which reduce the value the owner obtains upon exiting (see the Exhibit and Case Example 1 below).

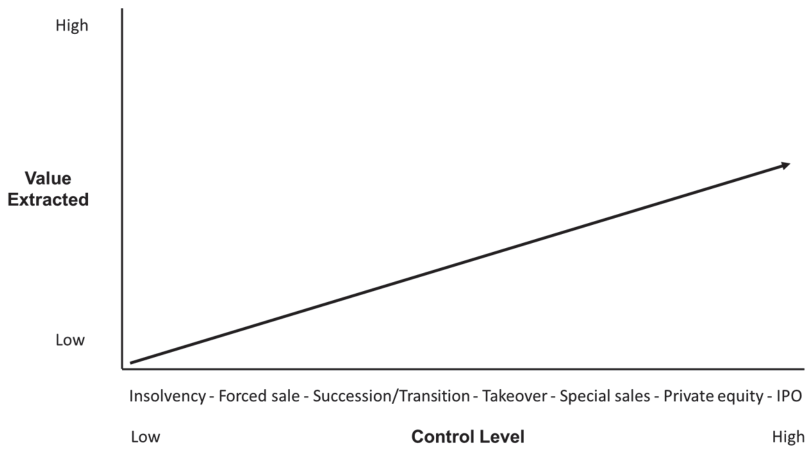

Figure 39 – Exhibit 14.1 The Exit Value Chart

<u>Note</u>: In relation to exiting from a failing business it is always better to be able to exit on your own terms (called an "informal" exit) than have it forced on you (called a "formal" exit). This allows you time to organise your affairs, and this will be illustrated in Case Example 1, below.

14.2.2 Methods of exit

<u>Overview</u>

Each of the formal and informal methods of exit described in the above Exhibit will be discussed below. Many of these options can also be applied to a part of the existing business rather than whole business. Public companies are often active when they take over a company and frequently wind up any poor performing divisions, improve and sell off divisions and even split up a newly formed consolidated company. Australian examples include Wesfarmers and Coles Myer.

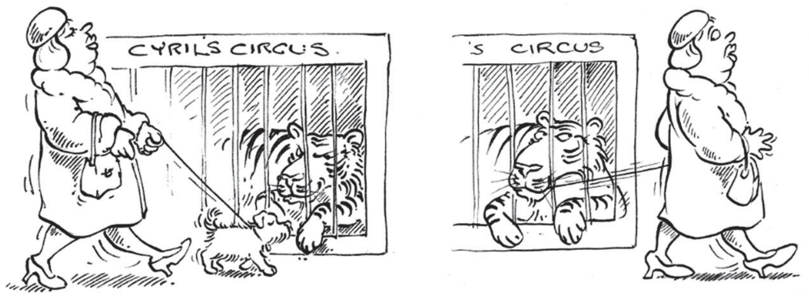

Figure 40 - In business keep an eye on things as they may exit without you realising it!

Insolvency

There are a number of possible formal insolvency actions including receivership, administration, liquidation and personal bankruptcy. Care is needed with these formal options as insolvency practitioners are well known for charging high fees for a long duration and often leaving little or no money for the original creditors and owners/shareholders. A business can alternatively conduct its own informal close down process. This is where the owner negotiates with creditors (those who are owed money including the bank) to allow an orderly sell off of the assets in order to pay the creditors out. If the creditors trust the owner(s) they may accept this option as often they will receive more money with less paperwork. This may result in the owner achieving value close to the next exit level method along in the above Exit Value Chart, that is the forced sale. The informal close down is perhaps the most common method of all business exit, and is illustrated in Case Example 2, below.

Forced sale

Often when the business is profitable, but for a variety of reasons the owner is not able to continue (for example illness), the owner must accept whatever offer is available or be faced with an insolvency position. This is the forced sale method of exit.

Succession

This is where the business is sold to another party, which may be to related people, unrelated people or even to the management team (known as an "MBO", Management Buy Out), or a combination of these options. Usually this will achieve a reasonable value for the owner but because of the close relationships, especially in family succession, the sale is often on special or discount terms. In the 2018 KPMG Enterprise and Family Business Australia survey, 60 percent of respondents said they plan on passing the leadership of their business onto another family member. For a discussion regarding succession and family business see Case Study 4 (Family Business).

Takeover

When the business has grown to the stage of being consistently profitable and has a good reputation in its market, it will be attractive for another company. A competitor, for example, may wish to take the business over (called a "trade sale").

Special sale

This a type of sale of business where the buyer can extract extra value because of the business asset being purchased. A common example is a high-tech company that has developed a proven innovative technology but lacks the resources to commercialise it. A large company in the same industry will often pay a premium to save themselves from the need to develop the proven innovative technology. For the small high-tech company, it is high risk strategy to seek to develop a new product(s), but if a sale can be made then there can be very high returns.

Private Equity sales (also known as Secondary market)

Another method of buying and selling a business is through the private equity secondary market. This is where a group of private Investors using management experts buy Investments, often a business, and within a relatively short period try to restructure, improve and sell it off for a profit. Some recent high-profile cases where the private equity players have made large profits at the expense of Australian shareholders have shown private equity in a poor light (for example Dick Smith and Myer). Nevertheless, there is an important place for this specialised option.

IPO – Initial Public Offers

This is when the business reaches a size and market reputation where it can offer shares in the company to the public for the first time. The terms of how this occurs and how much equity the owner retains varies depending on the situation.

14.2.3 Mergers and acquisitions

Mergers and acquisitions (M&A) are transactions in which the ownership of companies, other business organisations, or their operating units are transferred or consolidated with other entities. A merger is where two organisations will join together to form a new merged company, and an acquisition is where one company buys all or part of a target company.

14.2.4 The long process

Overview

When you factor in all the things that must be managed before the exit finally happens, you will realise that you need to allow considerable time. Many large corporations usually have enough resources on hand to quickly negotiate buying and selling and do this often. However, this is not the case with SMEs (Small and Medium sized Enterprises) as they do not have these resources.

The typical process

The typical process is as follows and generally proceeds in the following order:

- The Initial driver (for example retirement, sickness, drive to do something else etc) occurs

- Deciding when is the best time (assuming the owner has a choice. In the case of illness, divorce, creditors pressing for money there may not be a choice)
- Preparation of business for exit
- Putting together the advisory team
- Agreement on process
- Finding the appropriate business agent to help sell it
- Preparation of sale document/preparation of MBO (Management Buy Out) agreement
- Final agreement signed
- Hand over process
- Earn out/warranty period.

Prepare for exit when you begin

Always be prepared to exit the business and be able to do so quickly, as sometimes you are presented with an opportunity that may be too good to refuse. Preferably do this when you set it up so that it is simple and inexpensive from the beginning to legally and commercially separate and sell all or part of it off. An example is Qantas Airways. When it set up its low-cost subsidiary, JetStar, it was set up separately so that it could be easily separated and sold off.

Figure 41 - Always have the ability to exit quickly – as you do not want to get stuck in a business which is not meeting your goals.

Getting the Business and the Owner ready for exit

Some of the exit processes can move quickly (see Geoff in Case Example 1, below), but most of the exit processes usually take considerably longer than expected and as a result sufficient time should be allowed to prepare for the exit. Care is required as to when the process should begin. The process should commence when it is simply the best time for the business, which may not necessarily suit the owner.

Think like the buyer

The best way to get the business ready for sale is to think like a buyer, that is what would the buyer want to buy? The answer usually is that they would like to buy an efficient, well-administered, high morale company with the necessary assets to run it and with sought after goods and services. However, often accurate and up to date accounting processes are not mentioned but are vital in any sale.

One of the authors assisted a business owner in an industry which substantially depends on a website for the continuity of the business. The owner paid a very large amount of money for a first-class website, however unfortunately he did not read the website construction contract which stated that the web developer owned the intellectual property rights to the website. Thus, any alterations to the web site could only be made with the developer's permission, and if the business was sold then a separate agreement would need to be made between the developer (the owner of the website) and the purchaser of the business, for the ownership of the website. This thus was a total disaster for the owner as the lack of legal ownership of a vital asset of his organisation substantially reduced the value of the business. This was unfortunately caused by him signing a contract that he did not read. For further discussion on the intellectual property aspects of copyright and licencing see Case Study 11

One of the authors knows of an experienced businessperson who advocated having accurate and transparent accounting in a simple corporate structure. He had sold a business before and knew the process. When he went to sell it to the prospective buyer, a large South African company, the buyer insisted on performing a due diligence on the company being sold. Due diligence is an extensive process undertaken by a prospective buyer in order to thoroughly and completely assess the target company's business, assets, capabilities, and financial performance. The prospective buyer's investigative accountants took several weeks to study the accounts and by the end of the due diligence process found no reason why the prospective acquirer should not buy the target company's business. The businessman sold his share for a substantial price. There was also an "earnout" clause in the contract which meant some of the sale price was linked to future profits while the businessman had to work for a couple of years in the company and managed the transition. Earnout will be discussed below. Interestingly, although the sale process went smoothly there was a dispute later regarding the earn out clause.

