



Strategic Alliance

Building Business Values

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Finance Articles *by Microsoft.com*

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Key Performance Indicators

Summary

Running any business effectively requires good decision-making, which is based on good management information.

All businesses need to monitor profitability and cash flow carefully and use management accounts for this purpose.

This briefing outlines:

- How to choose key performance indicators.
- The three vital areas to monitor: sales, costs and working capital.
- How to identify key drivers for your business.
- How to present the information.

1. Selecting Information

There is a multitude of internal and external factors affecting the performance of every business. The sheer volume of information available to management can be a distraction.

1. You need to focus on a handful of key indicators which:
 - Reflect the performance and progress of your business.
 - Are measurable.
 - Can be compared to a standard, such as a budget or last year's figures.
 - Can be acted upon.
2. Most indicators are used to monitor and control the profitability and cash flow of the business.
 - The three key areas are sales (see 2), costs (see 3) and working capital (see 4). Any trends towards cash flow problems or falling profitability will quickly show up in these figures.
3. Some indicators are used as part of a strategy to boost profitability and cash flow.
 - These are the drivers of the business and they can be used to powerful effect (see 5 and 6).
4. Compare the past, present and future.
 - Figures for last year and last month provide hard facts and established patterns.
 - Figures in budgets and forecasts help you to identify potential problems and opportunities early on.

The figures must be calculated on a consistent basis.
5. Compare yourself with other businesses, especially competitors, if possible.
See Benchmarking.

2. Sales

1. Enquiry levels (or number of leads, or quotes given) provide early warning of any peaks or troughs in your sales.
 - Monitor where the enquiries come from, to establish which marketing campaigns work best.
 - If you have an established enquiry to sales ratio and know the size of an average sale, you can use the enquiry level to forecast turnover.
2. Building up the order book is a key objective of most businesses.
 - The 'order book cover' figure compares the total value of your order book to breakeven sales for one month.

A six-month order book means that you could survive for six months without making another sale.

3. When reviewing sales, monitor the figures that show what is happening:
 - Which categories of product are selling well?
How are your priority products (those with the best margins and the best payment terms) selling?
 - What has each salesperson achieved?
 - Are your conversion rates (the ratio of leads to sales) changing?

3. Costs

Like sales, your costs (and therefore profit margins) should ideally be tracked every week. Many retailers are able to track them daily.

Identify the key variable costs (eg materials) and what causes them to increase or decrease.

1. Maintaining a healthy gross profit margin is critically important.
 - Falling margins could result from any number of things.
For example, higher input prices (eg subcontract costs), product mix, production inefficiencies, discounts, mis-pricing, or even fraud.
2. Group different types of cost into cost centres.
 - For example, a warehousing and delivery business could split its direct costs into warehousing and delivery. Matching the costs against the revenue for each half of the business would show how profitable each operation is.
 - Related overhead items (eg telephone, postage and stationery) can be lumped together into one combined cost figure.
This greatly reduces the number of figures you need to look at. Only if the combined cost figure rises unexpectedly do you look at individual costs, to see what has caused the rise.

4. Working Capital

Cash generation is a major priority for most businesses. You control cash by controlling working capital – debtors, creditors, stock and work-in-progress.

1. Establish how much extra working capital is required to fund each extra ten per cent increase in monthly sales.
 - If sufficient finance is not available, you may need to delay (or reject) large orders.
2. An effective way to control debtors and creditors is to produce an ‘aged’ list of each, every week.
 - Any customer payments which are overdue, suspect, or simply large, should be highlighted and tracked.
3. Good stock control allows you to release cash, while still having the correct stock available.
 - ‘Stock turn’ is the ratio of cost-of-sales to stock. If the figure decreases, find out why. For example, you may be purchasing stock which you cannot sell.
 - The more you break down the stock figure into separate product categories, the easier it is to see where the problems are.

5. The Power of Drivers

Monitoring your sales, for example, will not necessarily help you improve your sales performance.

By contrast, understanding the drivers behind the sales of your business can provide a breakthrough.

The simplest way to explain drivers is by using examples, such as those below.

1. A management consultancy had a disappointing level of monthly sales for years, until it realised that man-hours sold per consultant per week was the key driver.
 - Once this was monitored, it became crystal clear which consultants were earning the revenue. Attitudes changed overnight and sales increased significantly.
2. After a period of stability and high profits, a specialist travel agency realised that staff turnover was a driver.
 - An experienced sales person was found to be three times more productive than a new recruit.
 - The recruitment and training process for new sales people was a major burden. To reduce staff turnover, the travel agency introduced a long-term incentive element into remuneration packages. It also introduced quarterly performance reviews.
3. An engineering company found that the defect ratio was a driver.
 - Defects led to goods being returned, extra work to rectify the faults, delays in payment and lower prices being achieved. The company reorganised the workforce to work in 'quality cells' and stopped using a machine which was unreliable. Productivity increased significantly.
4. Drivers vary enormously. For example:
 - Sales leads in a capital goods business.
 - Sales per square foot in a retail business.
 - Market share in a market where only the big will survive.
 - Machine downtime in a factory.
 - 'First time fix' in a maintenance business.
 - The morale of employees in a nursing home.

6. Identifying Your Key Drivers

What are the key factors which enable your business to outperform its competitors?

The questions you need to ask yourself are: What drives the sales figures? What drives the costs? What drives the cash flow?

1. For most businesses, the key drivers include major cost-efficiency items. (See 3.)
 - For example, two important drivers for a chicken processing company are inevitably going to be direct labour costs and yield (the weight of meat taken from each carcass). Both have a major impact on the gross margin.
2. Drivers often include 'soft' factors.
 - For example, effective networking (to build new business relationships) has proved to be the key driver for many newer businesses.
3. The measurement of drivers is sometimes indirect.
 - For example, if you have identified employee morale as a driver, you could monitor it by tracking voluntary overtime, absenteeism and sick days.
4. The drivers may change with time. The growth of your business, changes in your market or simply seasonal changes may cause this.

7. Presentation

Management information needs to be presented in a way that makes the important trends easy to see.

You can achieve this by restricting the number of figures you monitor. But the biggest breakthroughs are achieved by clever use of computer-generated graphs and charts.

The trends instantly become clear.

1. Specify which figures you wish to review and when.
 - Some figures need to be reviewed only once a year, as part of the annual budgeting cycle.
For example, premises costs.
 - Include 'red light' systems, to alert you to a particular danger or opportunity which could arise.
For example, if you purchase from abroad, do not waste time checking exchange rates each day. Instead, ask your financial controller to notify you if the exchange rates move outside agreed limits.
 - For some businesses, exception reporting is a useful method. For example, a retail chain might only report on those stores outperforming or underperforming budgeted sales by five per cent.
2. Specify how you would like the information presented.
 - A one-page summary sheet is advisable, backed up by detailed supporting information.
The summary sheet could list the key performance indicators, such as total sales and gross margin, plus the top five drivers that you have identified.
This forces you to concentrate on the issues which have the most impact on your business performance.
 - The information can be ordered according to functions.
For example sales, production and finance.
 - Always present the actual figures alongside the standard figures (eg the budget and prior year), so comparisons can be made.
3. Whoever prepares the information should include a written commentary.
This explains any important changes since the previous period, including the reasons behind them.
 - For example, sales might be low because a particular contract has been delayed.
4. Special attention needs to be given to any major projects or new areas of business.
 - Problems usually arise. Identify them early on and take action immediately.

8. Action

If your employees know that you are closely monitoring the performance of the business, people will tend to sort out most minor problems immediately.

You, the senior management, should therefore have more time and resources to focus on the more important issues.

1. Select the most urgent problems, identify the causes and agree on the best cure for each.
 - Agree which individual will be responsible for each action item, together with timescales. Record this in the minutes of the meeting.
 - You may need to dig deeper to find the real reasons behind poor figures.
For example, employees may not wish you to know when they have made mistakes.
 - If the same problem keeps re-occurring, it is often a sign that the person responsible is not capable of doing the job properly.

2. Avoid being distracted. Always come back to focus on the real drivers of the business (see Eye on the ball below).

The Signs Were There

A sign manufacturer won a large order to make, deliver and install signs for a retail chain with branches throughout Europe. Everyone worked frantically to fulfil the order.

The directors did not notice the falling profit margins, which resulted from the optimistic pricing of the delivery and installation elements of the contract (neither of which they had previous experience of). Nor, until the crisis stage, did they properly think through the cash flow implications.

They were used to being paid promptly, thirty days after a sign left the factory gate. Now they had to wait until each sign was delivered, installed and inspected before they could even invoice for it.

Had the company used effective management information systems, they could have anticipated the kind of problems that arose. They would certainly have identified the margin and cash flow problems earlier on.

Eye on the Ball

Always come back to what drives your business. Take the example of a house-builder.

The profitability and cash flow of house-builders is greatly affected by housing prices and sales activity levels in that market. These, in turn, are affected by local demand and supply and interest rates.

But it is all too easy for a house-builder to ignore these key drivers. There will always be sites which are running over budget and other distractions.

Suddenly, the house-builder may find that while he was busy building houses, the market for them has collapsed.

Managing Cash Flow

Summary

A business can survive for a short time without sales or profits, but not without cash. It is cash which pays the bills and allows trading to continue. And if you are growing and extending credit to more customers, the need for cash is even greater.

This briefing explains:

- The main components of cash flow.
- How to forecast and control cash flow.
- Tactics for generating more cash.
- Tips on using the right types of finance for your needs.

1. Components of Cash flow

Your cash flow is the balance of all the money which flows into and out of, your business each day. Cash flow is the actual payments of money, as opposed to what is owed by your debtors or to your creditors.

There are five main components of cashflow.

1. The main inflow of cash is usually the cash from sales.
 - If you sell on credit, your cash inflow is delayed until you are actually paid. Effective credit control is essential. (See 5)
 - A business which purchases on credit and is paid in cash, such as a retailer, is at a great advantage in cash flow terms.
2. New finance provides a one-off boost to your cash flow.
 - In the past, most businesses have relied on bank overdraft finance and have reached their borrowing limits quickly. Alternative methods of funding allow you to raise more finance (see 7).
3. The main outflow of cash is the money used for expenditure, including paying for your overheads.
 - Salaries (including National Insurance contributions) are often the largest and most inflexible cost.
 - Other major costs might include stock, raw materials and any capital expenditure.
 - Many businesses have to fund large amounts of work-in-progress. For example, a design agency might spend six months on a project before the client is prepared to be invoiced. In the meantime, the agency has to foot the bill for all the materials and labour that go into the job.
4. VAT and tax are regular cash outflows that tend to be paid out in large lumps. You can be penalised heavily for late payments.
 - Buying significant items just before a VAT period ends, rather than at the start of the next one, can help your cash flow.
5. Your business needs to give its owners and financiers a return on their investment.
 - You must pay interest – and repay capital – to lenders such as the bank.
 - If there is spare cash, you – and other shareholders – may want to draw back any personal loans made to the business.

