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wealth management

Key financial considerations **for small business owners**

Introduction

Small business owners are in a unique financial position, especially when they start planning for the future.

With what can often be fluctuating revenue and expenses to manage, many business owners don't have access to the range of financial resources that employees generally receive throughout their career such as a regular salary, superannuation, holiday pay and sick leave.

According to the Australian Bureau of Statistics, there are over two million small businesses in Australia, often described as "the backbone of Australia."

Tens of thousands of small businesses are entering and leaving the economy every year, and many will be relying on the business to provide for them and their families when they eventually decide to take a step back from the business and retire.

Running a small business presents many opportunities and the freedom to be your own boss, however it also comes with its own challenges and financial risks.

This guide examines some key financial issues and considerations for small business owners and includes some helpful tips you can adopt today.

1. Understanding the financial implications of your business structure

Sole Trader

One of the most significant considerations for business owners is to understand the financial implications of the business structure they are operating. As a sole trader for example, there is virtually no distinction between personal and company finances. While this is considered to be the simplest of business structures it means that one person is responsible for all of the company's revenue and expenses. Sole proprietorship doesn't offer separation or protection of personal and commercial assets which could become problematic in the future as your business grows and your liability increases.

Partnership

A partnership, on the other hand, is a business structure owned by two or more individuals who carry on a business together. There are two types of partnerships general partnerships, where all is shared equally; and limited partnerships, where only one partner has control of its operation, while the other individual (or individuals), simply contribute to, and receive only part of the profit.

A partnership can be a suitable business structure for an individual who wants to go into business with a family member, friend or business partner, such as setting up an IT consultancy, import/export business or a trade services business. A partnership allows the partners to share profits and losses and make decisions together within the business structure. However, each partner is fully responsible for debts and liabilities incurred on behalf of the business by other partners – with or without their knowledge.

While a partnership is relatively easy and inexpensive to set up, it is not a separate legal entity. The potential for disputes may emerge over time in relation to business direction, administrative control or profit sharing so it's important to have a formal partnership agreement outlining:

- each partner's role and level of authority
- each partner's financial contribution
- a procedure for resolving disputes
- a procedure for ending or resigning from the partnership

If there is no agreement in place, each partner is deemed to own equal shares of each asset.

Company Structure

A company is a complex business structure with high set-up and reporting costs. A company can either be a private (also known as proprietary) or public entity. A company is a separate legal entity and can incur debt, sue and be sued.

A registered company must have at least one director (and a company secretary unless it is a private company). A director is responsible for managing the company's business activities.

To become a company, an entity must:

- be incorporated under the Corporations Act 2001
- be registered with the Australian Securities and Investment Commission (ASIC).

The tax requirements for a company are different to those of other business structures. A company pays income tax on its income (or profits) at the company tax rate. There is no tax-free threshold for companies and tax is paid on every dollar earned.

Having a company business structure doesn't automatically mean that any personal assets will be protected. However, generally speaking, if you comply with all of your legal obligations as a director, the company will be liable for the company's debts. This means debts or liabilities of the company will be paid by the company, not you as a director.

However, if you breach your duties as a director, you may face regulatory action (eg for criminal or civil action under the Corporations Act 2001) and/or you can be ordered by a court to pay compensation to the company or the creditor.

If the company does not meet its Pay As You Go Withholding (PAYGW) and Superannuation Guarantee Contributions (SGC) obligations, as a director you'll be personally liable for penalties equal to these amounts.

The company's shareholders (the owners) can limit their personal liability and are generally not responsible for company debts.

Why business structuring is important

Business structuring and strategy can make a big difference when you pay tax annually or decide to sell the business in the future. You may be paying too much tax currently, or you may be required to pay Capital Gains Tax (CGT) on the total sale of the business if it is not structured appropriately to your needs. It's important to know where you stand, and what the implications may be when it comes to your succession plans further down the track.

2. Cash flow management

Small businesses fail when they run out of cash

Every small business knows that cash flow is a top priority. While many small business owners and self-employed Australians earn a good living, the flow of money is not always regular or consistent. It can be many weeks or even months between pay cheques.

The Australian Bureau of Statistics (ABS) shows there are 2.1 million small businesses in Australia. But starting one and, more importantly, keeping it afloat is never easy. Research suggests that first-time operators have roughly a 50/50 chance of survival, and that will largely depend on how they manage the business. The more efficient and savvy they are, the lower the failure rate.