Focus on the key competitive advantage

If a business is running successfully then by definition it has some form of competitive advantage. Competitive advantage could include one or more of the following:

- tangible things (product, plant and equipment etc)
- intangible things (intellectual property)
- the people.

Of the three above points buyers often focus only on the first two, but the third, people, is just as important. The reality is that any buyer would also want the people to be well organised, passionate, motivated and willing to commit and provide assistance above their basic duties to a receptive management.

When a business loses focus and goes off on tangents then this will affect its competitive advantage. In Section 1.3.2 in Case Study 1 (Choice of Business) we saw how Tommy, the smart Electrician, lost focus and purchased dressing gowns. His business would be more valuable and profitable if it focused on its key competitive advantage, that is on core business.

How the sale price is calculated

There is no one agreed method, but some of the methods include:

- *Generic businesses*: Many typical generic businesses are valued on some rule of thumb, that is the goodwill is often a simple percentage of provable turnover plus stock, (also known as "inventory"), if any. Examples with stock include chicken take-aways, newsagents etc. An example without stock is a tax accounting practice which can sell for up to $1 for each $1 of fees billed.
- *Non-generic small businesses*: One Can often value a business by using a profit multiplier and then add stock. For example, one may use a rough multiplier of around 2 or 3 times earnings (usually net profit before Interest, tax and depreciation) plus stock at valuation (SAV). Unlike "Enterprise valuations" (as explained in the next section on Large Businesses, the multiplier is subjective and can vary widely. In addition, there is some confusion as to whether this business value will also include selected business plant & equipment assets, or does this value just represent goodwill. Other business working capital items such as cash, debtors, creditors are usually retained by the seller. note that some employee liabilities continue with the purchaser.
- *Larger businesses (for example large corporates as listed on the stock exchange)*: The simplified multiplier approach used in non-generic small businesses is usually suitable for small businesses, but a more sophisticated "Enterprise" value is needed for larger businesses or for a more complex purpose as in John's vanilla slice business in Case Example 3, below. The "Enterprise" value is generally a value which includes all operating business assets and liabilities needed to run the business. The enterprise multiple used here is called the Price Earnings (or "P/E") ratio. The P/E ratio indicates how many dollars an investor can expect to invest in a company in order to receive one dollar of that company's earnings. Valuations of large well-established companies are based on this P/E ratio and can typically be a multiple of well over 15 times earnings. Thus, for each $15 you invest in the purchase of shares you should obtain a $1 dividend every year.

- *Risk factors*: The value of the business must be analysed and adjusted for by reference to a number of risk factors, which may affect the valuation of the business positively or negatively, and include:
  - SWOT analysis (Strength, Weaknesses, Opportunities, Threats)
  - Intellectual property owned (or not owned as we saw in the website example above)
  - Strength of product
  - Supplier relationships
  - Customer relationships and spread (see Frank's self-orderly wind up in Case Example 2, below)
  - Market strength and future prospects
  - History of the long-term sales and profitability.

<u>The business advisory team (team)</u>

A key ingredient in the formula for a good exit is how well you put together your advisory team, and this applies to all the exit options. The main reason for this is that your advisors can apply their experience to your specific case, including post exit issues, such as future options. The team should be small enough to be manageable but still cover all the areas needed. The members of the team usually include the external accountant, an experienced commercial lawyer and perhaps an experienced business advisor. This group of advisors will then work with some of the organisation's key senior managers and directors. The team should meet regularly, and one person be designated to coordinate with other appropriate persons, including the broker/agent, other owners etc.

<u>Selection of business broker/agent</u>

The selection of business broker/agent is another key strategic decision. A business broker/agent helps to find a buyer and, like real estate agents, has a clear agenda of signing up the client and maximising their commission. Because of the time and complexity involved the commission for a business agent is often around 10% of the agreed sale value, compared to a real estate agent who only charges 2 to 3% when selling a residential property (house, unit etc) or shop or commercial building.

Earn outs

This is where the price for the business is wholly or partly conditional on several future events, for example profitability, stock realisations, and other set goals. For an example of an earn-out clause see the second business example referred to under the "Think like the buyer" heading, above.

Getting to the actual price

Having determined an approximate price based on the above methods the price may be increased or decreased by one or more of the following factors (some of which are explored in Case Example 3, below, the John's Vanilla case):

- *Normalisation adjustments*: This is the process of removing non-recurring expenses or revenue from the profit figure being used for valuation purposes. This can include owners' salaries not at fair market value, legal and insurance claims, capital items etc
- *Due diligence costs*: The money and time required to prepare the documentation.
- *Adjustments*: These may be necessary due to "issues" found in due diligence. For example, if it was discovered that the business does not own a vital website when it said it did then the price payable for the business may substantially drop.
- *Structure of price*: The contract may require that instalments are to be paid over time, for example every six months a percentage of the agreed price will need to be paid.
- *Earn outs and other conditions*: these may cost money and time and thus may affect the price.

Process of exiting/closing the business

The closing process can be a period of high anxiety and stress and requires considerable effort, so time needs to be allowed for the following (if relevant):

- *Employee matters*: Ensuring all employees are notified and the correct entitlements paid

- *Notifications*: Customers and suppliers notified
- Terminations: Equipment, car and property lease termination and other legal agreements complied with.
- *Completing contracts*: Comply with contracts entered into before the sale of the business, and this may include the need to complete the purchase or sale of assets or complete specific work.
- *Sell any remaining assets*: Those that were not sold in the original sale of business contract now need to be disposed of.
- *Collect debts*: Collect outstanding trade debtors (due on the sale of goods / services in the ordinary course of business) and sundry debtors (due on the sale of assets, such as excess inventory, plant and equipment etc, not sold in the original contract).
- *Regulatory authority requirements*: Complete tax and regulatory authority requirements such as: ABN (Australian Business Number), GST (Goods and Service Tax), dealing with CGT (Capital Gains Tax issues).
- *Other matters*: attend to the mail, email, internet, telephone, power, water, bank accounts, social media and other areas. Some will transfer to the buyer and the others will need to be handled, and perhaps closed, by the seller.
- *Retention of business records*: Arrange to store business records for the minimum statutory period. The Australian Securities and Investment Commission (ASIC) requires companies to keep corporate records for seven years. The Fair Work Ombudsman (FWO) requires employee records to be kept for seven years. The Australian Taxation Office (ATO) requires taxation records to be kept for five years after the records are created, and if it relates to capital gain tax it may be longer.
- *What to do now?* Determine what you will do after exiting. This is a vital step and often forgotten!

Other things that need to be considered

As noted above, a key issue often neglected is what will you do after exiting? One of the authors had two cases where key personnel have unnecessarily hung on only because work suited them, while the business was crashing around them.

The advisory team can also assist the seller regarding another business activity to get involved in. This is exactly what happened recently with a businessman associate of one of the authors. The businessman's advisors kept working with the businessman to find new projects as they had built up a level of trust and a good working relationship. The businessman spoke to a number of business brokers and forwarded the businesses for sale that he was interested into his team who assisted in analysing them until one was found that suited the businessman's capabilities and objectives.

Facing a big change in work or occupation brings with it an amount of stress. Where this becomes a major issue for someone, they should seek professional advice as soon as possible, as management of these issues can allow the person one way or another to go back into business, if they wish.

In addition, a healthy lifestyle should be maintained and there are a large range of activities and pursuits available (perhaps not golf, as based on the writers' experience this actually causes more stress!).

14.3 The case study Facts

14.3.1 Case Example 1 - Geoff "no credibility" v Tammy "high credibility"

Geoff (Mr "No Credibility")

Geoff owned and ran a car hire business. He did not have particularly high ethics and never kept promises, cheated on his tax, took advantage of the customers etc. His long-suffering accountant tried valiantly to assist, and in retrospect he realises that he should have left the client when these issues appeared! He owed the bank a considerable amount of money and was unable to meet his repayments. Despite the accountant's efforts the bank was losing patience.