2. Cash Flow Forecasting

The more warning you have of cash flow peaks and troughs, the more time you have to deal with them.

1. Accounting software makes it easier to prepare budgets and revenue and expenditure forecasts for the months and years ahead.
 - You can quickly update your projections and make ‘what if’ calculations. For example, what if sales are 20 per cent below forecast for six months in a row?
 - For maximum flexibility and ease of use, you can use special forecasting software, such as Winforecast.
 - You could use graphics to make it easy to detect patterns and step changes.
2. Prepare budgets showing the level of sales and profits you expect to achieve and the costs involved in doing so.
 - Estimate the sales and margins, based on past experience. Overheads such as rent can be accurately predicted.
3. Prepare monthly (or weekly) cash flow forecasts, looking ahead one year, updated monthly.

These forecasts show what cash you expect to come in and when (if at all) you expect to run into problems.

 - Identify the major outgoings, especially those on fixed dates, such as the monthly payroll.

Make sure you will have sufficient cash on the day, to cover each payment.
 - The key is to be realistic. For your regular sales, use the established figures for sales volumes, debtor periods and bad debts.

For any new products or customers, be pessimistic – expect problems and delays and do not book a sale until the customer has paid the invoice.
 - Be aware that monthly forecasts do not take into account weekly fluctuations.
4. Include key indicators that give a picture of the health (and prospects) of your business.
 - For example, the volume and status of sales leads and the volume of orders.
5. Include the budgets and forecasts in the management accounts which you regularly send to the bank.
 - A bank which trusts your forecasts will be more prepared to extend your borrowing facility when you need extra finance.

3. Using the Forecasts

1. Monitor your actual performance against the budget and the cash flow forecast regularly – at least once a month. Identify any problems and take immediate action.
 - For example, if you know you will be short of cash in three months’ time, you might reduce stocks, slow down sales growth, or agree extended credit from a major supplier for that period.
 - The only way to generate cash over the long term is through retained profits. By comparing your performance with the budget, you can quickly judge whether sales and profits are going to plan.
2. Before taking on any large financial commitment, including major new orders, check that you will have sufficient cash flow (or other finance) to pay the costs involved.
 - Create a useful yardstick by working out how much extra working capital is required to fund each 10 per cent increase in monthly sales.
 - Restrict the growth of your business to whatever you can comfortably afford to finance. Always keep a financial reserve available for contingencies.

3. Develop red light systems to warn you automatically if something needs querying.
 - Your sales manager must let you know as early as possible if leads, orders, or sales, fall below a certain threshold, or if planned sales will be later than forecast. Or if a substantial customer stops buying from you.
 - Your financial controller should warn you if key indicators such as profit margins, liquidity ratios and stock ratios deteriorate beyond an agreed limit. You also need to know about any substantial invoices which are in dispute, particularly late debts and customers exceeding their credit limits.

4. Sales and Marketing

1. Today's sales are tomorrow's cash flow, so your overall aim is to keep increasing sales and profitability.
 - Increasing prices may reduce sales (and therefore cash flow) in the short term. But this is often outweighed by its major positive impact on profitability and cash generation over the longer term.
2. Even profitable companies can – and do – become insolvent through overtrading. This happens when you have to pay the costs you incurred fulfilling an order before you receive payment from your customer.
 - To avoid this risk, you may need to delay some orders and decline others. (See 3.2)
3. When negotiating contracts with customers, make generating cash flow one of your primary objectives.
 - You may be surprised at how easy it is to obtain deposits. For example, to pay for any materials which you need to buy in.
 - Negotiate stage payments for contracts which will take time to complete. Include a timetable for the customer to pay invoices as part of this agreement.
 - Agree a clear specification for the work to be completed, to minimise the chance of the customer disputing any invoices.
4. Improve your sales and profit margins by making sure all your work is invoiced for as soon as possible.
 - Suppliers are often asked to perform beyond their original remit. It is reasonable to negotiate additional payments in these circumstances.
5. If you need to improve your cash flow temporarily, adjust your sales and marketing plans to suit.
 - Bring forward sales by offering customers incentives to purchase quickly.
 - Bring forward payments by offering customers incentives (eg discounts).
 - Focus your marketing on short-term lead generation, rather than longer term objectives like brand recognition.
6. If you pay sales commission, link it to receipt of payment rather than receipt of order. There is a double cash flow benefit:
 - You delay payment of the commission.
 - Your sales people will persuade your customers to pay promptly.

5. Credit Control

An efficient credit control system speeds up your cash collection and reduces the number of bad debts. It also saves you time and shows your customers you run your business professionally.

1. Control how much credit you provide and to which customers.
 - Avoid giving any customer more credit than you could afford to lose if the sale

- turned into a bad debt.
2. Send out invoices immediately after you have supplied what the customer ordered.
 - If appropriate, make a follow-up call. Confirm that all the invoice details were correct and that there will be no problem paying it by the due date.
 3. Monitor late payments and chase them up methodically, largest debtors first.
 - All businesses – and the public sector – have a legal right to charge late-paying customers interest on contracts. See Interest on Late Payments for further information.
 - Using a debt collection agency, or a specialist solicitor, can be an effective method of dealing with non-payers.

6. Controlling Expenditure

1. Shop around, so you know the prices and service which you should insist on from your suppliers. (See 7.3 for other options.)
 - Consider whether you could make savings by purchasing some types of capital equipment second hand.
2. Implement simple cost control systems across your whole business, to identify scope for cost savings.

For a start, four types of easy savings can usually be found:

 - Overcharging by your suppliers, such as double billing or missing discounts.
 - Unnecessary costs, such as heating your premises at night.
 - Excessive costs, such as high priced suppliers providing a product or service that a low price supplier could provide.
 - Inefficiency, such as laborious paper-based systems which could be computerised (to reduce costs in the long term).
3. If you hold stock, good stock control can release substantial sums of money.
 - Aim to maintain just enough of each type of stock to service your customers on an on-going basis. Identify seasonal peaks and troughs.
 - Set a target stock-turn (eg six times a year) for each category of stock, then monitor your performance.
 - The faster your suppliers can deliver to you, the less stock you need hold.
 - Consider selling off any old or obsolete stock to raise extra cash.

7. New Funding

You need a solid financial base to underpin the cash flow of your business. Take full advantage of the different types of finance available.

1. Overdraft and loan finance may be limited by the security you can give the bank.
2. Factoring allows you to raise finance based on the value of outstanding invoices.
 - Growing businesses in particular often find that factoring provides a more substantial and flexible source of working capital than overdrafts or loans.
3. Consider using asset finance to purchase computers, vehicles, plant and machinery.
 - For example, both hire purchase and leasing allow you to spread the cost of the acquisition, with the asset itself providing the main security.
4. A strong financial base of equity finance (and directors' loans) is vital when a business starts up. Subsequent injections of equity finance can help you achieve step changes in the growth of the business.
 - For example, if you need extra finance to buy another firm or open a new factory.

Positive Cash Flow

Some types of business are cash-positive – as long as they are profitable, they should generate cash as sales increase. For example:

1. Retail outlets are paid cash and may not pay their suppliers for 60 days.
Likewise a taxi firm or a bus company takes cash, then pays the wages later on.
2. Some travel agencies are paid in advance by customers, but pay the holiday operator just before the holiday.
3. Many computer maintenance firms are paid a monthly or even annual retainer in advance.

No Profits and No Cash Flow

Here is a list of the bad business practices that cause many needless business failures.

- Taking on financial commitments (such as new employees) before the business can afford to pay for them.
- Doing large amounts of speculative work in the hope that a customer might then purchase what you have produced.
- Overvaluing stock, work-in-progress and fixed assets such as machinery.
- Making no provision for major expenses which you know are likely to happen.
- Failing to do any cash flow forecasting, particularly if your business is struggling to grow.
- Failing to agree the details of an order with the customer, or the payment terms, which leads to a dispute.
- Failing to implement an effective credit control system, starting with credit checking prospective customers.

Credit Control

Summary

Optimising cash flow and avoiding bad debts are two key objectives of any successful business. Setting up a good credit control system is the starting point for both.

This article will help you to decide what approach is appropriate for your type of business – and how you should handle different customers.

The article explains how to:

- Decide on credit terms for customers.
- Prevent late payment.
- Deal with customers who cannot – or will not – pay.

1. Before You Give Credit

1. Ask each new customer to complete a credit application (or trading application) form.

This should include:

- Full name of the business and whether the business trades under a different name.
- Registration number, if it is a limited company.
- How much credit is being asked for.
- Who the contact is for payment queries – including address details, telephone and fax numbers and email address.
- Where to send invoices, as this is often different from the delivery address. Check the statement address, as this can be different again.
- Which bank the business uses – name, address, sort code and account number.
- Details of at least two trade references, which should be regular suppliers.
- A request for consent to obtain a bank reference and a request for consent to obtain credit references.
- Details of who owns – and who runs – the business.

Make sure you comply with the Data Protection Act

2. Explain and agree your payment terms at the order stage and have these terms printed on your credit application form (and on other relevant documents, such as invoices).

The terms should include:

- The credit period offered.
For example, whether payment is due 30 days from the date of invoice.
- Details of any discounts or rebates you offer. For example, for prompt payment or bulk purchases.
- Whether your prices exclude carriage charges ('ex works').
- Whether you charge interest on overdue accounts and, if so, how much.
All businesses have a legal right to claim interest from late-paying customers in both large and small companies.
- It may be appropriate to include a 'retention of title' clause (saying that the goods remain your property until paid for).

Ask a solicitor for advice on this.

2. Checking Creditworthiness

Use the information you have been given to check the new customer's creditworthiness.

1. Get an online credit rating, by paying a credit reference agency for an instant company search (also available through many Business Links). It can be on your desk in minutes and will cost from £10 upwards.

This should provide you with valuable information about the customer, including:

- The last three years' reported financial information, taken from the accounts filed at Companies House.

Some of this may be out of date, but it can often give you a good idea of the company's financial strength.

- Details of County Court judgments (see 2.3).
- Suggested credit limits.

Even a highly detailed report – giving extra information such as comments on the company's past payment record and comparisons against companies of a similar size – will not cost more than about £35 to £45.