Research by the Australian Securities and Investments Commission (ASIC) lists the top three causes of failure as being:

- inadequate cash flow or high cash use;
- poor strategic management of business; and
- trading losses.

Amongst the biggest financial challenges facing small businesses are rising energy bills, increasing overheads, payroll costs and, more recently, difficulty securing finance.

Growing too quickly

Once your revenue begins to rise and you have a steady flow of customers or clients engaging with you and your business, the next stage of growth can become an exciting prospect. However business owners can often get so swept up in the moment and are so focused on moving forward, that they forget to take a step back and examine how they are going to make the next stage of expansion a tangible reality.

Business is a numbers game and many owners often underestimate this especially when they are caught up in the day-to-day running of the business itself. All too often, owners simply check their bank account balance, rather than aligning their goals to a specific set of numbers—financial forecasts—and adjust their strategies accordingly. This is where many small businesses run into trouble. Unless this growth is managed sustainably it can send you out of business.

Most of the cash flow problems associated with rapid growth have to do with money being tied up in accounts receivable. This can become a real issue during a significant period of growth as the business is still collecting old payments from when it was smaller, but now paying new, larger expenses that flow from the new period of growth.

In other words, as you grow, you are incurring an increase in expenses to accommodate an increase in demand and volume while collecting on receivables from the lower volume period that just passed. The money that's coming into the business simply isn't enough to meet the outflow of expenses during periods of strong growth. This shortfall is enough to send a business to the wall and is one of the main reasons why many small businesses fail within the first few years.

How to avoid the pitfalls of poor cash flow management

It's hard to find a small business owner who hasn't felt the pressure of running their day-to-day business operations while also handling all the financial management. From dealing with expenses, receipts and invoices through to tax-time issues and end-of-year reporting, these are the financial management activities that most small business owners dread. As such, an effective cash flow management strategy is vital for any small business.

Components of an effective cash flow management strategy

A cash flow management strategy begins with creating a cash flow statement. This is not to be confused with a balance sheet or income statement—both of which measure different aspects of your business's financial health.

To put together a cash flow statement, you'll need to get a handle on some key financial information such as:

- The amount of cash you currently have on hand
- An estimate of total cash receipts
- A list of your business's operating expenses
- An estimate of the cost of goods sold
- Any other cash payments the business will make

A cash flow statement is one of the three most important financial statements a business owner will use when performing a cash flow analysis. It's also important to consider this from the perspective of the company's ongoing viability and future growth prospects, as potential investors will refer to the statement of cash flows when reviewing and assessing the company's financial integrity. Your financial adviser can provide you with further guidance and assistance.

Cash flow forecasting is one of the most important forecasting tools for business and will help you to manage your finances more efficiently. It's also useful when seeking finance, as it shows lenders you have the capacity to pay them back.

Cash flow management tips you can adopt today

Cash flow management isn't as mysterious as it sounds; it's simply the act of balancing business income against business expenses. The overall goal is to ensure a positive cash flow at all times while making the most strategic use possible of your cash assets. Here are some tips you can apply today to improve your cash flow:

Invoice promptly

Get into the habit of sending invoices for payment promptly. It may seem fairly obvious, but the sooner you issue your invoice, the sooner you'll be paid. Also, make sure your terms of payment are clearly stated on the invoice, for example "7 days from date of invoice" or similar. Include the actual due date for payment on the invoice.

Request a deposit

If you are providing a service, it is not unreasonable to ask for a deposit before work commences and/or part payment as agreed stages of the project are finished.

Offer easy payment options

Provide your clients with a range of payment options such as credit card payment, BPay® and direct deposit into your bank account.

Provide payment incentives

Consider offering an incentive to clients who pay early - perhaps in the form of a small discount - but be careful not to compromise your profit margin.

Don't be too lenient with late payers

Keep a close watch on your accounts receivable turnover at all times. Once invoices have been issued, monitor who's paid and who hasn't and follow up those who haven't. Be firm and polite in requesting payment, and don't be afraid to take more formal action if it becomes necessary.

Keep your books accurate and up to date

Your cash flow is only as good as your accounting and reporting. Don't let this get out of hand. Make sure your accounting information is updated on a regular basis. Then you'll be able to see the overall financial position of your business at a glance.