The inevitable day came when the bank put the company into receivership (which is an insolvency action) based on the secured debt Geoff owed. The Bank at this stage were only interested in terminating the relationship as quickly as possible and obtaining their money.

The main asset of the company was the catchy telephone number which had some goodwill. Geoff offered to purchase the number from the bank with his own funds for $50,000 + GST. However, the Bank ignored him and sold it to a large existing car rental company for $25,000 + GST.

Geoff therefore ended up with nothing as he had totally lost control at this late stage. He did not even have enough resources to try to sue the bank for what he saw to be unethical conduct in selling the phone number for half of what he offered.

Figure 42 - Geoff's way of communicating with customers … on a good day.

<u>Tammy (Ms "High Credibility")</u>

At the same time, the accountant had another client that ran a curtain business that was also facing financial difficulties. In contrast the owner was very upfront with the bank (the same bank by the way!) and provided regular financials, business plans and communicated the position regularly.

The bank allowed her to do a self-liquidation. She negotiated with creditors and over a period of time transitioned to a small online business. She did eventually have to sell her house but was able to do it without a "fire sale" (that is, desperately taking whatever offer is given to get a quick sale).

14.3.2 Case Example 2 - Frank's self-orderly wind up

Frank had a business of wholesaling shoes. 80% of his sales were to a major department store and 20% to a range of independent stores.

Despite many attempts over the years he was unable to increase sales to independent shops, and indeed the percentage was beginning to fall due to the slow demise of independent shops.

The department stores gradually squeezed Frank's profits and made life generally very difficult for him. For example, the department stores required greater discounts (price reduction before payment), increased supplier rebates (where the supplier pays part of the purchase price back to the buyer after payment) and ordered erratically making it hard to plan.

Frank was getting fatigued by all this and in discussions with his accountant he realised that a reasonable sale of the business was not going to be possible due to the high concentration and relationship with the low profitable department stores. Frank was getting stressed because of these unknowns.

The accountant recommended that if Frank is still enjoying the business, he should continue but restructure on the basis that he can take quick action should the worst happen. *Once Frank resolved to do this, much of his stress dissipated.*

Frank closed his office, reduced stock and moved the balance of stock to a 3PL (this is a third-party logistics company which managed his stock for him), and commenced operating from his home office and garage.

As the department store orders continued to dry up over the next few years, Frank was prepared and ready to go into a self-wind up. He commenced by selling the balance of stock on special terms to existing customers.

By this stage Frank had sensibly planned an exit, was already involved in several other activities and was unconcerned about the business exit.

14.3.3 Case Example 3 - John's vanilla slice business - Bringing in investors and valuing the business

John had developed his vanilla slice business over many years and had a large local following. He has often considered expanding into other locations but had always been short of money. He was unable to borrow enough money to firstly allow for the potential expansion, that is to increase in working capital to run the business, and secondly to buy more efficient plant and machinery, for example, the purchase of the much needed automatic cutting machine to slice the vanilla slices quickly and accurately. John also considered that having outside people with business experience would greatly assist him. John considered bringing in "active investors", that is, people who can both invest money and have some regular involvement in advising the business.

John's Accountant, David, arranged several meetings with some potential "Business Angels" (who are investors with money willing to invest in small businesses). This almost worked but failed at the last moment.

David then arranged a small syndicate with people that David and John knew. David advised John to keep the syndicate small to be manageable. He also advised obtaining a business agent's valuation to assist in calculating the entry price for the Investors. John agreed to this.

David then provided the business broker with the average business profit for the last three years. It was $100,000. It was calculated on an EBITDA (Earnings Before Interest, Tax, Depreciation, Amortisation) basis and was adjusted to remove John's private expenses, including interest, owner's motor vehicle, owners home office charges etc. The business had plant, equipment, fixtures and fittings of $70,000 and stock of $80,000.

Based on the above information one business broker provided his valuations and they are reproduced immediately below, and further below in the Exhibit. Based on his experience the Broker provided three valuation options, two of which were based on profit multiples:

- Option 1: The first option was a multiple of 2 based on profit available to a working owner and is based on the profit before any salary is paid to the owner (this is Proprietor's Earnings Before Interest Tax Depreciation Amortisation - PEBITDA).
- Option 2: The other multiple is 2.75 based on profit after a reasonable salary is paid for an arms-length manager (this is Earnings Before Interest, Tax, Depreciation, Amortisation - EBITDA).
- Option 3: A third option is another rule of thumb, being the plant & equipment used in the business plus one year's EBITDA plus stock.

Option 1: Working owner – PEBITDA (Proprietor's Earnings Before Interest, Tax, Depreciation, Amortisation, and is the net profit to the full-time working owner).	
Average profit	$100,000
Add back owner's salary	$75,000
Total	$175,000
Using a multiple of 2 then the valuation = $350,000 +plus stock at valuation (SAV) of $80,000 = **Total Investment (valuation) = $430,000**	

Table 10 – Exhibit 14.2 The Business Broker Valuation (Working Owner)

Option 2: Investor – EBITDA (Earnings before Interest, tax, depreciation, amortisation, and is the net profit at arm's length for owner/Investor)	
Average profit before owner's salary	$175,000 (see Option 1)
Deduct reasonable managers salary	$85,000
Net Adjusted profit	$90,000
Multiple of 2.75 = then the valuation = $247,500 plus SAV of $80,000 = **Total Investment (valuation) = $327,500**	

Table 11 - Exhibit 14.2 The Business Broker Valuation (Investor)

Option 3: Assets - Value of Plant, Equipment, fittings and fixtures + up to 1 x EBITDA + stock	
Equipment	$70,000
Equipment – 1 year	90,000 (see Option 2)
Total	$160,000
Valuation = $160,000 plus SAV valuation of $80,000 = **Total Investment (valuation) = $240,000**	

Table 12 - Exhibit 14.2 The Business Broker Valuation (Assets)

Recommended price

Based on the three above broker options, the broker advised listing the business for sale at $300,000 plus SAV (stock at valuation) with an expected negotiated sale value at around $250,000 plus SAV. This figure would include the plant & equipment and fixtures and fittings. However, it would not include other working capital that an incoming Investor would need to invest for example debtors, cash in bank reserves, less creditors and other provisions which would total approximately $50,000.

David's interpretation of the broker's figures

David felt that in the circumstances the sale price should also include the $50,000 working capital, as described immediately above.

The breakup of the sale price can now be shown as below:

Plant & Equipment	$70,000 (from above)
Other net working capital, debtors, bank, IP, creditors etc	$50,000 (from above)
Goodwill – the balancing item to enable the total sum to be $250,000)	$130,000
TOTAL AGREED PRICE	$250,000
Price agreed	$250,000 (from above)
Add Stock	$80,000 (from above)
Total Investment (Enterprise Value)	**$330,000**
EBITDA (this is the net profit used as we have incoming Investors)	$90,000 (see Option 2)

Table 13 - Enterprise Value

On these adjusted figures the real Enterprise multiple is 3.67 x earnings, being $330,000/$90,000 = 3.67 x earnings. This is a reasonable Enterprise multiple based on a medium risk small business.

David then engaged a lawyer to draw up the Shareholders Agreement for the syndicate members. The valuation of $330,000 was included in the Agreement and each syndicate member (or "investor") invested an agreed amount. For example, one syndicate member took up $33,000, which equates to 10% of the business.

14.3.4 Case Example 4 - Choice of broker

Both authors were involved in choosing at very short notice a broker for a large SME client who suddenly decided he wanted to sell his business. They both felt that a small to medium sized broker would be the most economical method. The process under this option would be to prepare the sale memorandum, and simply allow the prospective purchaser to ask their questions and to do their own due diligence (formal process of accounting investigation to ensure accuracy of figures).

However, the owner insisted on using one of the big four accounting firms in Australia (KPMG, Deloittes, PWC and Ernst & Young), because he felt they would have the international connections to enable a big price. The authors disagreed but were overruled and were instructed to sign up firm X, the owner's then favourite big four firm.

The authors also advised the owner that the business was not ready for the sale process as it was a complex and difficult to understand corporate structure with complex accounting structures and cost allocations. They advised that the sale should be postponed until the company was restructured and loss-making divisions clearly separated or exited. Again, they were overruled.