2. Take up credit references from trade suppliers. Make sure the referee is a genuine core supplier to the business.

Realistically, trade references may have limited value, as they are usually slow, often guarded and sometimes biased.

The questions to ask people giving references are:

- How long they have traded with your potential customer.
- What credit terms (limit and period) they offer the customer.
- Whether your new customer pays up within the terms offered.
- What your customer's average monthly spend is.
- Whether they are in any way associated with your customer's business, other than as arm's-length trade suppliers.
- If there is any other information they would consider relevant.

Encourage quick replies by giving a phone number, sending an SAE, or asking (by phone) for the form to be faxed back.

3. Write to the Registry of County Court Judgments at 173-175 Cleveland Street, London, W1T 6QR (020 7380 0133) for details of all County Court judgments (CCJs) registered in the last six years.

The fee is currently £4.50 for each name at a specified address, payable in advance.

- A large number of judgments is a danger signal. It may indicate that the company is in financial difficulties, or that it has a habit of disputing or not paying invoices.

The cause of some of these disputes could be administrative error, but this is unusual.

- This information is available on individuals, as well as companies.

Though the cost will be slightly higher, it is easier and much quicker to get details of CCJs as part of a company search.

4. Apply for a bank reference, but be aware that these are notoriously vague and may take a long time to arrive.

- The response will use standard phrases.

You need to interpret these to decide whether or not they amount to a negative reference.

A reference may sometimes be too ambiguous to be useful.

- The fee is typically £9 to £15.

Pay your bank's fee up front and enclose the customer's statement of consent.

3. Giving Credit

1. When setting a maximum credit limit for each customer, consider:

- What credit does the customer want?
- Would the customer still place the order if you provided no credit at all?
The customer may prefer to receive a discount for 'payment with order'.
- How much credit can you afford to give?
Long credit terms for large orders may be out of the question.
- How much of a hold over the customer do you have?
If your customer can easily switch to another supplier, your risk is greater.
- How much could you risk losing?

Credit limits should be reviewed regularly. You may lose business if customers are offered more credit elsewhere.

2. Minimise the risks of giving credit.

- Give new customers a modest credit limit to begin with. You can raise the limit when the strength of your relationship justifies it.
- Open a credit card merchant account.
Seek advice from your bank.
- Consider taking out credit insurance for large transactions.
- Consider the cash flow and credit control advantages of factoring

3. Establish how different customers pay their invoices.

- Many businesses will not pay unless there is an order number.
- Some businesses need the invoice passed to the accounts department by a certain date, or it misses the monthly cheque run.

4. Fulfilling the Order

1. Get the order details right.

If they are incorrect, the customer may have every right to delay or even refuse payment.

- Ask your customer to confirm the order in writing, including an order number.
If you are providing a service, such as consultancy, the order should specify the work to be undertaken (eg by referring to an agreement).

2. Obtain proof of delivery for the goods.

- Get a signature acknowledging receipt of the goods. Consider using Royal Mail's recorded or guaranteed delivery services.
- Include a packing note with every order, giving the order number and listing the items being delivered. Keep a copy.

3. Ensure the customer is satisfied.

- Sort out any problems immediately.

5. The Invoice

1. A clear, easy-to-understand invoice will encourage customers to pay more quickly.

As well as the amount owing, make sure you include the following important details:

- A detailed description of the goods.

- A reference to the order number.
 - The agreed payment date (in line with the terms of trade).
- The invoice should also provide your details, including your address, VAT number (if applicable) and full bank details.
2. Send your invoice out the day the goods are sent.
 - Sending invoices out late sends the wrong message.
 - Send the invoice to the right person.

Find out beforehand who this is, or whether the invoice should be addressed to the customer's accounts department or to the accounts manager.
 3. Send statements out as early as you can in the month, every month.

Many businesses will not pay an invoice until they receive a statement.

 - Include details of all current transactions and your payment terms.

6. Chasing Up

1. If you want immediate action, phoning is one of the fastest ways to persuade late payers to pay up. Start chasing payment as soon as the account becomes due.

Always concentrate on:

 - The largest debts first.
 - Customers you guess may be in financial trouble.
 - The older accounts.

Except in special situations, it is unlikely that debts over a year old will be paid.
2. Maximise your effectiveness.
 - Keep customer details, invoice numbers, dates and amounts in front of you.
 - Keep a record, with dates, of all your calls.

7. Dealing With Excuses

Always be sceptical of excuses, as they can often be simple delaying tactics. Put these customers high on your chasing list.

Adopt a professional but friendly approach when dealing with the common excuses for non-payment.

1. 'I haven't received your invoice. Can you send a copy?'
 - Check that the invoice address is correct.
 - Immediately fax (or email) another copy of the invoice to the person you spoke to.

Phone to confirm it has been received and check when you can expect payment.
2. 'Your invoice is on the next cheque run.'
 - Check that the details on the customer's purchase ledger are correct.
 - Ask when the cheque run date is.
 - Call a few days beforehand to make sure your invoice is going to be paid.
3. 'I'll deal with it shortly.'
 - Ask when.
4. 'Your invoice hasn't been passed to accounts yet.'
 - Ask the buyer you supplied to authorise the payment.

Then phone the accounts office to confirm that the buyer has done so.
5. 'The cheque's in the post.'
 - Ask for the postal date and cheque number.
6. 'We've got a cash flow problem' or 'We can't pay until we've been paid ourselves'.

- This is an extremely serious warning sign.
It may be necessary to halt all credit and send a letter of claim (see 9).

8. Stop Lists

A stop list is a list of customers you do not want to give more credit to.

1. Update your stop list regularly.
 - Circulate it to appropriate employees, to prevent further credit being given.
2. Do not supply any more goods to customers on the list until they have paid their accounts up to date.
3. Inform late payers that they are 'on stop'.
 - This encourages them to pay up, especially when they realise they are going to want to place further orders.

9. Letters of Claim

1. A 'letter of claim' (or 'seven-day letter') is the first stage of the legal process.
 - You cannot sue someone until you have sent that person such a letter.
 - The letter tells your customer that if overdue invoices are not settled by a certain date (usually in seven days' time), you intend to sue without further notice.
2. Letters of claim can be sent any time after an invoice becomes due.
 - Some businesses have a policy of not paying until they receive such a letter.
 - You do not need a solicitor to send a letter of claim.

10 the Human Factor

Throughout the credit control process, maintain a positive personal relationship with your customers. You are more likely to get the response you want if you adopt a friendly approach.

If you have no alternative but to take legal action, maintain this approach by taking the following steps:

1. Discuss your situation with the customer.
 - Explain that you value the customer's business.
 - Explain that you have been advised to take legal action.
Make it clear that you only want to take this course if there is no alternative.
2. Speak to the managing director or finance director of the business, if possible.
 - Problems can often be sorted out by a director in your company talking to his or her opposite number.
 - This conversation may give you an indication of whether the company has the money to pay you.

Interest on Late Payments

Summary

All businesses have a legal right to claim interest from late-paying customers. The statutory right to interest, introduced under the Late Payment of Commercial Debts (Interest) Act 1998, applies to all contracts agreed after 7 August 2002. Late payments create cash flow problems and expose businesses to the risk that they will never be paid.

This article covers:

- Who can charge interest on late payments.
- How to decide whether or not to claim statutory interest.
- How to calculate how much interest to charge.
- How to claim what you are entitled to.

1. Who Can Charge Interest?

The statutory right to charge late-paying business customers interest applies to contracts which do not already include their own arrangements for 'substantial' interest. The right was introduced in three distinct phases.

1. Small businesses have been able to claim interest from large businesses and the public sector on contracts agreed since 1 November 1998.
2. On contracts agreed since 1 November 2000, small businesses have been able to claim interest on late payments from other small businesses.
3. All businesses and public sector bodies have been able to claim interest on late payments for sales agreed from 7 August 2002.
 - All organisations also have a right to claim reasonable debt-recovery costs. Creditors can claim an extra £40 for debts of up to £1,000, £70 for debts from £1,000 up to £10,000 and £100 for debts of £10,000 or more.

2. The Rate of Interest

1. The law gives you the right to charge interest at the Bank of England base rate plus eight per cent.
 - For example, if the base rate is four per cent, you could charge interest at 12 per cent.By comparison, a business overdraft is typically charged at two to three per cent over base rate.
2. Rates for calculating interest are fixed for six-month periods.
 - The base rate on 31 December will be used for debts becoming late between 1 January and 30 June. The rate in force on 30 June will be used from 1 July to 31 December.
 - To find out what the base rate is, call the Bank of England's Public Enquiries Unit (020 7601 4878) or visit www.payontime.co.uk.

3. Should You Charge Interest?

Although the rate of interest is high, the total amount of money involved may only be a few pounds. Think what charging interest and costs might do to your relationships with your customers.

1. Consider how customers are likely to react.
 - Determine if late payment is limited to a few of your customers, or if most of

- your customers pay late.
- Ask front-line employees (eg in sales) for their opinions.
2. Assess the effectiveness of your credit control system.
 - If you are ineffective at collecting money owed to you, customers may strongly object to being asked to pay interest and debt-recovery costs.
 - See Credit Control, for information on creating a credit control system that is appropriate to your business needs.
 3. Find out what other businesses in your industry are doing.
 - Your trade association may be able to provide advice.
 - Ask your customers if their other suppliers charge interest on late payments.
 4. Remember that it is not compulsory to charge interest on late payments or debt-recovery costs.
 - You retain the right to define your own terms and conditions. But customers cannot impose a contract denying you ‘substantial’ interest on late payment. And in the absence of any specific payment terms, the Act will apply.
 - You can only claim the costs under the Act if you claim the interest under the Act.

If you do not claim interest, or you claim it under a contractual provision or the provisions of a different Act, you cannot claim the costs.

4. When Is a Payment Late?

Under normal circumstances, you will have agreed with your customer when payment should be made.

1. A payment is late if it is made after the last day of the agreed credit period.
 - Agreements may be verbal or in writing. Verbal agreements are harder to prove.
2. If there is no agreed credit period, the law sets a default period of 30 days.
 - You can charge interest 30 days after you delivered the goods or provided the service, or 30 days after you notified the purchaser of the amount of the debt – whichever is the later.

To notify the purchaser of the amount of the debt, you should ideally send an invoice. But any other form of notification would do, including a phone call – though that might be difficult to prove if there is a dispute.
3. Where a standard practice on payment has become established, this is accepted – in the absence of any other agreement – as the credit period.
 - For example, if the purchaser usually pays you on the last Friday of the month after the month in which you send your invoice, this is when the credit period will end.
4. The exact wording of your agreement will determine when interest can start.
 - If you have agreed on part payments triggered by the completion of part of the work – for example, finishing the foundations of a building – interest will start running from the day after you have reached that milestone.
 - This is not the same as an advance payment or an instalment (which is not tied to a specific milestone).

