The Business Owner®

Lessons from a Turnaround Expert

Dear Business Owner,

Following is a summary of the lessons skillfully communicated in a new book by a veteran of private company turnaround, Gary Sutton, as interpreted and written by the editors of *The Business Owner*. Mr. Sutton's enlightened advice, drawn from years of experience finding and building profits in failing companies, rings true and should be applied to every business, not just to those in trouble today.

The following summary is certainly not comprehensive and persons interested in this topic should read the book to gain in-depth insight and first hand lessons from the author himself.

Identify What You Do Best. What meaningful customer benefit do you provide better than anyone else? Your ability to do so is the only basis by which you will be able to keep customers, earn a profit and stay in business. If you don't do anything better than the rest, you're on borrowed time. Not sure what you do best? You'd better find out or create something and quick.

The bottom line is the only place to flaunt your wealth.

To begin, ask your customers why they do business with you and what you do better then anyone else. Write it down. Share it with others. Hone it and revise it until you get it right. Don't worry if there isn't conclusive evidence that you do it "better than anyone else," just get it down. More important than what it says about you today is that it should become the vision for your company and the heart of your mission statement. It should be achievable and sustainable. It will be how and why you will compete effectively in the future, keep existing customers, gain new clients and succeed.

Focus. Once you determine what you do best, stick to it. Don't create confusion among your customers and employees by offering products or services that are not in your core area of expertise. Fuzzy direction kills more businesses than competition and dying markets. Specialize, and be the best at something of value to customers, or die.

Domino's Pizza is a great example. They deliver fast. They don't sell quality or price but "deliver in 30 minutes or less." Home Depot is another great example. They could sell about anything in their huge, well-located warehouses. However, they only sell home and garden supplies. When you need home and garden supplies, you know exactly where to go, don't you? On the other hand, Sears tries to be everything to everybody. An approach that simply does not work today when excellence is demanded by consumers. Stake your claim on a niche, stick to it and focus on getting better at it every day.

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The Reference Source

for owners of small and mid-size businesses and the professionals who advise them... since 1975

How to Build and Retain Wealth Through Private Business Ownership

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From The Editor

David L. Perkins, Jr.

Dear Reader:

The challenging economic environment that we face today calls for wide-open industry and market assessment, critical self-analysis and courageous decision-making. Only the strong will survive, and there is only one measure of strength – profits.

This issue begins by offering "Lessons from a Turn Around Expert". Mr. Sutton's experience in turning losers into winners provides valuable ideas that you can use to improve your own profitability and cash flow. Then the accompanying article, "How to Assess the Profitability of Products and Services", will help you assess contribution to the bottom line.

As the stock market falls and we are betrayed by those that are entrusted to manage the public companies in which we invest, resist the temptation to take your eye off the ball. Focus on the things you can control, such as the performance of your company. Encourage those that do have time to get involved in issues – such as your political representatives -- to press for a stronger set of checks and balances in the capital markets. And insist that persons such as Bernie Ebbers, former CEO of WorldCom, are held accountable for their greed and deception. His claim that he was not aware of how the books of his own company were prepared is ludicrous!

David L. Perkins, Jr.
Publisher and Editor

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Continued from front cover

Know What Your Customers Really Want. Get close to your customers. Really close. If you have closer relationships with your vendors than your customers, you have a problem. Organize periodic gatherings with your customers at which you can get feedback, advice and industry intelligence from them. Find out why they buy, what they really want and what your competitors are offering. Get below the surface and down to the emotional level. Buyers of cell phones want freedom and productivity, not phone service. Fitness centers sell hope, dreams and romance, not exercise. Cigarette and alcohol companies sell self-image and a sense of maturity and independence. McDonalds sells fun family times, not burgers. What do you sell?

Make What Sells, Don't Sell What You Make. When you have gotten close to your customers and learned what they really want, give it to them. Your entire organization should serve the wants and needs of your customers. Not all customers, but a select group of customers or potential customers that have certain wants or needs that you are more capable of fulfilling (or more determined or focused) than anyone else. If you are making products and then trying hard to find someone that will buy them, you have it backwards. Start instead by asking yourself what customer types you are uniquely suited to serve with your products and/or services.

Find the Profit. Identify the products and services that make money and stop doing the rest. Reinforce, improve and solidify the profitable business, and cut all expenses that are not necessary to the delivery of the profitable products and services. Scorn money losing and break-even products. If a product or service is losing money, try to make it profitable by raising prices. If that does not work, lower prices and see if volume picks up to achieve profitability. If neither works, discontinue the product line altogether. Then resist the temptation to add products or services that are not competitive and thus are not profitable.