The authors then wanted to re-negotiate the service agreement from X as they saw potential difficulties. The owner insisted the agreement be signed immediately.

X was hired and they recommended setting up a computer data room (Central Data Base) and providing an exhaustive list of documents and information which basically answers most of the buyer's due diligence questions and potentially reduces duplication. This, however, added considerably to the client's cost.

X also had a minimum fee plus success fee. There were surprisingly few interested buyers and they all complained about the difficult to understand structure. Those that made an offer had included so many conditions and "earn outs" that the price was uncommercial. Despite this the company was forced to pay firm X the minimum, yet substantial, fee. It ended up being a very expensive exercise and while a smaller broker also may not have resulted in a sale, the cost would have been manageable.

14.3.5 Case Example 5 - The Mouse Family/Furphy Family Succession Exits

The owners of the Mouse family business sold a 49% share of the business to non-family members using a formal MBO (Management Buy Out) agreement which all family and non-family directors signed. The business benefited by creating in the non-family managers a commitment to the future in the company. Later, when the youngest family member, Miles joined the company the MBO was amended. For further details see the Mickey Mouse Family business in Case Study 4 (Family Business).

As occurred with the Mouse family the Furphy family also have a succession plan. The business is continually transferred to one branch to reduce potential complexities. Both of the above are examples of succession planning. This family was also mentioned in Case Study 4 (Family Business).

14.4 Questions

Case Example 1. Geoff "no credibility" v Tammy "high credibility"

1. Why did Geoff's situation not work out as well as Tammy's?
2. What do we learn from this Case Example?

Case Example 2. Frank's self-orderly wind up

3. Could Frank have handled this exit any other way?

Case Example 3. John's vanilla slice business - Bringing in investors and valuing the business

4. Was the end value reasonable?
5. Could John have done a better deal? Should he have?

Case Example 4. Choice of broker

6. What are the main lessons to be learnt from this case?

Case Example 5. The Mouse Family/Furphy Family Succession Exits

7. Is the Management Buy Out (MBO) best way of extracting value for the owners? Discuss.

14.5 Suggested responses to Questions

14.5.1 Case Example 1. Geoff "no credibility" v Tammy "high credibility"

Question 1:

Why did Geoff's situation not work out as well as Tammy's?

- Geoff is the type of low ethics businessman that looks to make money by taking advantage of others and is highly "opportunistic". The approach may make some money in the short term but only in rare cases is this approach sustainable. When Geoff needed assistance from the bank, it was not forthcoming because of his reputation.
- Tammy was unfortunately in a poorly performing business but had built up a level of trust with her business associates. In the time of need, she was able to use the built-up reservoir of trust with the bank to assist in her close out.

Question 2:

What do we learn from this Case Example?

- Both Geoff and Tammy are on the low control end of the Exit Value Chart (see Exhibit 14.1), which means not much value is going to be extracted for them.
- Geoff was in the formal wind up stage where he had almost no control over the exit. However, Tammy moved into the informal wind up category which gave her a degree of control over the exit and this resulted in her obtaining a better wind up return than had it been a formal wind up.

14.5.2 Case Example 2. Frank's self-orderly wind up

Question 3:

Could Frank have handled this exit any other way?

- Frank's situation is similar to Tammy's in the previous Case Example.
- The difference is that his stress was more personal than financial. He just required some psychological support and assistance to change the business so that he could close it down easily should the department store stop, or significantly reduce, ordering.

14.5.3 Case Example 3. John's vanilla slice business - Bringing in investors and valuing the business

Question 4:

Was the end value reasonable?

- Valuations need to be interpreted in the light of the purpose for which they are conducted. This is a case of a valuation needed for internal purposes, that is introducing new Investors, rather than a simple sale process. For that reason, it is in the interests of all the parties to strike a reasonable position and ensure that there are no surprises later, for example that more money needs to be tipped in later to fund working capital such as debtors.
- The presentation of a total enterprise valuation allowed for full transparency to all the owners and investors. Note that this assumes the risk factors mentioned in Section 14.2 in the Background to this Case Study, above, will not affect the price.
- On the above Exhibit 14.1 Exit Value Chart the value achieved for the existing owners is reasonable and is somewhere in the middle of the Chart.

Question 5:

Could John have done a better deal? Should he have?

- John may have done better on a merger, takeover or outright sale but then he may have had to exit the business as an owner. With the permission of the new owners he may have continued for an agreed period as a key manager.
- John has taken a "bigger picture approach". That is by taking a discount on the maximum sale price in order to attract new Investors, he has taken the "gamble" that the business will gain more value in the longer term. In addition, he is able to remain as a key manager of the business.

14.5.4 Case Example 4. Choice of broker

Question 6:

What are the main lessons to be learnt from this case?

- This case highlights the importance of listening to your advisors.
- The advisors suggested the timing needs to be right to sell and not just sell when it is convenient to the owner. They also suggested to allow time to get the right business broker, get the right team and get the right contractual terms and conditions.
- One should sell when the business is doing well, and not when it is doing badly. Take advantage of the economic situation!
- A fail on all these points doesn't necessarily doom the exit but it makes it very hard to do well, particularly as there is not much safety margin left.

14.5.5 Case Example 5. The Mouse Family/Furphy Family Succession

Question 7:

Is the Management Buy Out (MBO) the best way of extracting value for the owners? Discuss.

- On the Exit Value Chart in Exhibit 14.1, above, these succession transactions generally provide reasonable value to the owners. It is possible that higher value could be achieved by a takeover, sale or IPO but at a lot more risk, time and expense.
- The MBO method delivers a “no fuss” way of transacting the exit for the current owners.
- Like all exits, the earlier the better as even this method takes time, and there are likely to be many more of these succession transfers with the population ageing. Both issues were discussed in Case Study 4 (Family Business).

14.6 Postscript

All business owners one way or the other face an exit. Like the Starting and Operating phases, the more time, effort and planning is invested the easier it will be to exit, and this will be with less stress and potentially more value achieved. Ideally the exit plan should be created when commencing the business. This is to ensure it is simple and inexpensive to separate the legal and commercial parts and sell all or part when you, and not when others, want to sell it off. In addition to this there needs to be a focus on the exiting owner who needs to understand as Paul McCartney (who found himself exited from arguably the world's biggest music band at the age of 28) said in the quotation at the beginning of this Case that exit is not the "end of the world" but the potential to do something new and exciting. This is important to consider as many people have little or no life outside of their work and are apprehensive of life after work, and so stay longer than they should, often to the detriment of the business.

Notes

Part 4 – Financial Analysis

Figure 43 - Financial Analysis

This Part covers the following Case Studies...

6. El Guapo Financial Analysis

Notes

Chapter

15

Case Study 15 - El Guapo Financial Analysis

Turnover is Vanity, Profit is Sanity, but Cashflow is King

Anon

15.1 Brief Overview

This case study is about the owner of a men's wear clothing retailer shop who seeks independent financial analysis from an accountant as to how his business is performing. This case study is about their discussions. We will consider key quantitative issues, but it should be remembered that qualitative factors should also be considered, including customer loyalty, staff morale and staff loyalty. These and other issues will be discussed in the below Case Example, but first we will provide a brief background to the case study. This case study was written from the writers' commercial experience and should be only used as general background information and for education purposes.

15.2 Background to the case Study

One of the best ways to understand and evaluate a business is to undertake a financial review of their accounts. Such an analysis can then highlight its strengths and weaknesses and indicate the areas which require further investigation.

Financial analysis is the study of a business's financial statements to evaluate the business performance and structural strength. The analysis focuses on the profit and loss statement (also called the income statement), balance sheet (also called the statement of assets and liabilities) and cash flow statement, and may indicate whether the business is stable, solvent, liquid or profitable enough to warrant an investment.

Ordinarily a financial analysis encompasses many of the following:

Vertical – Analysing data within a given time period, say one year, vertically from top (sales) to bottom (net profit)

- Horizontal – Comparing data over time
- Leverage - Leverage (debt to equity) ratios
- Growth – Analysing growth rates
- Profitability – Looking at gross profit and net profit margin rates
- Liquidity – Balance sheet analysis, for example the "current ratio"
- Efficiency – Efficiency of asset utilisation, for example the "inventory ratio"
- Cash Flow – "Cash is king" review cash flow statements, Source and Application of Funds.
- Rates of Return – Investment analysis, for example return on equity
- Valuation - Estimating business value
- Scenario & Sensitivity – Measuring risk
- Variance – Comparison to budget analysis.