Interest on these starts the day after the goods are delivered or the whole job has been finished.

 - Small and medium-sized enterprises, with up to 250 employees, can ask representative bodies – such as the Federation of Small Businesses and the Forum of Private Business – to go to court on their behalf to challenge grossly unfair contract terms used by purchasers which may affect their ability to

recover interest on debts.

5. Calculating the Interest

Calculating the interest due is a straightforward, step-by-step process.

1. Calculate what the interest would be for a full year, by multiplying the amount owed by the total rate of interest (base rate plus eight per cent).
 - For example, if the debt is £1,000 and the base rate is four per cent, then the annual interest would be $£1,000 \times 12 \text{ per cent} = £120$.
2. Calculate the daily interest by dividing the annual interest by 365.
 - For example, the daily interest on this £1,000 debt is $£120 \div 365 = 33\text{p}$.
3. Calculate the interest due by multiplying the daily interest by the number of late days.
 - For example, if the £1,000 debt were paid 30 days late, you could charge $33\text{p} \times 30 = £9.90$.
4. If there is no specific agreement to indicate otherwise, any part payment will go towards reducing the interest before it starts to be applied to reducing the original debt.
 - For example, if you received payment of £1,000 in respect of the £1,009.90 now being charged, the amount outstanding would be £9.90 of the original debt. Interest on the £9.90 would continue to accrue.
5. The amount outstanding changes on a daily basis. Be practical, as payer or payee, about settling the debt.
 - For example, agree that if the debt is paid within one week, then no further interest will be charged.
6. Your VAT position is unaffected. You charge interest on the gross amount of the debt (including any element of VAT), but you do not pay VAT on this interest. Nor do you pay VAT on any debt-recovery costs you claim.
 - In the example in A (above), the original £1,000 debt may be made up of £851.06 plus £148.94 VAT.

6. How to Claim Interest

If you decide to start charging interest on late payments, you need to make provision for it as part of your routine credit control system.

Even if you do not usually intend to collect interest, draw attention to your rights in a revised 'terms and conditions' statement. It may encourage customers to start paying on time.

1. Notify each customer in writing. State that you will charge interest on late payments as you are entitled to do by law.
 - Contact habitual late payers to discuss how the system will affect them. Explain that their late payments cost you money.
2. Ensure that your customers understand and agree to your payment terms.
 - State the agreed payment date on each of your invoices.
 - The invoice should clearly state your new terms and conditions and that you intend to exercise your right to charge interest on late payments.
3. Inform customers when interest begins to accumulate. Give the following information:
 - The original invoice number.
 - What account the bill is for.
 - How much is owed.
 - The extra amount of interest the customer will owe you each day.

- To whom the payment should be made.
 - Payment instructions.
4. Present the customer with a final bill once the interest and the original amount that was due have been paid.
 - The final bill should specifically mention the number of days that interest has been charged for and the base rate that was used in calculating the interest.

7. What If a Customer Objects?

Despite the law, your customer may be unwilling to pay interest on late payment – but they cannot ‘opt out’ of doing so. In the interests of customer relations, try other ways of obtaining your money before considering legal action.

1. Make it clear that you would prefer to come to an agreement regarding the debt.
 - If you cannot reach agreement with your customer, you can follow several approaches to obtain the money.
2. Consider applying pressure by placing this customer on a stop list until the debt has been paid.
3. Consider selling or passing the debt (or part of it) to a third party, such as a debt collection agency.
 - The purchaser of the debt can use the courts to obtain payment of the debt and the interest.

If you sell or transfer a debt, you must inform your customer in writing that it has been assigned to a third party.

4. You may ultimately want to pursue your claim for the original amount and interest through the court.
 - Your claim will be helped if you can provide written evidence that you delivered the goods or completed the job and that the customer was satisfied.
 - If you have legal expenses insurance, this should encourage a non-payer to pay up when threatened with legal action.

8. Further Help

Further advice on claiming and paying interest on overdue invoices is available from a number of sources.

1. Your accountant or financial adviser should have an understanding of the legislation and how it could affect your business.
2. Check with the Better Payment Practice Group (www.payontime.co.uk).
 - The website offers an online interest calculator and you can submit through the site questions on late payment that experts will answer.
3. Your local Business Link can offer advice, or visit www.businesslink.org.
4. Check with the Small Business Service (www.sbs.gov.uk/finance/latepayments.php).

What Difference Does it Make?

Under the law, company finance directors who have made a habit of taking extra credit from suppliers to improve cash flow may have to think again.

1. There will be less free credit to be had just by paying slowly.
 - The ‘base rate plus eight’ formula means money ‘borrowed’ by delaying payment will be more expensive than overdraft money from the bank.
2. Attitudes towards late payment should change for the better.

The Clock Ticks On

Claims for interest do not have to be made straight away.

1. A supplier has six years in which to make a claim for interest on late payment, as long as trading terms were agreed and the customer was duly notified when interest began to accumulate.
 - The six-year claims period is the same throughout England, Wales and Northern Ireland, but the period is only five years in Scotland.
2. Businesses may still make claims for interest after they have stopped supplying goods or services to a particular purchaser.
 - The only way for purchasers to be sure of avoiding future claims is to pay bills on time.
 - Liquidators and receivers acting in connection with a business can also pursue ex-customers for interest on late payments, going back up to six years.

Debt Recovery

Summary

Most businesses experience some problems getting paid on time by their customers. Good credit control helps to prevent this becoming a serious problem .

However, there are occasions when a customer cannot, or will not, pay. To avoid a bad debt, you may need to use a third party or take legal action to recover the money you are owed.

This briefing explains:

- The key issues to consider when deciding how to proceed.
- How debt collection agencies, solicitors and arbitration can help you.
- Which legal remedies might be the most appropriate.

1. Is it Worth a Fight?

There are no hard and fast rules about whether to pursue a debt and which approach to take. Much depends on the individual circumstances of the debt and the customer.

1. How much money are you owed?
 - In terms of time and money, it may be best to write off very small sums, but the Small Claims Track (see 4) offers a cheap route without the need for solicitors.
2. Who is your customer?
 - If it is a customer whose business you value, be diplomatic in your approach.
 - If it is a one-off customer, you can be more assertive.
3. Why has the customer refused to pay?
 - Is there any dispute over the goods?
If so, resolve it immediately. Otherwise, the debt will be difficult to recover.
 - Is the customer in cash flow difficulties?
If so, try to negotiate a payment on account (part payment) and reschedule the remainder. Confirm this in writing.
 - Are there already outstanding judgments against the customer?
If so, the debt may well be irrecoverable. Ask your local court how to check the Register of County Court Judgments.
 - Is the customer bankrupt or in liquidation?
If so, the debt is probably irrecoverable.

2. Debt Collectors

Debt-collection agencies (and solicitors who specialise in debt collection) have the time, expertise and resources needed for the job.

1. Using a reputable debt-collection agency (or a specialist debt recovery solicitor) is a fast method of recovering debts.
 - Your customer will often pay up straight away, either in full or in instalments. You also save your own time.
2. Using an agency is often sensible when you want to keep the customer.
 - You are unlikely to keep a customer who has been pursued through the courts.
3. Costs are normally calculated as a percentage of the money recovered.
 - The commission on the money recovered is typically eight to ten per cent for commercial debts (and three to 15 per cent for consumer collections), though it can vary depending on the size and age of the debt.
 - The percentage commission may be higher for a one-off recovery than if you use the agency for all your unpaid debts.

- Some agencies charge an annual subscription (often £25 to £100).
 - Some agencies charge a flat fee in the form of vouchers. You buy, say, £400-worth of vouchers, which you send in with each invoice to be collected.
 - If you are asked to pay any money in advance, check the agency's record (see 5). Rip-offs can and do, happen.
4. The agency can also instruct solicitors on your behalf if a customer still refuses to pay up.
 - This will save you time but it may be cheaper to instruct the solicitor direct.
 5. Make checks before using an agency.
 - Is it registered with the Credit Services Association (0191 213 2509 or www.csa-uk.com)?
 - What methods does it use?
You could be liable if it uses unlawful methods such as harassment.
 6. Your solicitors, or your accountants, may be able to recommend a good agency or may offer debt collection services themselves.
 - Unless your solicitor specialises in debt collection, this may be expensive.

3. Statutory Demands

The other alternative to going straight to the courts is to issue a statutory demand.

1. You can only use this for undisputed, higher-value debts.
 - This means outstanding debts of more than £750.
2. You send a formal demand for payment in a specified format.
 - The format is set out in the Insolvency Rules. You can get appropriate forms online (eg from Oyez at www.oyez.co.uk).
 - Alternatively, ask your solicitor to organise it. This is a relatively low-cost procedure.
3. If the debt is not paid after 21 days (and you think there is money available), you can petition the court to wind up the company (or make an individual bankrupt). (See 8)
 - The prospect of being wound up (or made bankrupt) often has much more effect on debtors than court procedures to recover the money.

4. Small Claims Track

If you pursue a debt for up to £5,000 using the courts, your case will be allocated to the Small Claims Track, part of the County Court. The procedure has opened up rapid and simple methods for individuals and small firms.

1. Making a claim using the small claims track is inexpensive. County courts are listed in the telephone directory. Your local court can send you the forms to fill in, plus leaflets explaining each stage and the fees involved.
 - A Solicitor is not usually required.
 - The court fees can be added to the amount of your claim. So, too, can interest on the debt from the time it became due. Both should be included at the outset. However, you can only claim very limited solicitors' fees.
 - Present written evidence that you have tried to resolve the dispute before resorting to proceedings or you may be penalised even if you have a valid claim.
2. Once the court serves the claim form, your customer (the defendant) can respond in one of four ways:
 - Pay the claim.

- Admit the claim, or part of the claim.
 - Ignore the claim by not responding within 14 days. In this case, a default judgment can be enforced.
 - File a defence to your claim. A defence can include a counterclaim (saying that you owe the defendant money).
This usually leads to a hearing. (See 4)
3. If the defendant suggests a compromise of some sort, you can accept the offer or progress to a small claims hearing. (See 4.4)
 - Agreeing to accept payment in instalments is often advisable.
 4. A small claims hearing is an informal meeting between yourself, the defendant and a district judge.
 - This takes place on a fixed date at court.
 - The judge listens to you, to the defendant and to any witnesses and reviews the evidence which each of you puts forward (eg invoices, letters, expert opinions).
 - The judge then tells you his decision and explains his reasoning.
He can also explain what to do next.
 - Provided you submit written evidence and give at least seven days' notice, you do not have to attend the final hearing in person.
 5. If the defendant has agreed in writing to pay the claim, or you have been awarded judgment at the hearing, you can then request the court to enter judgment.
 - This records your legal right to the debt, but does not guarantee payment. (See 6)

5. Claims Over £5,000

Court claims between £5,001 and £15,000 are dealt with by a fast-track procedure. Claims over £15,000 use the multi-track procedure.

