Don't let big profits distract you from business fundamentals

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The failure of mobile company AG Mobile should be a wakeup call to business that neglecting to pay close attention to key financial principles can ruin even seemingly successful businesses, say financial experts.

The announcement in January 2017 that local smartphone brand AG Mobile would be liquidated, came as a shock to the business world in South Africa and rest of the continent. After all, this company grew its turnover in Africa from R180m in 2014 to R550m in 2015.

Company CEO Anthony Goodman said that despite big profits, the business ran into cash flow problems when it grew too big and could no longer maintain the business based on exceptionally high owner-risk borrowing terms. Its business model – offering cheaper smartphones for lower-income groups – was a winner, in the beginning, at least.

It is one of the biggest mistakes that business owners and entrepreneurs make, says Associate Professor Mark Graham of the University of Cape Town (UCT) Graduate School of Business (GSB). Focusing too much on profit and not paying enough attention to vital financial aspects like cash flow, inventory management, waste and damage and other expenses, can see companies running into trouble.

“Profit and cash are two very different things and when you look at them on paper, they tell you a lot about your business,” says Professor Graham. “When people put too much value on making profit and not enough on ensuring the cash flow is healthy, their business could go under.” He explains that while a company may sell lots of products or services, the cash from such transactions usually come in at a later date, causing potential problems when it comes to paying staff or suppliers.

Associate Professor Graham is a professor of accounting at UCT and the convenor of the Finance for Non-Financial Managers programme at the GSB, which unpacks how finance works in business and teaches non-financial people how to analyse and interpret financial reports and statements. The course is designed to help ensure that business people from all functional areas (i.e. not just the finance professionals) are more financially literate.

The course is also aimed at entrepreneurs and start-ups, providing crucial financial information in only four days that could help businesses newcomers avoid the common pitfalls that have crippled so many others.

Willie Nortier, COO of specialist investment company Business Partners, says many businesses grow too fast, over-extending themselves and then are unable to deliver on promises.

He says matching capitalisation and growth in that order is important to ensure that money is not tied up when it is needed. Growing too fast may seem like a good thing at the time but if the company can’t adapt to it, it could be its downfall.

Another international example is that of kids’ fashion label Pumpkin Patch, a concept that originated in New Zealand and that in 2007, was valued at $790m. Nine years later the clothing empire was worth nothing, it was placed into administration and owed $76m. One of the biggest reasons for the failure was the rapid expansion of the brand across the globe, while neglecting the New Zealand and Australian stores where it had started.

While starting a business is always tough, economists forecast that 2017 will be an even tougher year, not just in South Africa but also elsewhere in the world. The uncertain political situation, rising food and fuel prices as well as slow economic growth will put pressure on local operating conditions. It is vital that senior managers, department heads and entrepreneurs know exactly how to interpret what's is going on in their financial statements to be able to effectively make good decisions, says Associate Professor Graham.

"It is a cliché, but knowledge is power. Understanding the language of business and demystifying the jargon is what it is all about," he says. He adds that every company does things differently, so it is important to understand the fundamentals of financial principles to ensure people realise what operating a business is all about.

"People don't know what the basics are when it comes to financial reports, what debt equity and the right capital structure might be. By getting to grips with concepts like working capital management and cash flow vs profit, means business owners and managers can give themselves the best chance of success in the year ahead."

For more information about the Finance for Non-Financial Managers programme contact Executive Education department at the UCT Graduate School of Business on 0860 UCT GSB or email execed@gsb.uct.ac.za.

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