In this case study the owner of the business is interested in his accounting reports and asks his external accountant to explain them and how they can be used to help him understand his business. To answer questions the accountant will be drawing on the financial statements and his knowledge of the above financial analysis techniques.

15.3 The case study Facts

Jose (pronounced Hosay) Feliciano is the owner and Manager of El Guapo Clothes, a small shop in downtown Melbourne. Jose is of Hispanic background and named his business El Guapo which in Spanish means a "good looking male".

Jose was interested in how his business accounts were prepared and interpreted and wanted to obtain a better understanding of his business and so asked his accountant, Luca Pacioli, to assist.

Luca explained that everything starts with the data input, which can be explained by the Worksheet (see Page 8a, of the financial information in the below financial statements) which is a manual way of describing what accounting software is doing behind the scenes. Luca showed Jose the worksheet stating that completion requires a number of steps:

1. The starting point is to use the closing balances of the prior year balance sheet (see Column A on Page 7) to determine the balance sheet opening balances for the current year (see Column B)
2. Then cash transactions, both bank account receipts and payments through the year, are input into the worksheet (see Column C.1)
3. Then journal adjustments are input (see Column C.2). There are two types of such adjustments: the first is cash transactions that did not go through the organisation's bank account, for example a loan from the bank that was paid direct to a supplier. The second is non-cash transactions such as depreciation (see also Page 3 for how the depreciation was calculated). For a list of the journal adjustments see Page 8 of the below financial statements.
4. When the figures in Columns B, C.1 and C.2 are added horizontally, the result is the Trial Balance, which are the closing balances of the Profit and Loss Statement items and the Balance Sheet items.
5. The trial balance is then used to produce the following:
    - Balance Sheet (see Page 1 of the below financial statements)
    - Profit and Loss Statement (See Page 2 of the below financial statements)

- Cash Flow Statement (see Page 6 of the below financial statements)
- Source and Application of Funds (see Page 9 of the below financial statements).

Figure 44 - Are you using the best tools to determine how your business is running?

15.4 Questions

Jose wanted further information about the financial strength of the business and met up with Luca, his external accountant, where Jose asked the below questions. You are Luca, and want to respond to Jose's questions:

1. Jose asked why his sales in the profit and loss statement had increased by $20,000 ($405,000 - $385,000: see Page 2 of the below financial statements), and yet his net profit had increased by only $5,000 ($35,000 - $30,000: see Page 2 of the financial statements). How should Luca respond? You should refer to the gross profit in your response.
2. Jose noted that his bank account in the balance sheet had increased by $62,000 ($72,000 - $10,000, see Page 1 of the below financial statements) and asks if his profit should be this $62,000. How should Luca respond?
3. Jose asked how strong the business is. He wanted to know about the risks if his turnover drops. How should Luca respond?
4. Jose said he is always running around "fighting fires" (that is, reacting to problems that urgently arise) and getting very weary and would like to take some time off and asks Luca when the best time would be to do this, and how could it be organised. How should Luca respond?
5. Jose noted that there was a comment in the KPI analysis (see Ratio 2 on Page 4) that the average collection period is deteriorating (was 14 days and is now 18 days), that is collections from account customers (those who paid after an invoice was rendered to them and called "accounts receivable" or "debtors") are being received 4 days (that is, 18-14) later on the average. Jose said he felt that according to his figures this was not correct. He felt that somehow the sales to account customers were not being considered. Luca advised him that sales to account customers were $200,000 for last year and $285,000 for this year. How should Luca respond?
6. Jose was wondering about his future, the large amount of time he has invested, and will continue to do so, to build up the business and whether he should keep or sell it. How should Luca respond?

15.5 Suggested responses to Questions

Jose wanted further information about the financial strength of the business and how to run it and met up with Luca, where Jose asked the below questions. You are Luca, and want to respond to Jose's questions:

> **Question 1:**
>
> Jose asked why his sales in the profit and loss statement had increased by \$20,000 (\$405,000 - \$385,000: see Page 2 of the below financial statements), and yet his net profit had increased by only \$5,000 (\$35,000 - \$30,000: see Page 2 of the financial statements). How should Luca respond? You should refer to the gross profit in the response.

15.5.1 Suggested response:

Luca explained that Jose's net profit had increased by only \$5,000 simply because Jose is not allowing for the cost of the sales and other expenses. Luca further explained this as follows:

- Income exceeded expenses:
  - The gross profit on the increased sales increased by \$18,000 (\$233,000 - \$215,000, see Page 2);
  - The expenses increased by \$13,000 (\$113,000 - \$100,000, see Page 2); and
  - If you take the \$18,000 increase in gross profit minus the \$13,000 increase in expenses, you arrive at the \$5,000 increase in net profit.
- Gross profit margin increased from 55.8% to 57.5%: Profits have increased due to the increase in gross profit margin, which is due to sales price increasing and/or the purchase price of stock decreasing.

Question 2.

Jose noted that his bank account had increased by $62,000 ($72,000 - $10,000, see page 1 of the below financial statements) and asks if his profit should be this $62,000. How should Luca respond?

15.5.2 Suggested response:

Luca explained how the Balance Sheet functions. Luca explained that to see what profit he made Jose would need to look at the Profit and Loss Statement (see Page 2), and *not* the balance sheet, where one finds the bank account. He continued stating that an increase in the bank balance does not mean that he made a profit of $62,000, because the bank account is only one of many assets and liabilities that Jose owns and there are many movements in the Balance Sheet of which the bank account is just one item. Luca went through the Sources and Applications of Funds statement to explain this point (see Page 9 of the below financial statements), which shows where the money came from and where it went for a given period, here the financial years ended 30 June 20x1 and 20x2.

Question 3

Jose asked how strong the business is. He wanted to know about the risks if turnover drops. How should Luca respond?

15.5.3 Suggested response:

- Luca said that to respond to this question we can use the KPI schedule (see Page 4 of the below financial statements), and a quick glance at it indicates that the most of the KPIs look reasonable against standard measures in all four of the KPI Groups.
- He said, however, there are still many risks which Jose needs to monitor carefully. Luca suggested that measuring the strength requires a "sensitivity analysis", that is a determination as to how far Jose is away from a problem occurring. For example, it is critical for Jose to realise that although the business currently works on a good gross profit margin (57.5% in the current year, see Page 2 of the financial statements), the downside of this high percentage is that a small drop in turnover could plunge the business into a loss. For example, a $100 loss in sales translates to a $57.50 drop in gross profit, which could cause Jose significant financial problems if his turnover drops substantially. Luca continued by saying that If a competitor, say a discount business which has a low gross profit margin of about 30%, has a drop in sales of $100 this would therefore only translate to a loss of only $30 in gross profit. The result of this comparison of businesses is that it reinforces that due to his high gross profit margin Jose should manage the business carefully to ensure that sales do not drop, and this requires Jose to value every customer. Please note that "gross margin" is usually a percentage figure whereas "gross profit" is a dollar figure, which really is the same thing but expressed differently.

Question 4

Jose said he is always running around "fighting fires" (that is, reacting to problems that urgently arise) and getting very weary and would like to take some time off and asks Luca when the best time would be to do this, and how could it be organised. How should Luca respond?

15.5.4 Suggested response

- *When*: Luca said that he would need to examine the business' monthly cash inflow report over a few years. He did this (see Page 5, below) and noted that it is typical in Jose's industry that there is often a slump in trade in January to March (especially February) after the Christmas trade has finished, and this could be a good time to take some time off.
- *How to organise it*: Luca advised Jose to prepare a timetable of duties required which Jose, and staff, need to attend to prior to, during and after the break. This is required to determine if indeed he can go, and if so, for how long, and assumes that Jose has enough money to pay for his holiday.
- *A further issue*: There is currently too much reliance on Jose, and this risk needs to be addressed.

Question 5

Jose noted that there was a comment in the KPI analysis (see Ratio 2 on Page 4) that the average collection period is deteriorating (was 14 days and is now 18 days), that is collections from account customers (those who paid after an invoice was rendered to them and called "accounts receivable" or "debtors") are being received 4 days later on the average, and Jose said he felt that according to his figures this was not correct. He felt that somehow the sales to account customers were not being considered. Luca advised that sales to account customers were $200,000 for last year and $285,000 for this year. How should Luca respond?