1. You start proceedings by issuing a claim.
 - Claims over £15,000 can be issued in the High Court. Claims for less than this must be issued in the County Court.
2. It is advisable to use a solicitor or barrister to represent you.
 - Obtain good legal advice before proceeding. A trial can be expensive for the defeated party.
3. If the defendant issues a defence to your claim, the procedure is more formal and complex than for small claims.
 - Your legal adviser and the court staff can explain what is involved.
 - You may not wish to proceed further if a defence is issued. But you may have to pay costs if you abandon the claim.
4. Try to establish the length of time it will probably take for the case to go to trial.
 - The courts try to limit this to 30 weeks for fast-track cases.
 - In extreme circumstances, it can be two years before a multi-track case is heard.
5. Whichever party loses is likely to end up paying the court fees and most of the legal costs of both parties.
 - Even if you win, you will probably have to pay part of your own legal costs.
 - If you cannot show that you first tried to settle the dispute out of court, the judge may order you to pay your own costs.

6. Still No Payment?

If your claim is successful (see 4 and 5), you are awarded judgment by the court. If the defendant still refuses to pay up, or falls behind in payments, you can attempt to

enforce judgment through the court (see 7). Just because you have been awarded judgment does not guarantee success.

1. Often, the reason the defendant did not pay in the first place was lack of funds.
 - There may be no valuable assets to sell either.
2. The defendant may be able to appeal against the judgment.
 - This could delay payment. At worst, the judgment could be cancelled or altered.

7. Enforcing Judgment

There are four main methods of enforcing judgment. In each case, you complete a form and pay the court a fee to start the process. The fee is added to the amount of your claim.

1. The most common method is to use a Warrant (or Writ) of Execution. This is effective if the defendant has assets (eg goods on his premises) which can be taken and sold for a significant sum.
 - The court will send bailiffs to collect the money you are owed.
 - Alternatively, the bailiffs can seize suitable goods to sell at auction. Bailiffs are prohibited from taking basic domestic items (eg clothes), items which defendants need for their jobs (eg tools, car) or rented items (eg television).
 - Judgments for debts over £600, which are registered at the High Court, can be enforced by sheriffs. Sheriffs have a much higher success rate than bailiffs.
2. If the defendant's bank account is in credit, consider using a Third Party Debt Order.
 - The bank (or building society) is ordered to put aside the amount of your claim from the funds in the defendant's account. The defendant is offered a hearing.
3. If the defendant is employed, consider using an Attachment of Earnings Order.
 - The defendant's employer is ordered to deduct the amount from the defendant's wages and pay it over.
4. If there is no easier way to obtain the money, consider a Charging Order. This prevents the defendant from selling the assets which you charge (usually a house or stocks and shares) without paying you the money you are owed. Usually, the defendant is an individual rather than a limited company.

8. Insolvency Procedures

Winding-up is the procedure whereby a company is forced to cease trading and its assets are sold in order to pay off creditors. The equivalent for an individual is bankruptcy.

1. These procedures can be used to enforce payment if the debt is more than £750 and is not in dispute.
2. Trade creditors (suppliers) usually end up receiving, at best, a small percentage of the money owed to them.
 - First to be paid off are the liquidator's (or trustee's) fees, tax, VAT, some employee pay and any money owed to secured creditors such as the bank.
 - If there is any money left over, the unsecured creditors (eg suppliers and employees who are owed money) share it. Creditors are paid in proportion to the amount of money owed to them.
3. If the terms of your contract with the customer include a retention of title clause, you may be able to reclaim the goods themselves (if it is possible to identify them).

Be Firm, Be Reasonable

When it comes to recovering problem debts, the only winners are the debt-collection agencies and the lawyers.

1. Discuss the situation with your customer.
 - Find out why the debt has not been paid and try to resolve the problem.
 - Explain what steps you intend to take.
 - Try to reach an agreement.
2. Before you start any kind of legal proceedings, let the customer know.
 - A solicitor's letter makes it clear to the customer that you are serious.

Many customers will pay up immediately, or at least settle out of court.

The customer will probably want to avoid costs, hassle and uncertainty as much as you.

Alternative Dispute Resolution

Long before a payment dispute ever arises, it is possible to agree a dispute resolution procedure with your customer. This can be written into the contract between you.

1. The main attraction of this approach is the flexibility it provides.
 - You can agree how formal the procedure should be and who should act as the arbitrator or mediator. In this way you can control costs.
 - Disputes can be resolved more quickly than in court, with less confrontation.
2. One form of dispute resolution (if the parties agree) is arbitration.

This involves using a professional arbitrator. Importantly, you can make the arbitrator's decision legally binding.

 - Arbitration is rarely used for debts below £2,000 because of the costs involved.

For more information, call the Chartered Institute of Arbitrators (020 7421 7444).

Managing Creditors

Summary

You rely on good relations with creditors for the smooth operation of your business. Suppliers (trade creditors), the bank and statutory bodies such as Inland Revenue all have a major effect on the cash flow of most businesses.

When your cash flow is tight, you may not be able to pay your bills on time. If you manage the situation well, your creditors will have more trust and confidence in you than before. But managed badly, the situation can quickly develop into a major crisis. This article covers:

- Deciding your objectives for each creditor.
- Identifying your key creditors.
- Handling your bank and the taxman.
- Dealing with creditors if you are in financial difficulties.

1. Your Payment Policy

A well thought-out payment policy is a vital part of building a strong and trusting relationship with your suppliers and other creditors.

1. For every supplier, work out what your purchasing objectives are.
 - The priority is usually reliability, followed by quality, price and then credit terms.
 - Shop around. If you have a choice of good suppliers for a particular product, your supplier may be prepared to extend the credit period to keep your business.
 - Agree these objectives with your accounts department and train them in how to treat your creditors.
2. Set out a general policy on payment and make sure your suppliers understand what your payment terms are.

For example, you might pay within 30 days of receipt of invoice. Or you might do a monthly cheque run.

- If you generate cash, like most retailers tend to, you can afford to pay quickly in return for price discounts.
- Write down your terms of trade and ask any new supplier to agree them by signing and returning them. If the supplier's terms of trade conflict with yours, come to a (written) agreement before you order.

If you manage your cash flow well, you should be able to pay your suppliers on time.

3. Allow for some flexibility.
 - Be prepared to trade off credit in return for other concessions (or vice versa) from your suppliers.
 - Some suppliers operate on a cash-up-front basis, or require a deposit.
4. Communicate the benefits to your suppliers, so they support you in the future.
 - If you pay promptly, your suppliers should expect to do you a favour in return when you need one.
 - If you negotiate extra credit, show the suppliers what they get in return.
5. Review your terms regularly.
 - Check whether other suppliers would offer better terms. If they would, ask your existing suppliers to improve theirs.

2. Key Creditors

Identify which creditors are vital to the survival and growth of your business. Then work out tactics to win the support of each one.

1. Your financial backers are usually top of the list.
 - Treat your bank as an investor, by providing regular management accounts in a format which the bank has agreed is useful. (See 4)
 - Make sure you are aware of what would happen if you were unable to make a payment on time.
For example, at what point would your hire-purchase company repossess the equipment?
2. Decide which suppliers are mission critical, on the basis that there is no alternative supplier immediately available.
 - IT suppliers (who regularly maintain your IT system) are often high up the list, as trying out a new supplier can be a risk in itself.
 - Your landlord cannot usually evict you (for non-payment) at short notice. But your landlord would have the right to seize goods within your premises, without going to court.
 - Suppliers of commodity items, which you can buy elsewhere, are bottom of the list.
3. Identify which creditors are likely to be inflexible and could seriously damage your business as a result. (See below)
 - Statutory bodies such as Customs and Excise and Inland Revenue can automatically surcharge you for late payment. (See 5 and 6)
Local authorities can sue you for non-payment of business rates.
 - Utilities can cut off your telephones, electricity, water or gas.
One problem is that these organisations are large and impersonal, so it is hard to build a supplier relationship (see 3). If you hold back payment because of a dispute, you may be penalised, immediately. You may have to pay up first and argue your case afterwards.

3. Building a Relationship

Will the supplier go the extra mile for you when you need a rush delivery, or extended credit?

1. Negotiate clear, written agreements at the outset. Then stick to them.
 - Be aware of your supplier's right to interest on late payments.
2. Involve your suppliers in your business, so that they understand your needs.
 - Suppliers are often good at coming up with ideas for how to improve your product or your whole business, as they supply other companies like your own.
3. Keep them informed, to build up their trust in you. Otherwise small problems can escalate into large ones.
 - A common example is the situation where you withhold payment because you received damaged goods.
It is not enough to telephone the operational manager at the supplier, to explain the situation.
You should also confirm it in writing and copy the letter to the managing director or finance director there – otherwise when they review the aged debtors list, they may assume that you are simply refusing to pay on time.
Also keep informed about developments at your suppliers.
For example, a change of ownership can mean a drastic reduction in the credit a supplier extends to you.
4. Ask for benefits in return for giving suppliers what they want.

- For example, you might negotiate to receive an enhanced service in return for committing to place regular orders.

4. Your Bank

If you are going through a cash flow crisis, you need your bank more than ever. But if your bank is financially exposed, this is the exact time when the bank is most likely to reduce its financial support for you.

1. Identify who the real decision-maker is at the bank.
 - More and more lending decisions are made on the basis of computer-generated risk profiles of businesses. This leaves local bank managers with less decision-making power.
 - You need a champion in the bank who knows your business and who will be listened to when decisions are made.
2. Build up a track record, so the bank trusts you and the information that you provide.
 - Supply the bank with regular management accounts, including cash flow forecasts and a brief commentary explaining variances. Be proactive, rather than waiting to be asked for the information.
3. Give advanced warning to the bank of any cash shortages. The earlier your warning, the more support you may receive in return.
 - Provide evidence to show that the cash shortage is only temporary. Third party evidence, such as a confirmed order, can be particularly effective.
4. Shop around, so you have options ready when you need them.
 - Even if you expect to remain a loyal customer, find out what is on offer from other banks and alternative sources of finance. This will enable you to negotiate better terms and you can win the bank's respect in the process.
 - In principle, the bank can demand repayment of an overdraft at any time. Consider the benefits of alternatives such as bank loans, leasing, hire-purchase and factoring. In smaller businesses, personal finance is increasingly a major source of funding as well.

