You had your business appraised, now what?

By: George D. Abraham

Once the value of your business has been established, the appraisal can stand as a benchmark for improving the value for a later date. From this point on, every dollar that is added to earnings can increase value by $3.00 to $5.00 or maybe more. Now is the time to look closely at the business, keeping in mind some of the positives and negatives the appraiser may have pointed out in the appraisal.

Analyzing Profits and Expenses

Profitability can be increased by either increasing or decreasing revenues, variable costs and fixed costs.

Revenues

Increase in Price of Product or Service: Increasing revenues by increasing price would have to be less than the offset created by the price and resulting profit increases.

Decrease in Price of Product or Service: If decreasing price, revenue would have to increase sufficiently to compensate for the decline in the price. However, if revenues were to increase, as a result of a decline in price, there is a possibility that a decrease in the per-unit fixed and variable costs, due to increased economies of scale, may occur.

Analysis: In analyzing your products, you may find that one has the highest gross margin (GM) and contributes the most to gross profit (GP), but how many units do you have to sell to achieve this? How much of this product inventory must you have tied up to support the sales and what is the rate of stock turn in days? What is your return on investment (ROI)? A simple spreadsheet analysis can help you make the right decisions.

Product	% of Gross Profit	Gross Margin	No. Units	Inventory Turn	Inventory Needed	ROI
A	50 %	$90,000	30,000	344	$85,000	106 %
B	20 %	$50,000	12,000	170	$40,000	125 %
C	22 %	$50,000	17,000	144	$44,000	114 %

Although a substantial benefit will result by decreasing the stock tied up in product A; it does not improve net profit. However, it will definitely increase cash flow and ROI. The increase in cash flow could mean more cash available to promote your business, and thus, an increase in revenues for all products with a consequent improvement in profitability, ROI and cash flow.

A Customer Analysis:

Company owners never forget the customers that contributed to their success and consequently have never increased their price. In general the cost of doing business over the years has gone up significantly and most of these long time customers will understand raising your price, if presented correctly. A simple spreadsheet analysis can help you with these decisions. Below is an example of a Commercial Air Conditioning and Heating Company's analysis.

Customer	% of Gross Profit	Gross Margin	Distance From Ofc. (Mi.)	Average Service Hrs.	Avg. Revenue Per Hour	Cost Per Hour	ROI
A	12 %	$6,500	13	26	$271	$198	137%
B	23 %	$13,000	42	63	$206	$198	104%
C	8 %	$5,000	8	13.5	$370	$198	187%

Customer B, with the highest percent of gross profit has the lowest return on investment and is taking up a significant amount of time which may create a shortage of trucks and servicemen.

Fixed Costs

Costs incurred irrespective of whether or not any sales are made; associated with the physical capacity of the business to provide its service to customers.

Increase: Increase in fixed costs should lead to or be the result of improved product or service quality. If the price of the product is increased to compensate for the increase in fixed cost, the market would have to perceive a higher quality in the product to accept a higher price. If there is no increase in price of the product, the heightened quality would have to attract enough new customers to offset the increase in fixed costs.

There is also the element of increased productivity, time savings and utility reduction that can make the purchase of new equipment feasible. If there is a new, more energy efficient, machine that can cut time, increase output and save electricity, the savings may outweigh the cost.

Decrease: Revenue volume would have to remain unchanged. The decrease in fixed costs could not be allowed to affect product or service quality-which would have a consequential effect on sales. If revenues did decline, the fall in gross profit would have to be less than the decrease in fixed costs.

Variable Costs

Costs that vary directly with sales revenue; in other words, when sales rise or fall, they rise and fall.

Advertising: In analyzing advertising it is not unusual to find that half of the new business is generated by one source. If this is the case, then you can eliminate are decrease those advertising sources that generate the least return and increase the one that is the most profitable. A simple spreadsheet analysis (below) can tell you exactly what is working best for the company.

Source	Cost	Reponses	New Customers	New Revenues	ROI	% of New Revenues
D	$1,800	13	3	$1,800	100%	18.8%
E	$600	22	9	$5,400	900%	56.2%
F	$1,200	6	4	$2,400	200%	25%
Totals	$3,600	41	16	$9,600	12	100%

Labor: Are there employees that will retire in the next couple of years and what would it cost to replace them? If a retiring employee who, after many years of service is making $$60,000 a year can be replaced by an entry level employee at $30,000, would it be advantageous to offer a $15,000 bonus to retire early? First years savings is $15,000 or $75,000 ($60,000 - $30,000 - $15,000 bonus x multiple of 5 x $15,000) in value of the company. The second year adds another $75,000 for a total of $150,000 added to the company's value after 2 years.

Vehicles: Does the company really need those one ton Ford Vans at a cost of $35,000 each with 10 to 13 miles per gallon or can the same service be performed with the new Ford Transit Connect at $23,000 getting 22 to 25 miles per gallon? Many service companies have found that, over the years, the need for the increased size of their trucks have decreased and seldom do they need to haul any large parts. If there are occasions whereby a large part needs to be delivered, one of the large trucks are kept to accommodate this. Again, a simple spreadsheet with the cost of the vehicle, insurance, service costs, tire expense and miles per gallon savings can be very advantageous.

Income Taxes: The game has changed. Throughout the history of the company you have labored trying to minimize taxes. You may have leased equipment and vehicles as it was advantageous because it lowered profits. Keep in mind that we are now looking for more dollars to the bottom line as each dollar now is worth $5.00 more in value. If purchasing equipment or vehicles means you have to pay taxes of 36% by eliminating this expense, you are adding $.64 to the bottom line and that becomes 5 times the amount in value or $3.24. In other words if you are leasing equipment or vehicles for $20,000 per year, by eliminating the expense, you increase your company's value by $64,000 ($12,800 after 36% tax effect x 5 = $64,000).

Further analysis of the expenses the company pays you as a benefit, such as your life insurance premiums, auto expenses, non-essential travel and entertainment, etc., may add more profit to the bottom line and 5 times the amount in value to your company, which may be more beneficial to you.

Shipping Costs: In a recent appraisal assignment we found that instead of raising the price for the company's product, the owner shifted the shipping costs to the customer and gave the customer a 5% reduction in price which eased the pain of an increased cost. It was done with a well written letter explaining the company's increased costs and no customers were lost.

Expand the Company: Maybe it's time to buy a smaller competitor? Who knows, the smaller competitor may be owned by a younger individual that may purchase the whole company when you are ready to retire, and since that person is familiar with the company and perceives little risk (as opposed to an outside buyer) he or she may pay a premium for the company.

In summary, many of these cost saving examples may not work for most companies, but hopefully it can help in analyzing other expenses that may add more dollars to the bottom line.