15.5.5 Suggested response

Luca said this is an example of where sometimes you need to drill down to look at the underlying figures. Referring to the Average Collection Period (KPI number 5 on page 4) the sales figures in that KPI include both cash sales and credit sales and that he needed to separate out the credit sales to get an accurate picture. He did the following calculation:

Collection period this year =	(Debtors x 365) / net sales
=	(20,000 x 365) / 285,000
=	25.6 days (for account sales)
Collection period last year =	(15,000 x 365) / 200,000
=	27.4 days (for account sales)

With the above Luca concluded that the collection for account sales period has improved rather than deteriorated.

Question 6

Jose was wondering about his future, the large amount of time he has invested, and will continue to do so, to build up the business and whether he should keep or sell it. How should Luca respond?

15.5.6 Suggested response

- Luca suggested that Jose first consider his personal situation and then evaluate his options, that is what does Jose financially and psychologically want out of the business and would he like to expand it, bring family into it, close it etc.
- There are many non-financial questions for Jose to consider, for example does he:
    - like working in the business and would he like to continue for many years?
    - Would he like to work with family? (and would they like to work with him?)
    - wish to sell the business?
- Once Jose sets down his objectives a plan should be developed to meet them. For example, who will take over, a family member or an outsider? If there is an intention to sell the business, then Jose needs to get the business ready at least 12 months before and approach a business broker for assistance. This is especially the case when the sale is to a non-family member.
- The benefit of having prompt and accurate financial records will make it much easier to plan for any course of action Luca decides to take.

15.6 Postscript

This Case is an example of the need for a holistic review of the business. It is more than a consideration of the cash situation, but also a consideration of sales, expenses, margins and future business. Business people who are not experienced in this area should use an experienced financial accountant to assist. It would be very helpful if the accountant also taught the owner how to do their own basic analysis to lessen the dependence on the accountant. Remember that nothing focuses your attention more that if you are losing money and are running out of cash. Lack of cash, like lack of blood, will result in a corpse.

15.7 Attachments – Various El Guapo financial statements and documents

The attached El Guapo financial statements and details are © 2019, Cyril Jankoff.

Page	**Content**
1	Balance sheet
2	Profit and loss statement
3	Depreciation schedules
4	Key Performance Indicators (KPIs)
5	Cash flow statement – month by month
6	Cash flow statement – summary
7	Worksheet
8	Journal adjustments and bank reconciliation
9	Funds statement.

Page 1 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

Balance Sheets for the Periods Ended 30 June 20x1 and 20x2

ASSETS	**This year $ 20x2**	**Last year $ 20x1**	**Variance $**	**Variance %**	**Note**
Current Assets					
Bank - Cash Mgt Acct	72,000	10,000	62,000	620.0%	1
Stock (Inventory)	190,000	200,000	-10,000	-5.0%	2
Debtors (Accounts Receivable)	20,000	15,000	5,000	33.3%	3
Prepaid Expenses	5,000	0	5,000		4
Total Current Assets	287,000	225,000	62,000	27.6%	
Fixed Assets (or Non-Current Assets)					
Plant & Equipment cost	100,000	100,000	0	0.0%	5
Accumulated Depreciation	-40,000	-20,000	-20,000	100.0%	6
Total Fixed Assets	60,000	80,000	-20,000	-25.0%	
Total Assets	347,000	305,000	42,000	13.8%	
LESS - LIABILITIES					
Current Liabilities					
Accounts Payable	60,000	50,000	10,000	20.0%	7
Prepaid Income	2,000	0	2,000	N/a	8
GST - Net Payable	40,000	35,000	5,000	14.3%	9,10,16
Related Loans	0	10,000	-10,000	-100.0%	11
Total Current Liabilities	102,000	95,000	7,000	7.4%	
Non-Current Liabilities	0	0	0	0.0%	
Total Liabilities	102,000	95,000	0	0.0%	
NET ASSETS	**245,000**	**210,000**	35,000	16.7%	12
EQUITY					
Shareholding and capital issued	100,000	100,000	0	0.0%	13
Accumulated Profit	145,000	110,000	35,000	31.8%	14
Net Equity (or Capital Balance)	**245,000**	**210,000**	35,000	16.7%	15

A. Notes to the Balance Sheets for the periods ended 30 June 20x1 and 20x2
PURPOSE: The balance sheet is a snapshot of the organisation's assets, liabilities and equity *at balance date*

NOTES:
1. Bank account earned interest
2. Inventory of menswear clothing stock for resale - valued at cost
3. Accounts receivable - for sales to good customers (and lay-buys)
4. Prepaid Expenses are expenses paid in advance, for example insurance, rent etc
5. The cost of plant and equipment (no change as nothing purchased or sold in the two years)
6. Accumulated depreciation (add deprecation from the latest year's P&L Statement)
7. Accounts Payable is amounts owing to creditors
8. Prepaid Income is income received in advance, for example advance sales payments.
9. 'GST paid' is GST paid on purchases, and thus is GST owing to the firm (really a current asset)
10. 'GST payable' is GST collected on sales, less paid, and thus is owing to the Tax Office
11. Loans from a related party
12. Net assets are assets less liabilities. Must balance with Net Equity
13. 100,000 shares issued at $1 each - no change over the year
14. The increase between the two years in the accumulated profit is this year's profit ($35,000)
15. The Net Equity amount must balance with the Net Assets - hence it is a 'balance sheet'.
16. GST owing at the beginning of the year was $35,000 and at the end was $40,000, an increase of $5,000 during the year.

Table 14 - El Guapo financial statements (Balance Sheet)

Page 2 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

A. Profit and Loss Statements for the Periods Ended 30 June 20x1 and 20x2

INCOME	**This year $ 20x2**	**Last year $ 20x1**	**Variance $**	**% Variance %**	**Notes**
Net Sales ($)	405,000	385,000	20,000	5.2%	1
LESS: Cost of Sales					
Opening stock	200,000	220,000	-20,000	-9.1%	2
ADD: Purchases	162,000	150,000	12,000	8.0%	3
	362,000	370,000	-8,000	-2.2%	
LESS: Closing stock	190,000	200,000	-10,000	-5.0%	4
Sub total: Cost of Sales ($)	172,000	170,000	2,000	1.2%	5
Sub total: Cost of Sales (%)	42.5%	44.2%	-1.7%		5
Gross Profit ($)	233,000	215,000	18,000	8.4%	6
Gross Profit Margin (%)	57.5%	55.8%	1.7%		6
LESS EXPENSES					
Occupancy costs - rent	65,000	65,000	0	0.0%	7
Sub total: Occupancy costs: Rent (%)	16.0%	16.9%	-0.8%		7
Depreciation (per schedule)	20,000	20,000			8
Sub total: Depreciation (%)	10.0%	9.1%	0.9%		8
Operating (Sales, General & Admin) costs	113,000	100,000	13,000	13.0%	9
Sub total: SGA/Operating costs (%)	27.90%	25.97%	1.93%		9
Total Expenses ($)	198,000	185,000	13,000	7.0%	
Total Expenses (%)	48.89%	48.05%	0.84%		
Net Profit/Loss ($)	**35,000**	**30,000**	5,000	16.7%	10
Net Profit/Loss (%)	8.64%	7.79%	0.85%		10

B. Notes to the Profit and Loss Statements for the periods ended 30 June 20x1 and 20x2
PURPOSE: The P&L Statement shows how the organisation performed between two dates.