5. VAT

Customs and Excise has a reputation for rarely tolerating unnecessary delays in the payments to it. Paying VAT late, or making any mistakes in your VAT Return, can end up being costly.

1. If you need time to pay, approach the VAT office with a clear payment plan.
 - Unless you have clear evidence that the plan is reasonable and viable, it is unlikely to be accepted. For example, if you have had a major bad debt or a fire, show how your cash flow will recover during the next six months.
 - The first answer you receive is almost invariably 'no'. But continued, reasoned correspondence may lead to a solution.
 - You are far more likely to be granted a temporary 'arrangement to pay', such as paying off the debt monthly over three months, than a longer term arrangement.
 - If you fail to stick to the agreement you can be surcharged (see 2) and you are less likely to be granted another arrangement thereafter.
2. If you repeatedly fail to pay on time the penalties escalate rapidly.
 - Once you have been warned, the next step is a fixed surcharge of 2 per cent of the tax outstanding for that period. This increases to 5 per cent, 10 per cent and

15 per cent for each subsequent default. (For amounts below £200, there are three warnings then a 10 per cent and 15 per cent surcharge.)

- Once a surcharge liability has been incurred, you need to pay your VAT on time for a full year to come out of the surcharge system (and revert to a pre-warning status).

6. Employer's PAYE and NI

Inland Revenue and the Contributions Office are similar in their approach to Customs and Excise.

If you are late in paying tax or National Insurance, there may be less onerous penalties.

1. Individual Collectors of Taxes (or tax inspectors) have the authority to agree an arrangement to pay with you.
 - Adopt the same approach as for Customs and Excise.
2. Interest is payable on any late payments, currently at a rate of 6.5 per cent per annum.

7. Financial Difficulties

1. If you are in financial difficulties, or expect to be, get professional advice quickly.
 - Consult a reputable firm of insolvency practitioners. Contact the Association of Business Recovery Professionals (020 7831 6563) or the Insolvency Practitioners Association (020 7623 5108).
 - Directors who allow their limited company to continue trading with no reasonable prospect of avoiding insolvent liquidation may be personally liable for 'wrongful trading'.
They also run the risk of 'creating preferences'. For example, if you paid back a director's loan in preference to paying a trade creditor this would probably be a preference – in which case the money would have to be repaid.

Assuming that you are not advised to cease trading, take steps to improve your cash flow (see 2 and 3).

2. Agree extended credit with your suppliers.
 - The further ahead you can plan this, the better. Reassure your suppliers that the problem is only temporary.
For example, you might explain that you are taking on a large order which will cause a hole in your cashflow in four months' time. Or you might be recruiting and training a new salesman, which will reduce sales in the short-term but will boost sales thereafter.
 - Agree a plan, then stick to it.
 - You will probably be advised to part-pay several creditors, rather than paying one and ignoring the rest. Aim to achieve some visible progress in the eyes of all the creditors. This will help buy you time to trade your way out of the difficulty.
3. Keep your bankers informed, to avoid any panic at their end.
 - If you have not done so already, investigate the scope for extending your borrowings. (See 4.4.)
4. If you receive any writs, immediately ask your solicitor or accountant how to proceed.

Free - With a Sting Attached

Many businesses help themselves to credit from their suppliers, far in excess of the terms that were agreed. Because trade credit is usually interest-free (see 3.1), there is a temptation to abuse it.

To understand the long term impact of this approach, you only have to compare it with how you treat your employees.

You could also pay them late. At first you would get away with it, because the employees would have no other options. But gradually the good employees would find better jobs. You would be left with the worst employees, who could not find jobs elsewhere. And, given the resentment you would have created, you might expect some departing employees to try to cause trouble for you - perhaps by complaining to your customers.

Asking for extra credit from a supplier is fine and most suppliers will support you. But by helping yourself to extra credit you show that you are not trustworthy, that you disregard the supplier's own cash flow needs and perhaps that your business is in financial difficulties.

Creditor Rankings

In the case of an insolvency, creditors are paid off in the order below.

1. Secured creditors with a fixed charge on assets such as property and machinery.
Most bank finance is secured with a fixed charge and/or a floating charge. (See 3)
If you fail to make payments on time, the creditor has the right to have the asset sold to cover all or part of the debt.
2. Preferential creditors.
These usually comprise Customs and Excise, the Inland Revenue, the Contributions Office and employees.
3. Secured creditors with a floating charge on assets such as stock and work in progress.
4. Unsecured creditors, including most trade creditors.

Cost Control

Summary

Cutting costs is the simplest way to improve your bottom line. Introducing a cost control system can bring immediate savings and ensure that you remain competitive in the longer term.

But cost control needs to be carefully managed. While eliminating wasteful activities is clearly beneficial, indiscriminate cost cutting can lead to falling quality and poor morale.

This article covers:

- Identifying where to focus your efforts.
- Managing cost control.
- Specific cost control opportunities.
- The pitfalls.

1. Your Costs

Cost control works best as part of your routine financial management. The first step is to look at your existing costs.

1. Identify your major cost centres. Typically these might be purchasing, production, sales and marketing, financing, administration, premises, facilities management and R&D.
 - In a small business, a cost centre is usually the area one manager is responsible for (see 3.1).
2. Identify the major types of cost within each cost centre.
These might include staff costs, raw materials and supplies, utility bills for energy and water, capital expenditure, other purchases (eg consultancy services and advertising space), premises, telecoms, travel, transport and financing costs.
3. Choose the costs to focus on first.
 - Costs that may offer easy savings (see 5).
 - Large costs that you may be able to change in the short term.
Fixed costs (eg long-term fixed rate loans or fixed price contracts for raw materials) are hard to control in the short term.

Some cost centres, such as R&D, make important but indirect contributions to your bottom line.

You need to account for these contributions before deciding whether to cut their budgets.

2. Systematic Cost Control

1. Start from your business objectives.
For example, you might aim to manufacture 1,000 units per month, or to win ten new customers.
 - What are your quality standards?
For example, your customer service standards might require a trained employee to respond to all enquiries within a specified time.
2. Establish your 'standard costs' for achieving your objectives.
Standard costs are the costs you would have in an ideal world (but see 4).
You need to consider:

- What resources you need.
For example, components of a specified quality or staff with specific skills.
 - How much of the resources you need.
Standard costs assume optimum performance (eg no unnecessary wastage of raw materials or staff time).
 - What the resources cost.
3. Establish realistic 'budgeted costs' based on your actual experience.
 - Budgeted costs will usually be higher than standard costs.
For example, you might expect two per cent of all production to be wastage (including substandard goods), raising unit costs.
 - Budgeted costs may sometimes be lower than standard costs.
For example, your customer service staff costs may be lower than the standard cost, because you are currently using fewer, lower paid staff.
 4. Record your actual costs and compare them with the standard and budgeted costs. It may be appropriate to compare unit costs (cost per unit produced) or total costs (including overheads such as premises).
 - Costs that are higher than your budgeted costs may indicate opportunities to reduce costs in the short term.
In general, the larger the cost overrun, the more scope there should be for savings.
 - Costs that are higher than your standard costs usually indicate opportunities to reduce costs in the longer term.
 - Lower costs may indicate good management, but might also reflect quality failings or impending problems.
For example, costs can be cut in the short term by cancelling all training - at the risk of causing longer-term skills shortages.

Using a spreadsheet or cost control package, it is easy to record and compare costs on a regular basis (eg monthly).
 5. Periodically review what you are doing and how you are doing it.
 - Benchmarking yourself against other organisations may show that your performance is sub-standard.
For example, if your wastage levels are higher than the industry average.
 - Internal review, or input from an external consultancy, may suggest alternatives.
For example, standardising components to reduce design and manufacturing costs.

3. Who Is Involved?

1. Each cost centre is usually the responsibility of one manager.
 - Some costs can be easier to control if one manager is responsible for that cost throughout the organisation.
For example, concentrating all purchasing can make it easier to achieve economies of scale.
2. Involve employees in cost control.
 - Employees can suggest cost-saving ideas, especially if there is an incentive to do so.
Ask what causes them problems or wastes their time.
 - Employees are more likely to co-operate with cost control initiatives if changes are explained to them.
3. Include your customers and suppliers.

- Ask your customers if you are providing them with anything they do not need.
 - Your suppliers will know what other purchasing options are available that might suit your business.
4. External consultants can be a useful resource (see 7).

4. Easy Savings

Some costs can be reduced with little risk of an adverse impact on quality and performance.

1. Checking supplier invoices may reveal overcharging.
 - Common examples are double billing, incorrect charges and missing discounts.
2. Eliminate unnecessary costs.
 - Get rid of obvious overcapacity (eg unused telephone lines).
 - Cut out blatant waste (eg heating premises at night, or with windows open).
 - Scrap useless processes (eg paperwork that is completed, filed and forgotten).
3. Crack down on excessive costs.
 - Use second class postage, or email or fax, unless only first class post will do.
 - Find alternatives to high priced suppliers, or negotiate discounts.
 - Avoid over-specifying (eg high-quality components for a low-quality product).
 - Ban wasteful luxuries (eg full-fare business class flights).
Cutting back on items employees see as ‘benefits’ or ‘perks of the job’ needs careful handling (see 6.1).
4. Root out inefficiency.
 - Identify manual, paper-based systems that could be replaced by computers.
 - Avoid frequent small orders. They waste time and may mean you lose discounts.
 - Consider switching to single monthly invoicing to cut processing and admin costs.

5. Opportunities

Effective use of a systematic approach will highlight opportunities to control costs with little risk. In some cases, there will be easy savings such as cutting the cost of supplies (see 4).

In others, cost reduction will require changing the way you do things. Some of the most common opportunities are listed below. In every case, be aware of the potential pitfalls (see 6).