3. Keep your business and personal finances separate

For many business owners, maintaining a clear distinction between business and personal finances is one of their biggest challenges. Part of this often comes down to the question of where your company finances end, and where your personal finances begin, especially if you have grown your business from scratch to where it is now. However if you don't maintain a clear separation you could face a raft of consequences.

Why it's important

There are several reasons to be proactive about distinguishing between business and personal finances. Tax implications are foremost:

Cleaner accounting

Using a personal rather than a business account can create confusion at tax time, meaning that you'll have to devote time and energy trying to separate your business and personal transactions. While it's common for many sole-traders, small business owners and entrepreneurs to pay for business expenses out of personal accounts or personal expenses out of the business account, it's going to be much more difficult to determine which expense is which should the need arise.

When you separate your personal and business accounts it's easier to get a clear picture of your finances. This is not only true for day-to-day transactions but also when you need to work out your overall financial position.

Risk to your personal assets

Failing to draw a clear distinction between personal and business finances may put your personal assets at risk. If your business is structured as a company keeping the two separate works to your advantage. For example, should a creditor take action against you for an unpaid debt, they may be in a stronger position to claim your personal assets to satisfy the outstanding debt if there is no clear distinction between your business and personal finances.

You may need to get finance in the future

As your business grows you may find you have to open a business account in order to secure finance for further expansion. You may be able to get a business credit card based on your personal credit history alone, but you will need a separate business credit profile to secure larger business loans or establish vendor lines of credit. Separating your personal and business accounts now could save you a lot of work having to do it later on and help to demonstrate to the lender your business's overall financial position.

How to keep them separate

Open bank accounts specifically for your business

While it may seem obvious, setting up different bank accounts and credit cards to manage your business and personal finances is one of the easiest ways to keep them separate. Only use your business accounts for transactions that relate to your business and likewise with your personal accounts. This allows you to build a business credit profile independently from your personal account. Talk to someone at your bank to find out which type of account is best for your business.

Create a budget for your business and personal finances

Create a budget based on the income and expenses of the business and stick to it. Similarly, set up a budget for your personal finances. This will help to avoid a situation where you may be tempted to dip into your personal savings if there is a shortfall on the business side, and vice versa.

Pay yourself a salary

Paying yourself a regular salary from the business account can make it easier to manage your business budget and will help to maintain the boundary between your business and personal finances. It's important to keep in mind that you should only pay yourself out of your profits – not your revenue. And although money may be coming into the business, don't assume you can pay yourself a big chunk of these funds. Before you take your share, you need to consider costs and expenses such as taxes, payroll, your overheads and other costs associated with running the business. Pay yourself the same amount each month and manage your personal budget accordingly.

Manage your paperwork effectively

The sheer volume of paperwork involved in running a business can become overwhelming very quickly. Managing this documentation in a systematic and methodical way is one of the greatest challenges small business owners face. Whatever accounting system you use or don't use, keep all your records in one place. It doesn't matter if it's a folder in your home office, a folder in your business, or a database in your cloud-based accounting system. Just put it there.

Simplify your accounting

If you're not confident with numbers, hire a professional who can help. Even if it's just for one or two days a fortnight, a qualified financial professional can make a world of difference to the financial administration of your business. It also pays to invest in quality accounting software, so you'll always know your cash position. This can also be of assistance in forecasting your cash flow for future business planning.

4. Set aside money for tax

A common pitfall for small business owners is failing to set aside money for income tax. As you become more established, the Australian Taxation Office (ATO) may also require you to make quarterly pay as you go (PAYG) tax instalments.

What are the tax rates for income?

Sole traders

As a sole trader, you pay the same tax as individual taxpayers, at individual income tax rates. The tax-free threshold is $18,200 for both sole traders and individuals. The rates can change from time-to-time, so it's important to know what the rate is for the income year you're reporting on.

The following rates for 2018-19 apply from 1 July 2018:

Taxable income	Tax on this income
$0 to $18,200	Nil
$18,201, to $37,000	19c for each $1 over $18,200
$37,001 to $90,000	$3,572 plus 32.5c for each $1 over $37,000
$90,001 to $180,000	$20,797 plus 37c for each $1 over $90,000
$180,001 and over	$54,097 plus 45c for each $1 over $180,000

Note: The above rates do not include the Medicare levy of 2%

After your first year in business, you must lodge a tax return. You'll generally pay quarterly Pay As You Go (PAYG) instalments that go toward the amount of income tax you will have to pay at the end of the year.