RATIOS: All above ratios (eg cost of sales, gross profit etc) follow accounting convention and are a percentage of

NOTES:
1. Sales are according to the accruals method of accounting
2. Inventory (stock) at the beginning of the year (valued at cost price method)
3. Purchase of inventory - actual cost
4. Inventory (stock) on the last day (valued at cost price method)
5. The Cost of Sales (CoS or CoGS) is the cost of the inventory sold
6. The gross profit and the gross profit margin percentage is a very important measure. Start of a trend?
7. Occupancy (= rent + associated costs)
   Note: Manufacturing, wholesale and distribution is about 5-15%; low-end retail about 10-15%
   & high-end retail about 20-25%.
8. The depreciation is deducted from the cost of the asset - see the Balance Sheet and Depreciation Schedule
9. Operating costs are those costs that relate to the operating of the business.
10. Net profit is sales less all expenses

Table 15 - El Guapo financial statements (P&L)

Page 3 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

Depreciation Schedules for the Periods Ended 30 June 20x1 and 30 June 20x2

Description	**Original Cost**	**Opening WDV** (Notes 1,3,4)	**ADD: Additions**	**LESS: Disposals**	**Total for Depreciation**	**No of Months**	**Depreciation Rate %**	**LESS: Depreciation** (Note 2)	**Balance = Closing WDV**	
Year Ended 30 June 20x1										
Shop fittings (long list)	100,000	100,000	0	0	100,000	Full year	20%	20,000	80,000	X
	In BSheet (Note 4)							In P&L (Note 5)	In BSheet (Note 5)	
Year Ended 30 June 20x2										
Shop fittings (long list)	100,000	80,000	0	0	100,000	Full year	20%	20,000	60,000	Y
	In BSheet							In P&L (Note 6)	In BSheet (Note 6)	

Notes:
1. WDV = Written Down Value
2. The "straight line" method of depreciation has been used in this schedule. This is where the cost of the asset is spread out evenly over its life. This is to be contrasted to "accelerated" deprecation which is a higher rate of depreciation deducted early in the useful life of an asset.
3. The closing WDV of one year is the opening WDV of the next
4. The shop fittings were purchased for $100,000 on 30 June 20x0.
5. By 30 June 20x1 (one year after purchase) the fittings were depreciated by $20,000 ($100,000 @ 20%) and the WDV was $80,000 ($100,000 - $20,000).
6. By 30 June 20x2 (two years after purchase) the fittings were depreciated by $40,000 ($100,000 @ 20% x two years) and the WDV was $60,000 ($100,000 - $20,000 - $20,000).
7. The above table can be summarised as:

Asset purchased on 1 July 20x0		100,000	
LESS: Depreciation	Year 1	-20,000	($100,000 x 20%)
WDV as at 30 June 20x1		80,000	(Agrees with X, above)
LESS: Depreciation	Year 2	-20,000	($100,000 x 20%)
WDV as at 30 June 20x2		60,000	(Agrees with Y, above)

Table 16 - El Guapo financial statements (Depreciation Schedule)

Page 4 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

Key Performance Indicators (KPIs) for the Periods Ended 30 June 20x1 and 20x2

Ratio Category/Name	This Year 20x2	Last Year 20x1	Unit	Formula	Comments
Group 1 Ratios: Liquidity					
1. Current Ratio	2.81	2.37	Times	Current Assets/Current Liabilities	Improving - low gearing, funds from equity mainly
2. Average Collection Period	18.02	14.22	Days	(Debtors x 365)/Net Sales	Low collection period, but it is deteriorating
3. Average Payment Period	135.19	121.67	Days	(Creditors x 365)/Purchases	Payments are being made later
Group 2 Ratios: Profitability					
4. Gross Profit Margin Ratio	57.5%	55.8%	%	(Gross Profit/Net Sales) x 100	Gross profit margin improving slightly (In retail GP%>40% is ok)
5. Net Profit Margin Ratio	8.6%	7.8%	%	(Net Profit/Net Sales) x 100	Net profit margin improving slightly. Should be >than 10%
6. Return on Total Assets	10.1%	9.8%	%	Net Profit/Total Assets	ROTA is improving slightly
7. Return on Owner's Equity	14.29%	14.29%	%	Profit/Net Assets (ROI)	ROI coincidentally unchanged. Seek to be over 15%. This is a key ratio.
Group 3 Ratios: Capital Structure					
8. Debt (or gearing) Ratio	41.6%	45.2%	%	Total debt/total equity	Declining. Debt is low as a percentage of equity
9. Total Assets/Total Liabilities	3.40	3.21	Times	Total Assets/Total Liabilities	Improving. Very low gearing, funds from equity mainly
Group 4 Ratios: Efficiency (or Activity) Ratios					
10. Inventory Turnover Ratio	2.13	1.93	Times pa	Sales/Inventory	Inventory turnover ratio improving slightly
11. Capital turnover	1.65	1.83	Times pa	Sales/Capital	Capital turnover ratio deteriorating slightly
12. Rental/Sales	16.05%	16.88%	%	Rental/Sales	Improving. Depends on Industry but should be under 15%

Notes:
PURPOSE OF RATIOS:
1. A ratio is the mathematical relationship between items in financial statements, expressed either as a ratio or as a percentage. It is used in analysing the profitability, financial stability or operating efficiency of an entity.
2. Ratios are best used in comparison over time, compared with other ratios and similar organisations. There are many different types of ratios, with some of the more important ones appearing above.
3. The above comprises four Groups of ratios, but some organisations use more or less.
4. There are many different ratios. On occasions they may be calculated differently. Thus, it is vital that for comparison purposes that you use a consistent formula.

Table 17 - El Guapo financial statements (KPIs)

Page 5 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES
XYZ Pty Ltd Cash flow Statement
For the Period 1 July 20x1 to 30 June 20x2

Receipts	**20x1 Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**20x2 Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Total**	
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual		
Sales Revenue	**35,000**	**35,000**	**35,000**	**35,000**	**40,000**	**50,000**	**30,000**	**20,000**	**25,000**	**30,000**	**30,000**	**35,000**	400,000	
Sale of Equipment etc														
Loans Received														
Prepayment received												2,000	2,000	
GST collected on sales	3,500	3,500	3,500	3,500	4,000	5,000	3,000	2,000	2,500	3,000	3,000	3,500	40,000	
Total Receipts	**38,500**	**38,500**	**38,500**	**38,500**	**44,000**	**55,000**	**33,000**	**22,000**	**27,500**	**33,000**	**33,000**	**40,500**	**442,000**	
Less Payments														
Equipment purchased														
Loans repaid									10,000				10,000	
Prepaid expenses												5,000	5,000	
Purchases	14,000	14,000	18,000	24,000	12,000	8,000	10,000	10,000	12,000	12,000	12,000	14,000	160,000	
Rent paid	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	60,000	
Sales, General & Admin (SGA) Exp	8,000	8,000	8,000	10,000	12,000	16,000	8,000	8,000	8,000	8,000	8,000	8,000	110,000	
GST paid on purchases	3,000	3,000	3,000	3,000	3,000	3,000	2,000	3,000	3,000	3,000	3,000	3,000	35,000	
Total Payments	**30,000**	**30,000**	**34,000**	**42,000**	**32,000**	**32,000**	**25,000**	**26,000**	**38,000**	**28,000**	**28,000**	**35,000**	**380,000**	
Cashflow In/Out	**8,500**	**8,500**	**4,500**	**- 3,500**	**12,000**	**23,000**	**8,000**	**- 4,000**	**- 10,500**	**5,000**	**5,000**	**5,500**	**62,000**	
ADD: Opening Bank	10,000	18,500	27,000	31,500	28,000	40,000	63,000	71,000	67,000	56,500	61,500	66,500	10,000	A
Closing Bank	**18,500**	**27,000**	**31,500**	**28,000**	**40,000**	**63,000**	**71,000**	**67,000**	**56,500**	**61,500**	**66,500**	**72,000**	**72,000**	B

Note:
1. Opening bank balance as at 1 July 20x1 was $10,000 (see "A"). It is also the closing bank balance as at 30 June 20x1 (see Balance Sheet)
2. Closing bank balance as at 30 June 20x2 was $72,000 (see "B")
3. The closing bank balance as at 31 July 20x1 ($18,500) becomes the opening balance as at 1 August 20x1 ($18,500). Follow the direction of the arrow.
4. When you read "Actual" above it means that the financial accounts have been completed. If you read "Estimated" then this is an estimated figure either because the accounts are incomplete or the figure is an estimation of what may occur in the future.
5. This is a simplified monthly cash flow statement. In reality GST collected would be netted off against GST paid and if GST collected exceeded that paid then the difference would be paid to the Australian Taxation Office. If GST paid exceeded that received then there would be a refund. This reconciliation would occur monthly, and for smaller organisations it would be quarterly or even annually. This reconciliation occurs through the submission of a Business Activity Statement (BAS).

Table 18 - El Guapo financial statements (Cash Flow, Monthly)

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Cashflow Statement for the Period Ended 30 June 20x2

Cashflows relating to OPERATING activities				
Receipts from customers		402,000		
Payment to suppliers and employees		-335,000		
Net operating cash flows				67,000
Cashflows relating to INVESTING activities				
Cashflows relating to FINANCING activities				
Repayment of/Proceeds from loans	-	10,000		
GST Movement ($40,000 - $35,000)		5,000	-	5,000
Net increase (decrease) in cash held				62,000
ADD: Cash at beginning of the year		A		10,000
Cash at end of the year		B		**72,000**

A =	Opening balance sheet cash balance	(20x1)
B =	Closing balance sheet cash balance	(20x2)

Notes:

1 A Cashflow Statement provides information about the changes in cash and cash equivalents of a business by traditionally classifying cash flows into operating, investing and financing activities. It is a key report to be prepared for each accounting period for which financial statements are presented by an enterprise.