1. Reduce your payroll costs.
 - Outsource non-core activities.
 - Use consultants, freelancers or part-time employees, instead of full-time employees.
 - Redesign processes to eliminate duplication of effort and to cut out activities that waste time.
 - Make more use of technology and automation.
 - Do not overpay when recruiting new employees.
2. Improve your purchasing.
 - Switch to cheaper suppliers, or negotiate price reductions or higher discounts for early payment.
 - Consolidate purchasing with fewer suppliers to get better discounts.
 - Agree long-term supply contracts or guarantee minimum annual purchase

- volumes in return for lower prices.
 - Build personal relationships with suppliers to encourage preferential treatment.
 - Simplify purchasing procedures to reduce your costs and those of your suppliers.
 - Form strategic buying alliances (eg purchasing consortia) with businesses in your area or trade to buy larger volumes.
 - Give individual employees purchasing limits to reduce administration and ask your bank about purchasing cards.
3. Find ways to make production more efficient.
 - Trim back your product range and increase production runs.
 - Use standard components to lower design, purchasing and manufacturing costs.
 - Change processes to minimise wastage of raw materials and energy.
 - Improve quality control to cut rejection rates and reworking costs.
 4. Review your finances.
 - Finance fixed requirements using loans, instead of overdrafts.
 - Reduce unnecessary overdraft and loan facilities.
 - Cut back on working capital through just-in-time purchasing, better credit control and agreeing longer payment terms with your suppliers.
 - Apply for grants and subsidised loans.
 5. Get the most out of your premises.
 - Introduce homeworking or hot desking to cut space requirements (and travel costs).
 - Reconfigure existing premises and work flows to minimise wasted time and space.
 - Sub-let spare space.
 - Control utility costs.
 6. Cut the cost of communications.
 - Use email whenever possible.
 - Use the corporate intranet to reduce duplication of information and unnecessary meetings.
 - Use cheaper telecoms facilities (eg alternative suppliers, leased lines).

6. Pitfalls

Reducing costs can be damaging. Before making changes, check that your standards will not be compromised and that your ability to meet objectives will not be harmed.

1. Reducing costs which directly impact on employees is fraught with difficulty.
 - Employees are not machines.
The work performance suggested by time and motion studies is unlikely to reflect people's actual behaviour.
 - Reducing costs such as training and meeting times is often counterproductive in the longer term.
 - Introducing improved procedures can be difficult and expensive.
Employees may be resistant to change and may need extra training.
 - Poor conditions, pay and benefits will not attract and retain good employees.
 - Changing an existing employee's terms and conditions, to the employee's detriment, can be a breach of contract.
 - Making employees redundant brings short-term costs and the risk of possible employment tribunal proceedings.

- It may also damage morale among those who remain.
2. Almost every cost saving has a potential downside. For example:
 - Over-dependence on one supplier puts you at risk if the supplier fails.
 - Production and marketing plans that are driven by cost-cutting considerations are unlikely to be responsive to customer requirements.
 - Tighter control of financing may leave you with no safety margin when cashflow is unexpectedly poor.
 - Cutting short-term 'investment' costs (eg training, advertising, equipment or new product development) can lead to long-term weakness.
 - Attempting to control unalterable costs is itself a wasteful process.

7. Consultants

1. External consultants can offer an advantage over purely internal cost control.
 - Consultants may have up-to-date, specialist knowledge.
For example, they may be acquainted with up-to-date benchmarks for your industry and current market conditions for utilities and other suppliers.
 - A consultant's thinking may be able to avoid being influenced by vested interests and historical preferences within your company.
2. Select a consultant carefully.
 - Look for membership of an established and appropriate professional body, with a published code of conduct.
For example, the Chartered Institute of Purchasing and Supply (01780 756777).
 - Check references and look for evidence of a good track record, working with businesses comparable to yours.
 - Find out about the consultant's financial standing and check that there is indemnity insurance cover in place.
Consultants may have specialist expertise in particular areas (eg production engineering or energy costs).
3. Negotiate a clear, written contract.
 - Agree what you will pay.
If fees are to be based on a percentage of savings, agree how these savings will be calculated.
 - Arrange when you will pay.
Avoid having to make upfront payments, before you can see the results of a consultant's work.
 - Insist that the consultant signs a formal confidentiality agreement.

Deregulation

1. Prices of gas and electricity have fallen as a result of competition – though this is unlikely to continue.
Businesses are no longer restricted to buying from their local suppliers.
 - Suppliers can offer tailored pricing packages, based on your requirements.
Remember to compare like with like when looking at competing quotes.
 - Suppliers may offer additional discounts for buying both electricity and gas from them, or paying by direct debit.
2. Choose a supplier that offers the right quality of service. Look for:
 - A flexible contract which suits you (eg guaranteed prices).
 - Added value services such as technical support and energy efficiency advice.
 - A supplier with a good track record.

Pricing

Summary

The prices you charge for your products can have a dramatic effect on sales and profits.

Setting your prices too high can reduce sales abruptly, while undercharging can devastate your profits. The logic is simple. Your optimum price is one that gives the largest total when you multiply your margin by the number of sales you can achieve. But making sense of that, in relation to the costs you pay out and the markets you serve, is a key issue for every business. This article covers:

- Understanding the market and how your product fits in.
- Deciding on a pricing strategy.
- Pricing tactics.
- How to increase prices.

1. The Market

1. Unless you have a complete monopoly of a unique product, your product's value will depend on the competition.
 - Who are your competitors, and what do they offer?
 - What are the key features and benefits of their products?
2. Find out which products are seen by customers to offer the best value.
 - Which products are the most successful? Do different market segments buy different products?
 - What are the key criteria customers base their decisions on? Which criteria justify higher prices for different products? How do prices vary?

2. Your Offering

Assess how what you offer compares with what else is available.

1. Break down what you offer (or could offer) into all its components.
 - The core product itself. For example, a car.
 - Additional product components.
For example, number plates and the owner's manual.
 - Customisable features of the product.
For example, choice of colour and extras such as air-conditioning.
 - Additional services.
For example, delivery and recovery services.
 - Additional elements of the overall deal.
For example, a financing package and guaranteed buy-back price.

Include all the components which customers may sometimes ask for – such as rush delivery.

2. List all the benefits that customers perceive each component as offering. For example:
 - Quality and reliability.
 - Convenience.
3. Assess how much each benefit is worth to your target customers, using what you

know about the market (see 1), and additional market research if necessary. Different benefits will often have different values for different market segments. For example:

- Reliability will be more important to a customer who uses your product in a mission critical application.
- A product will be worth more to a customer who can make a large profit from distributing or processing it.

Different customer perceptions of value may mean that you should offer different packages to different market segments, or use special pricing tactics (see 5).

4. Customers' perceptions of value for money will depend on what they expect their total costs to be.

For example, the costs of car ownership include depreciation, fuel costs and servicing, as well as the purchase price.

- Providing lifetime value for money is more important if you aim to get repeat business from the same customer.

3. Pricing Strategy

1. Take account of the constraints on your business. For example:

- Investor requirements (eg high short-term returns or long-term growth) and other external influences.
- Your financial resources and your production capacity.
- Your cost structure (see 4).

2. The most appropriate strategy will depend on how you want to position the product.

- In many markets, a high price contributes to the perception of a product as being of premium value.
- You may want to establish consistent pricing across your product range, or to position individual products 'up' or 'down' market.
- Different strategies may be appropriate at different stages in the product's life cycle.

For example, capitalising on existing customers' inertia at the end of a product's life by charging a high price.

3. You can charge higher prices if high barriers to entry will prevent the emergence of new competition.

For example, if you have a patent, special skills or strong customer loyalty.

- Customers will be more loyal if purchasing an unsatisfactory alternative carries significant risk to them.
- If barriers are low, you may want to limit your prices (and achieve a merely acceptable return on capital employed) in order to avoid encouraging new entrants.

4. You may want to charge different prices for different customers.

- Customers who purchase repeatedly, or buy add-on or related products, are the most valuable.
- Customers who are expensive to satisfy (eg demanding special features or service) will be less profitable, unless you can charge them higher prices.
- One-off sales generally carry far higher costs than repeat business.

4. Your Costs

1. A cost-plus approach to pricing has many disadvantages.
 - It does not take into account the level of demand and competition.
 - The price you need to charge depends on the volume you sell, which in turn will depend on the price you charge.
 - The mistake to avoid is failing to include all your costs in your analysis. If you do this, you will end up undercharging.
 - Cost-plus pricing reduces the pressure to control costs.
2. Although your costs do not tell you what your prices should be, they do tell you whether they are viable.
 - If you charge less than your direct variable costs, you will make a loss.
 - If you charge more than your direct costs, each sale will make a contribution towards covering your fixed costs and ultimately making a profit.
 - The contribution each sale makes towards covering your fixed costs tells you what volume you need to sell to reach breakeven.
3. Your cost structure may influence your strategy.
 - If you have high costs relative to your competitors, you will need to position your product with a premium price.
 - The higher the proportion of fixed costs, the more important it will be to generate high sales volumes.
 - Some costs are unrecoverable if sales are not made soon enough.
For example, the costs of underemployed staff, perishable goods and products which become obsolete.
4. Analysing your costs can be a useful benchmarking exercise.
 - In the absence of other reasons, margins below industry norms suggest your costs are too high or your prices too low.
 - Industry margins provide a rough guide to the prices which may be achievable when considering new products.
 - Differences in costs can be a useful way of creating consistent pricing across a range of products or markets.
 - Analysing the additional costs can help to prevent you from undercharging for special orders or demanding customers.

5. Tactics

1. Varying your prices with differential pricing can increase your profitability.
For example:
 - Charging lower prices for high profile products to capture customers who will also buy higher margin products.
 - Charging different prices at different times of the day, week or year to reflect changing demand or the changing value to customers of your product.
 - Charging different prices for different levels of service or product specification.
2. Discounting can be worthwhile, but only if it achieves your aims.
 - In some industries, trade discounts are the norm and you may have to offer them to match the competition.
 - A cash payment discount can encourage early payment.
Some customers may claim the discount but delay payment anyway.
 - Clearance discounts can help you to sell off old stock and release working capital.
 - Bulk discounts encourage large orders, which may carry lower unit costs for you.

- Retrospective discounts or rebates may encourage customers to concentrate their purchases with you.
 - Introductory discounts may encourage customers to try a new product. However, they may create the wrong image for your product or generate sales which are not repeated when the discount is removed. They can also cause resentment among current customers.
3. Special tactics may work in particular situations. For example:
 - Bundling additional products together and charging a package price. This works well if the perceived increase in value is greater than the additional costs.
 - Charging a psychologically attractive price. For example, £7.99 can be perceived as being more than a penny less than £8.00.
 - Charging a fixed price across a range of products. This makes it easier for you to predict your income. Also, some customers may prefer being able to compare products without having to make price comparisons.

6. Checking your Prices

Review your prices regularly to ensure that they are optimal.