Company

The company tax rate is currently 30% or 27.5% if your business is a "base rate entity." To qualify as a base rate entity your business must:

- have an annual aggregated turnover of less than $25 million (this increased to $50 million from 1 July 2018); and
- 80% or less of your assessable income must be base rate entity passive income (such as interest, dividends or rent).

There is no tax-free threshold for companies - you pay tax on every dollar the company earns. The company tax rates and lower company tax rate can change, so it's important to know what the rate is for the income year you're reporting on. Although the company tax rate is 30% (or 27.5% for base rate entities) and there is no tax-free threshold, the tax rate for companies is less than the highest rate for individuals.

5. What's your plan b?

Life insurance cover and why you need it

One key risk of running your own business is being unable to work due to illness or injury. Without sick leave, your financial situation could take a turn for the worse if you become sick or injured - so it's important to have a plan b - to protect you, your business and your dependents.

Life insurance is a must-have for small business owners. Life insurance cover provides your family (or a nominated beneficiary) with a lump sum benefit should you become terminally ill or in the event of your death. Think of your family first, and make sure they're well taken care of should you pass away or become disabled. In most cases, business owners need to purchase two different types of life and disability policies:

- A personal life and disability policy with your *family* as the beneficiary
- A key person life and disability policy with the *business* as the beneficiary

Key person insurance is similar to personal life insurance, but the beneficiary is the company instead of a family member. If the key person of the business, usually the business owner, passes away or becomes disabled, the company gets a payout equal to a multiple of the owner's salary or the business's profits. The remaining members of your business can utilise that money to pay employees, train staff, and keep the business afloat. Key person insurance can be a lifesaver for family run businesses where the owners are critical to the ongoing viability of the business.

Business insurance cover and why you need it

Accidents can strike at any time and if you're in the business of providing a product or service an unexpected mishap could have costly repercussions.

For example, let's say you're a plumber and you incorrectly fix a pipe for a restaurant which forces it to close its doors for a month. You could be forced to pay out what the restaurant would have earned during that time – all because of a genuine mistake.

This is why business insurance exists. It provides protection against a range of things that could otherwise drastically affect your business financially.

Types of business insurance

	If your business:	You run the risk of:	Insurance can help with:
Product liability insurance	▪ Designs, produces or manufactures a physical product (eg, assembly, design firm or takeaway food) ▪ Supplies or installs a physical product (eg, electrician, online distributor or retailer)	▪ Your product causing damage or loss to people or property ▪ Your product failing to fulfil a promise or responsibility ▪ Claims of faulty installation	▪ Court and legal fees ▪ Compensation and damages costs
Public liability insurance	▪ Has publicly accessible premises (eg, supermarket, dentist or restaurant) ▪ Performs services in public spaces (eg, road workers, personal trainers or event organizers)	▪ People injuring themselves on your premises ▪ Property being damaged or stolen ▪ Claims of negligence or dereliction of duty leading to financial loss	▪ Court and legal fees Property damage and loss costs ▪ First aid expenses ▪ Advertising liabilities
Professional indemnity insurance	▪ Gives advice (eg, consulting or medical) ▪ Provides a service (eg, building surveyor or IT professional)	▪ Claims of incorrect, misleading or damaging advice ▪ Accusations of poor or fraudulent service	▪ Court and legal fees Public relations fees to protect your reputation ▪ Cost of investigation into the claim ▪ Compensation and damages costs.
Cyber liability insurance	▪ Web-based businesses ▪ Businesses that rely on digital data	▪ Cyber breaches ▪ Data theft ▪ Business interruptions	▪ Court and legal fees ▪ Lost business revenue ▪ Public relations fees ▪ The cost of theft
Management liability insurance	Companies with: ▪ Team of managers ▪ Directors ▪ Corporate boards	▪ Employee claims for wrongful dismissal ▪ Financial penalties for occupational health and safety breaches ▪ Financial penalties for directors breaching their duties	▪ Court and legal fees ▪ Public relations fees ▪ Fines
Construction insurance	▪ Builders ▪ Renovators ▪ Construction businesses	▪ Site being damaged by natural disasters or other causes ▪ Employees being injured on site	▪ Physical loss, destruction or damage to the property ▪ Legal liability for third-party injury or property damage ▪ Expediting expenses ▪ Transit of construction materials

Choosing business insurance cover that's right for you

Selecting the type of insurance cover that's right for your business will vary according to a number of factors, such as the nature of your business and the industry you operate in, your location, and the size of your business. For example, an electrician will face different challenges and risks, to say, a restaurant owner, dentist or IT consultant. Just as a mobile or home-based landscape gardener will have varying needs to those of similar landscaping business with a physical retail presence.