2 The Source and Application Funds statement (See Page 9 Financial Statement) is useful as a simplified form of the Cash Flow Statement for the purposes of financial analysis.

Table 19 - El Guapo financial statements (Cash Flow, Summary)

Page 7 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

Worksheet for the Year Ended 30 June 20x2 (latest year)

	A		B		C. Transactions Between the Two Dates										D	
	Closing Balance as at 30 June 20x1		Opening Balance as at 1 July 20x1		C.1 Cash Transactions					C.2 Non-Cash Trans Journal Adjustments			C.3 Total Cash & Non-Cash Trial Balance		Closing Balance as at 30 June 20x2	
					C.1.1 Cash Receipts		C.1.2 Cash Payments									
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	No.	Dr	Cr	No.	Dr	Cr	Dr	Cr
Profit and Loss Statement																
Sales		385,000				400,000			3	15,000	20,000	6		405,000		405,000
Sales	220,000								4	200,000			200,000		200,000	
Purchases	150,000						160,000		5	50,000	48,000	2	162,000		162,000	
Closing stock		200,000									190,000	7		190,000		190,000
Rent	65,000						60,000		5	5,000			65,000		65,000	
Depreciation	20,000								1	20,000			20,000		20,000	
Sales, General & Admin (SGA Exp)	100,000						110,000		5	5,000	2,000	2	113,000		113,000	
Sales, General & Admin (SGA Exp)																
Profit	**30,000**														**35,000**	
	585,000	585,000													595,000	595,000
Balance Sheet																
Stock (Inventory)	200,000		200,000						7	190,000	200,000	4	190,000		190,000	
Debtors (Accounts Receivable)	15,000		15,000						6	20,000	15,000	3	20,000		20,000	
Prepaid Expenses							5,000						5,000		5,000	
Bank - Cash Mgt Acct	10,000		10,000		442,000			380,000					72,000		72,000	
Plant & Equipment cost	100,000		100,000										100,000		100,000	
Prepaid Income						2,000								2,000		2,000
Accumulated Depreciation		20,000		20,000							20,000	1		40,000		40,000
Accounts Payable		50,000		50,000					2	50,000	60,000	5		60,000		60,000
GST - Net Payable		35,000		35,000		40,000	35,000							40,000		40,000
Related Loans		10,000		10,000			10,000									
Shareholding and capital issued		100,000		100,000										100,000		100,000
Accumulated Profit		110,000		110,000										110,000		110,000
Current year profit																**35,000**
															387,000	387000
	325,000	325,000	325,000	325,000	442,000	442,000	380,000	380,000		555,000	555,000		947,000	947,000	982,000	982,000

Table 20 - El Guapo financial statements (Worksheet)

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1. Journal Adjustments for the Year Ended 30 June 20x2 (latest year): Refers to Column C.2, on Page 7.

			Dr	Cr
1	Depreciation	P&L Statement	20,000	
	Accumulated depreciation	Balance Sheet		20,000
	Being depreciation for the year (per schedule)			
2	Accounts payable	Balance Sheet	50,000	
	SGA Expenses	P&L Statement		2000
	Purchases	P&L Statement		48,000
	Being reversal of prior year's accounts payable			
3	Sales	P&L Statement	15,000	
	Accounts receivable	Balance Sheet		15,000
	Being reversal of prior year's accounts receivable			
4	Inventory (P&L)	P&L Statement	200,000	
	Inventory (Balance Sheet)	Balance Sheet		200,000
	Being reversal of prior year's closing stock			
5	Purchases	P&L Statement	50,000	
	SGA Expenses (electricity)	P&L Statement	5,000	
	Rent	P&L Statement	5,000	
	Accounts payable	Balance Sheet		60,000
	Being closing accounts payable for current year			
6	Accounts receivable	Balance Sheet	20,000	
	Sales	P&L Statement		20,000
	Being closing accounts receivable for current year			
7	Inventory (balance sheet)	Balance Sheet	190,000	
	Inventory (P&L)	P&L Statement		190,000
	Being closing inventory for the current year			

2. Bank Reconciliation

Cash book			$	
Opening cash book balance	1 July 20x1	Earler year	10,000	
ADD: Receipts			442,000	
			452,000	
LESS: Payments			380,000	
Closing cash book balance	30 June 20x2	Latest year	72,000	X
Bank balance				
Agrees with bank statement balance	30 June 20x2	Latest year	72,000	Y

Note:
1. The bank reconciliation statement is a statement prepared to determine if there are any differences between the organisation's bank ledger (see 'X') and the bank statement of that account (see 'Y'). Such differences can arise as a result of unpresented cheques, uncredited deposits, bank charges and errors. That is, we seek that X = Y.
2. The bank reconciliation figures must agree with the balances in the worksheet, above.

Table 21 - El Guapo financial statements (Journal adjustments)

PAGE 9 of the Financial Statements: EL GUAPO BUSINESS CLOTHES FOR EXECUTIVES

Source and Application of Funds (Funds Statement) for the Periods Ended 20x2

	Column A		Column B	Column C	
ASSETS	**This year**	**Last year**	**Variance**	**SOURCE** Where did the money come from?	**APPLICATION** Where did the money go to?
	$	**$**	**$**		
Current Assets	**20x2**	**20x1**			
Bank - Cash Mgt Acct	72,000	10,000	62,000		62,000
Stock (Inventory)	190,000	200,000	-10,000	10,000	
Debtors (Accounts Receivable)	20,000	15,000	5,000		5,000
Prepaid Expenses	5,000	0	5,000		5,000
Total Current Assets	287,000	225,000	62,000		
Fixed Assets					
Plant & Equipment cost	100,000	100,000	0		
Accumulated Depreciation	-40,000	-20,000	-20,000	20,000	
Total Fixed Assets	60,000	80,000	-20,000		
Total Assets	347,000	305,000	42,000		
LESS - LIABILITIES					
Current Liabilities					
Accounts Payable	60,000	50,000	10,000	10,000	
Prepaid Income	2,000	0	2,000	2,000	
GST - Net Payable	40,000	35,000	5,000	5,000	
Related Loans - per schedule	0	10,000	-10,000		10,000
Total Current Liabilities	102,000	95,000	7,000		
Non-Current Liabilities	0	0	0		
Total Liabilities	102,000	95,000	0		
NET ASSETS	**245,000**	**210,000**	35,000		
EQUITY					
Shareholding and capital issued	100,000	100,000	0		
Accumulated Profit	145,000	110,000	35,000	35,000	
Net Equity (or Capital Balance)	**245,000**	**210,000**	35,000	82,000	82,000

PURPOSE: The Source and Application of Funds (Funds Statement) shows how the organisation used its financial resources over a period of time.

PREPARATION STEPS:
1. The Balance Sheet items are compared from the current period to the previous period (Column A).
2. The variances between these amounts are calculated (Column B).
3. The variances are then allocated to either the source or application of funds (Column C).

FUNDS STATEMENTS:
1. This statement is a summary of a business changes in financial position from one period to another.
2. Over time this Funds Statement has been replaced by the Cash Flow Statement (see Page 6 of the Financial Statements) which shows a business's cash inflow and cash outflow over an accounting period. This Funds Statement is still often used.
3. The above Source and Application Funds statement is useful as a simplified form of the Cash Flow Statement (See Page 6) for the purposes of financial analysis.

Table 22 - El Guapo financial statements (Funds statement)

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"I've come to realize that life is neither a battle nor a game to be won, it is a game nonetheless, but to be played... enjoyed. There are neither winners nor losers... just players--and what's great is that you can choose who to play with."

VAL UCHENDU

It's up to each of us how we choose to deal with the business "battlefield". Relax! We are here to help!

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- A little theory
- The actual business cases
- Then some questions and example discussion points

The chapters are arranged logically in sequence:

- We start with the How and Why we start a business.
- The various operations of businesses are looked at.
- The methods of exiting and ending of the business,
- The financial analysis required to assist with all the phases of a typical business.

And finally – to quote a well-known business leader,

I don't take myself seriously, but I do take the business seriously, (Meaning we need to realise we are all just pawns in the Universal game of chess, but we should try to assist the people we work with and care for).

Enjoy.

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