1. Keep up to date with the market.
 - What is the competition doing?
 - How are customers' perceptions of the value of your product and competing products changing?
2. Turnover and changes in turnover may indicate a pricing problem or opportunity.
 - Products with high or growing market share may present an opportunity to increase prices.
 - If you pitch or tender for business, too high a success rate suggests that you are under pricing.
 - If both margins and market share are low, you need to change something – or discontinue the product.
3. Limited trials of price changes can provide valuable information at reduced risk. For example:
 - Changing the price for a sub-sector of your market.
 - Introducing a new product at the new price while continuing to offer the old product.
4. Analyse the effectiveness of any pricing tactics you use.
 - Are you achieving your aims? For example, increasing sales to target market segments or smoothing capacity usage.
 - Are there signs of unwanted side effects? For example, reduced sales of full price products.
 - What is the overall effect on profits?

7. Increasing Prices

1. Analyse the impact on profits of any proposed price change before you make it.
 - Give customers advance warning if they need to budget for your price increase.
 - What will the effect on sales volumes be?
 - What will the effect on margins be?

Increasing prices (and hence margins) can sharply increase your profits, even if your turnover drops.

2. Explain to your customers why you are increasing prices.
 - Use the price change as an opportunity to re-emphasise the benefits you offer.
 - A good explanation can strengthen your customer relationship.
3. You can try to hide price increases. For example:
 - By gradually introducing new, higher priced products and making old products obsolete.
 - By lowering the specification (and your costs), while maintaining the same price.
 - By improving the specification and raising the price.
 - It is wise to increase the price by more than the cost of the improvement.
 - Hiding price increases runs the risk of adverse reactions when customers realise what you are doing.
4. A good relationship with customers can help to improve their perception of the value of your product and the risk of trying alternatives.
 - Spending more on marketing and customer care may allow you to increase margins and turnover.

Aim High

Under pricing your product can be even more dangerous than overcharging.

1. It is far easier to reduce prices than to increase them.
 - If in doubt, try higher prices first.
2. Customers may not respond to low prices.
 - A low price may create an image of a low quality product and service.
 - Your target market may not be particularly price-sensitive.
3. Low prices may attract unprofitable customers.
 - While prices are low, so are margins.
 - Price-sensitive customers tend to be disloyal when prices increase.
4. Cheap products may cannibalise sales of more expensive ones.

Price Quotes

1. Spell out everything which is included in the price.
 - Assigning a price to every component (eg delivery) and then giving it back as a discount highlights the value of your offer.
2. For one-off sales, you can compete with an attractive price on the core component of what you are offering.
 - Then charge a full price for all the extras once the customer has decided to buy.
3. Anticipate any negotiation when pricing your product.
 - Non-negotiable prices can enhance your image of quality and value.

Benchmarking

Summary

Every business can use benchmarking. At its simplest, it helps you to compare statistics and control costs. More sophisticated benchmarking looks at process design and business strategy. Benchmarking is a process that compares your business activities to similar companies. It identifies opportunities for improvement and often provides the momentum necessary for implementing change.

This briefing outlines:

- The opportunities benchmarking offers.
- How to select benchmarking partners.
- How to use benchmarking.

1. The Opportunities

Benchmarking simply involves comparing your business activities and processes with those of other organisations (see 3). It questions what you are doing and highlights opportunities for improvement.

1. The simplest form of benchmarking is to compare costs.
 - For example, utility bills or salaries.Costs which are higher than the industry norms may provide opportunities for savings
2. Most benchmarking compares key performance indicators.

This tends to focus on productivity and efficiency.

 - Some indicators can be easily expressed as simple statistics.
For example, sales per employee, gross profit margins or wastage levels.
 - Others may require qualitative, as well as quantitative, analysis.
For example, to assess the effectiveness of training activities or levels of customer satisfaction.Indicators which show that the company is underperforming represent opportunities to improve.
3. Benchmarking often proves particularly successful when comparing processes.

This involves looking in detail at how other organisations carry out the same or similar processes.

 - For example, what technologies and production techniques they use.You may be able to apply some of these ideas to your business.
4. Benchmarking can also be used to compare businesses at a strategic level.
 - For example, what strategic objectives organisations have, where resources are focused and what standards they work to.Again, there may be an opportunity to incorporate lessons learnt from successful organisations into your own strategy.

2. Planning

1. Establish a project team from different parts of the business.
 - Select influential people who will have the power to see changes through.
Unless your company is prepared to change, the project will lead to nothing.
 - A team of six people, at most, will find it easier to reach consensus.
 - Provide any training necessary for the team to understand the benchmarking process (and project management skills).
2. Link the benchmarking activity to your company's objectives.

- Identify which activity you want to benchmark and what the key performance measures are.
Benchmarking models (see Benchmarking at your desk below) or consultants (see 6.1) can help you.
 - There is little point in benchmarking peripheral activities.
Focus on the key areas of your business.
3. Benchmarking will not work unless you know yourself.
Be clear about the ‘cultural’ factors which influence your performance. These will include:
- The business environment you operate in.
For example, your market and your customers’ requirements.
 - Your management structure and style.
For example, if your company has highly centralised management control, it will be difficult to introduce processes which work in more decentralised organisations.

3. Benchmarking Partners

Use the aims of your project to establish the kind of benchmarking partners you want.

1. You can use internal partners (eg different departments or sites) in order to standardise and improve your operations at the level of your best performers.
 - If you only do internal benchmarking, you run the risk of complacency.
 - Internal benchmarking is unlikely to lead to any dramatic insights.
2. Most benchmarking involves external comparisons.
 - Aim to compare yourself against businesses of a similar size and structure, with similar objectives.
Understanding how their objectives, constraints and cultures differ from yours is important if you are going to make meaningful comparisons.
 - You can also compare separate processes which are going to be similar across different companies.
For example, the operation of the mail room is likely to be similar for most companies.
 - Competitors usually provide a direct comparison.
It may be difficult to collect detailed information from them.
 - There may be legal or ethical constraints which prevent a free exchange of information.
For example, if the information is confidential or if you could be accused of anti-competitive collusion.
3. Benchmarking against outstanding businesses is one of the best ways to bring about a quantum leap in performance.
 - It can be more difficult to make comparisons if they operate in a very different business environment.
4. Identify and select three to six individual partners.
 - Your Business Link and trade association can suggest potential partners.
 - Business publications and other information sources can provide ideas.
 - Talk to colleagues, customers and suppliers to establish who leads the field in the area you are benchmarking.
 - If you are searching in a broad or unknown area, contact a benchmarking clearing house or club (see 6.3).

4. Collecting Information

1. Approach those organisations with whom you want to make comparisons.
 - Use any existing contacts to make the initial approach, or contact your opposite number.
 - Explain the objectives of the study and emphasise its mutual benefits.
2. Draw up a benchmarking agreement or use a standard agreement, available from the Benchmarking Centre (01507 534071). This should include:
 - What information you want to exchange.
Never ask for information that you are not prepared to share in return.
 - How you will use the information.
 - Who will use the information.
 - How and when you will collect the information.

The more focused your research is the more useful it is likely to be (see 6.5).
3. Decide how you want to collect data.
 - Simple operational data can be exchanged by using a questionnaire – either by post or through a phone survey.
 - A site visit will give you a much better feel for the environment in which your partner operates.
Use a checklist and visit in pairs. (Two people may find it easier to get complete, objective information and impressions.)
4. Send copies of your visit reports to the partner organisations so that they can verify the facts and figures.
Invite your partners to conduct similar visits.
 - They can collect information on you.
 - You can hear their views on how you operate.

5. Managing Improvement

1. Summarise where you differ from your benchmarking partners.
Depending on your objectives, you may identify:
 - Differences in performance indicators.
For example, higher staff turnover or lower gross margins.
 - Differences in individual processes.
For example, how you recruit or how your production processes work.
 - Differences in strategy.
For example, what your human resources policies are, or what quality standards you have for your products.
2. Investigate why you differ.
Typical reasons include:
 - Your cost control is poor.
 - Your processes are outdated or inefficient.
 - You have made a different trade-off.
For example, if you choose to recruit low-grade (and inexpensive) employees in the knowledge that they will soon leave.
 - You have a different focus from your benchmarking partners.
For example, if you have a different target market.
 - You have different organisational constraints.
For example, if you do not have the financial resources to invest in new technology.
3. Decide what action to take and implement the changes.

There will normally be several options open to you:

- You may decide to do nothing.
You may accept that there is a good reason for the difference, or that it would be impossible to make changes.
- You may feel that you should adapt your processes.
If your benchmarking partners are similar to you and achieve better results with a different process, you may want to adopt elements of that process in your business.
- You may target specific areas for improvement and further investigation.
For example, if it is clear that your marketing is underperforming but unclear what you can or should do about it.
- You may realise that you need to redefine elements of your strategy.
For example, changing your objectives or standards.

Like all business improvement tools, the success of benchmarking depends on management commitment.

The more complex and far-reaching the change, the more time and effort you will need to devote to developing and implementing action plans.

4. Review how well the benchmarking study went and what impact the changes had.
 - Did the benchmarking study achieve its objectives?
What went well and what would you do differently next time?
 - How well is your business performing now?
Did the actions you took lead to incremental improvements or to a step change in performance?

6. Where to Get Help

1. You may want to involve a consultant.
Although many benchmarking studies are conducted without external help, a consultant can help with:
 - Establishing internal data and organisational processes.
An external consultant may find it easier to be objective about your business.
 - Identifying and contacting benchmarking partners.
 - Project management.
 - Overcoming resistance to change.Only use a consultant for the parts of the study you require help with.
2. Business Links can provide help and information.
 - Most Business Links offer a benchmark service, the UK Benchmarking Index, which provides a health check of your organisation.
It can also highlight where benchmarking activity would be most beneficial to your business.
 - Business Advisers are trained to take you through the process.
3. Other sources of information and help include:
 - Your trade association.
 - The Benchmarking Centre (01507 534071 or www.benchmarking.co.uk).
 - The Best Practice Club (0800 435399 or www.bpclub.com).
 - The Public Sector Benchmarking Service (www.benchmarking.gov.uk).

Benchmarking At your Desk

Valuable benchmark information can be obtained without approaching an external benchmarking partner.

1. You can benchmark key statistics against widely available industry norms.
 - For example, published information on key financial ratios for your industry, or salary surveys.
2. You can assess yourself using a benchmark package.

Benchmark packages may include:

 - A model of how businesses should operate. For example, standards such as ISO 9000 and Investors in People.
 - Quantitative data covering specific activities, based on a sample of companies. Find out if the sample used is relevant to your business and find out if the data has been validated.
 - A 'facilitator' to help you collect and analyse data about your business.
3. You can get involved in a collaborative study of your industry.
 - Your trade association may run a benchmark study.
 - A benchmarking consultancy may already be running a study, or be able to arrange for you (and other companies) to share the costs of one.
4. You can use the Internet as a primary source of data.