However, one thing that all business's share is the need to have adequate safeguards in place so that if or when things do go wrong, you and your business are adequately protected against a financial crisis.

It's also important to keep in mind that some types of insurance are compulsory for different types of businesses, whether it's a legislative requirement, an obligation as a member of a professional board or association, or required by a contract you enter into with a landlord or a customer.

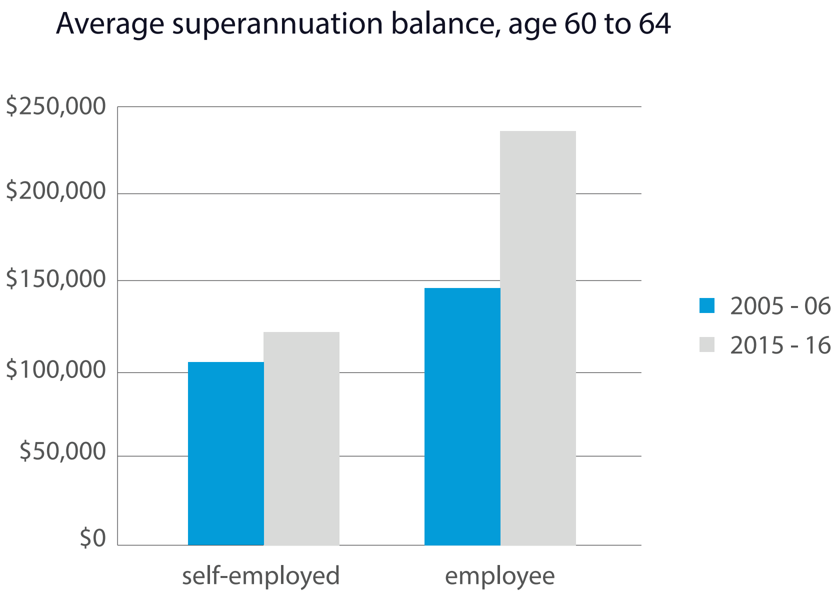
Your financial adviser can provide invaluable guidance and assistance in helping you to review, evaluate and select the type of insurance cover that's right for your particular business needs and circumstances.

6. How do you plan to retire?

Many small business owners think of their business as their superannuation and the means to funding their retirement when they eventually decide to sell the business at the time of their choosing. However, being able to sell a business for what the owner believes it is worth can be a very different matter - especially if the enterprise is largely based on the owner's personal endeavours.

According to the Association of Superannuation Funds of Australia Limited (ASFA), the majority of the self-employed have nil or low superannuation balances, and do not make regular superannuation contributions despite the availability of tax concessions.

For those approaching retirement, AFSA reports that the average superannuation account balance for self-employed males 60 to 64 years of age is around $143,000, compared with around $283,000 for male wage and salary earners. For women, the difference is even starker. The average balance for self-employed women aged 60 to 64 is around $83,000, compared with around $175,000 for female wage and salary earners.



It makes sense for small business owners to take advantage of superannuation's concessional tax treatment as even relatively modest superanuation savings can make a significant difference to their standard of living in retirement. As a guide, you or your business may be able to claim a tax deduction of up to $25,000 annually for contributions to your superannuation fund. It's an easy way to trim your tax today while building a nest egg for the future. Be sure to make your contributions before 30 June to claim them as tax deductions, but be careful not to go over the contribution caps so that the penalty tax does not apply.

7. Succession planning

What does the future look like?

Getting ready to hand over your business to someone else when you're ready to retire is a big step. Most likely, your business has been a major part of your life for a long time, and letting it go can be surprisingly more difficult than many people anticipate.

In addition to the adjustment in your lifestyle and your finances, it can also be an emotional and unsettling time. One of the main considerations you'll need to think about is whether you still want to have some involvement in the business after you leave it. Many small-business owners simply assume their children will want to take over the business, when often their children may have very different dreams and ambitions of their own.