Build Your Brand. Once you identify what you do best and commit yourself to total focus, tell the world. Turn your area of focus into your mantra. Be specific. Instead of using generic words like "fast" or "quality," say "in 30 minutes or it's free" or "the only NASA certified parts." Put your identifying mantra on everything you distribute. Educate your employees, vendors and customers in what you are great at so that they too can spot ideal customers for you. This is called branding – the creation of an identity. Great companies are great marketers. Some of the most successful companies today, such as Microsoft, Intuit and AOL, are led by marketing experts and do a tremendous job at branding their image.

Cut Costs. Above all, the customer wants lower prices. The lower the better. As such, the company that can afford to offer it the cheapest will win. Who can offer it the cheapest? The company with the lowest operating costs. In a competitive environment and during difficult economic times, the most important competitive dimension may be operating costs. The company with the lower cost structure can charge market prices and gain financially

compared to the competition, or it can use its cost advantage to undercut the prices offered by the competitor and gain market share.

When your costs are lower then everyone else, you win every time. So, do yourself a favor. Fall in love with being cheap. Don't buy anything that does not enhance the customer relationship in a meaningful way. Don't buy anything new unless it is more productive per dollar spent than the used alternative. Moreover, don't make any product or service in-house that can be purchase elsewhere for less. Beware of any urge to spend money on non-essentials. Take a lesson from The Millionaire Next Door … The bottom line is the only place to flaunt your wealth.

When your costs are lower than everyone else, you win every time.

Pay for Performance. Hire proven winners. Downgrade education as criteria for hiring and promotion and enhance the stature of real results. Within your company, track performance and make the results open to all. Make continued employment contingent on production. Pay commissions based on customer satisfaction survey results as well as sales. Track the results from every marketing and advertising effort, product, employee, vendor and business unit. Incentivize everyone including your lawyer, accountant, ad agency, etc. Hold family members to the same standards as non-family members or watch your company implode.

Remove Politics, Fighting, Secrets, Lies, Sex, Alcohol, Drugs and Gambling from the Workplace. Demand integrity and make swift examples out of those that do not follow your lead. Encourage straight talk, questions, ideas and constructive criticism. Discourage adulation and yes-sayers. Get real people with the guts to express their real opinions, even when they disagree with your own. Treat people fairly. Do what is right and demand the same of others.

Don't Bet on the Break-Through Order. Serve your core, existing customers profitably and add more just like them. When you have the luxury to spend some time and money on new products or markets, do so. However, don't bet your business on breakthrough products or customers. Too often, they never come through. Close is not good enough.

Keep it simple. Track the key results. Manage from one piece of paper, literally. Track customers won and lost, shipments, back orders, cancellations, returns, payroll expense, advertising responses, number of inbound calls, product development status, cash balance, cash flow and asset balances. Highlight deviations and take swift action when trends are in the wrong direction.

Reassess Your Do-Good Attitude. Too many business owners spend time, when their businesses are struggling, giving speeches, volunteering at the chamber, cutting ribbons and sitting on non-profit boards. You, as the owner of a tax-paying business, are a rare commodity. By being successful and earning a profit you employ others, provide for families and pay taxes that fund schools, roads, police, politicians and social services. The most important thing that you can do for your community is to keep your business running, employee people and pay taxes.

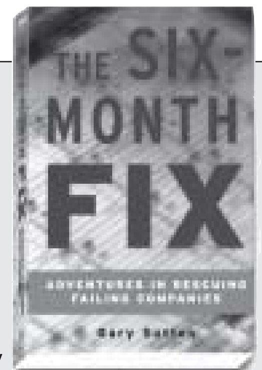
If your bottom line isn't above the industry average and continually growing, eliminate all non-essential activities that take the time of you or your employees. Duck the speeches, ribbon cuttings and community board duties … you have more important work to do.

Cash is King. What you want is cash flow and cash in the bank. Anything else can't buy groceries. Don't look at anything but cash and the things that lead to cash. Balance sheet assets are evil. They take up cash, so be relentless in lowering their values. Increasing non-cash assets spells trouble unless your cash flow is growing along with it.

Sell Harder. Sales calls lead to sales. Get your sales force cracking and personally show them the way. As the owner, you should be selling more than anyone else. Track the number of calls, letters, emails, meetings and results.