If you want your business to continue in your absence, as many business owners do, then a succession plan is essential. An effective succession plan creates a smoother transition by laying out who will take over various roles and duties. A succession plan can also determine what happens to your business. For example, if you don't want to keep the business within the family, you can express your desire to sell the business upon your death. Whatever your plans are, keeping the business in good financial shape will be essential to making the transition as smooth as possible when the time comes.

For your own protection and peace of mind, it's wise to make sure everything is done formally and legally well before you're ready to leave the business. Without a documented succession plan you risk jeopardising everything you've worked hard to build over the years.

There are many options to consider so it's worth talking to a professional financial adviser who can explore the various scenarios with you and develop an effective succession planning strategy that's right for you. After all, what could be more important than ensuring your hard work continues to pay off for you and your family well into your retirement years and beyond?

8. Protecting your legacy

As a small business owner you've built an asset that most likely accounts for a large part of your wealth, so it's important to plan how you want this to handled at the time of your passing. It's not a subject many people want to think about, but sound planning now will protect the business that you've worked so hard to build. This is true for all businesses but especially for family-owned businesses that you may wish to pass down to the next generation.

Effective business estate planning accomplishes two things. First, it ensures that someone you trust takes over your business when you are no longer present, doing the right thing by your customers, and second; since your wishes are outlined in writing, a good estate plan also simplifies things for your loved ones if you pass away prematurely or become disabled.

Start with a will and basic estate plan

The following basic documents should form the foundations of your business estate plan:

- A will that states your wishes about how your business and other property should be divided upon your death.
- A power of attorney, which appoints another individual to manage your finances and undertake business transactions in the event you're incapacitated.
- A healthcare directive, which appoints another individual to make medical decisions for you if you cannot do so for yourself.

Without a will, your business will be divided up according to the default laws in your state. A will, power of attorney, and healthcare directive ensure that someone you trust inherits business property and manages business transactions on your behalf.

Beyond these basic documents, there are deeper things to talk through with your lawyer and financial adviser which will vary according to your circumstances and your wishes.

Have a discussion with the affected parties

After you have created your estate plan, make sure all the affected parties know what's at stake. This may be a difficult topic to talk about but ideally, you should involve your family members throughout the entire process. This will help to avoid conflict further down the track. For instance, if you're unsure about one of your children's interest in continuing the family business, you should find out sooner rather than later so that the estate plan accurately reflects their wishes as well as your own.

Once the estate plan is in place, you and your family should sit down with your financial adviser to make sure everyone understands what's in the plan. This conversation doesn't necessarily need to reveal detailed aspects in relation to specific assets of value or the size of the estate, but just knowing that they'll be receiving something of value down the line can change your beneficiaries priorities and the decisions they make during their lives, which can be reassuring for everyone involved.

Don't leave it too late

Estate planning is important for everyone, but especially for small business owners. Your business is one of your biggest assets and something that you've worked very hard to establish over the years. Business estate planning provides peace of mind that your company can continue on as a successful, thriving venture. It starts with creating a will, but estate planning for business owners is often more complicated than that. There are tax, insurance, and family issues to think through and discuss with your financial adviser to ensure that you, your loved ones, and your business will be well taken care of now and in the future.

A final word: put a value on your time

The nature of running your own business is such that it's almost impossible to adhere to a perfectly scheduled week of activities or predict the demands of tomorrow.

For small business owners in particular, planning and tracking your daily time expenditure is really a financial practice. For instance, have you considered what an hour of your time is worth? It's a good idea to get into the habit of calculating the cost of each activity based on this number, so that you can become more efficient, focused, and profitable over time. For example, you may find that you're spending three hours every day on administrative tasks that could be better outsourced for a lower cost in terms of your man-hours.

Or you may find that you're spending 30 hours every month doing specialised work (such as accounting or marketing) that may take a qualified professional only 10 hours to do. Even if the professional charges twice what your time is worth, it may be a more productive use of your time to outsource those tasks and focus on what you're best at.

The value of advice

Many small business owners are so caught up in the day-to-day running of their enterprise they seldom have the time or energy to take a step back and look at the big picture or to focus on those key financial issues and considerations that can literally make or break whether your business continues to operate successfully into the future.

We can help you to define and articulate your business and personal goals and develop a financial plan that will pave the way for success and security in the long-term.

Further information

To find out how we can help you look forward to a secure financial future please feel welcome to contact us.

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