Focus on Getting Better, Not Bigger. Bigger will come when you get better. Raise quality and two great things will happen: 1) Your costs will fall with lower waste, fewer returns and cancelled orders, and 2) Revenues will rise through lower customer attrition and more customer referrals.

Stop Flattering Yourself. You are only as good as the satisfaction of the last customer served. Your customers and your bottom line don't care how long you have been in business or what your grandfather went through to get you where you are today. If your strategy for success includes a historical story or reference, think again. Get over the fact that you "were the first" or "we founded this industry." Stop flattering yourself and get to work. ❑



Ask the Expert:

An Open Conference Call for the Subscribers of *The Business Owner*
Thursday, October 17,
10am Central Time

Gary Sutton, experienced turnaround expert, author of *The Six Month Fix* and subject of the above article titled "Lesson's from A Turnaround Expert," will be available to answer questions for the readers of *The Business Owner*. If you receive *The Business Owner* and own a small or midsize business, email your question to david@thebusinessowner.com. We will then provide you, via email, with instructions for joining the call which will be from 10am and 11am Central Time, Thursday, October 17.

How to Assess the Profitability of Products and Services

The front page article in this issue of *The Business Owner* urges owners of under performing companies to analyze the profitability of each product and service and consider eliminating the money losers. The formulas for such an analysis and the steps to take are as follows:

$$\text{Gross Profit Margin(\%)} = \frac{\text{Gross Profit Per Unit}}{\text{Total Revenue Per Unit}}$$

$$\text{Break Even(units)} = \frac{\text{Fixed Costs}}{\text{Gross Profit Margin Per Unit}}$$

$$\text{Profitability(\$)} = \text{Revenue} - \left[\text{Fixed Costs} + \left(\text{Units Sold} \times \text{Variable Cost per Unit}\right)\right]$$

Step 1: Determine the gross profit per unit and gross margin per unit. Gross profit per unit is the incremental profit earned per unit sold, as described in the following formula:

$$\text{Gross Profit(\$) Per Unit} = \text{Revenue Per Unit} - \text{Variable Cost Per Unit}$$

The revenue per unit is the revenue earned from a single unit sold. The expense or cost considered is that expense or cost that is incurred directly and solely due to the additional unit sold -- also referred to as both the direct cost, and as the cost of goods sold. Such costs may include the cost of materials (tangible or otherwise), labor, or both. Such cost ignores indirect costs (also referred to as fixed costs) such as facilities, non-direct labor (which is commonly referred to as sales, general and administrative expense), insurance, office supplies, etc.

The gross margin is simply an expression of the relationship between direct revenue and direct cost, expressed as a percentage and calculated using the following simple formula:

$$\text{Gross Profit Margin(\%)} = \frac{\text{Gross Profit Per Unit}}{\text{Total Revenue Per Unit}}$$

To illustrate, consider XYZ Company, a reseller of industrial filtration units. They calculate their direct cost per unit at $500. The $500 is the sum total of all direct costs that are incurred to deliver a single sold unit, such as the filtration unit itself, which is purchased from an outside vendor, and the cost of the labor paid to XYZ employees that perform very light machining and assembly on each unit. They sell each unit for $1,000. XYZ calculates their gross profit and gross profit margin on this product line as follows:

Revenue	$1,000	100%
Variable Cost[1]	$500	50%
Gross Profit	$5,000[2]	50%[3]

1 also commonly referred to as Cost of Goods Sold and Direct Cost

2 referred to as gross profit (expressed in dollars)

3 referred to as the gross profit margin. Calculated by dividing the gross profit by total revenue.

Again, XYZ only incurs the $500 direct cost when a unit is sold. In practice, XYZ anticipates orders and builds units in advance, but the costing and calculation of gross profit remains unchanged.

Step 2: Determine the Fixed Costs Associated with the Product Line. Fixed costs are costs that are incurred by simply maintaining the capability to produce the product and product line, and to market and sell the products in the marketplace. Such costs do not increase with each additional unit produced or sold, and they typically include indirect labor and overhead costs such as rent, utilities, machinery, equipment, bookkeeping, licenses, permits and taxes.

XYZ Company calculates their annual fixed costs associated with their industrial filtration product line as follows:

Facilities Rental	$15,000
Utilities	$2,500
Facilities Maintenance	$2,500
Overhead Labor	$15,000
Office Supplies and Misc.	$5,000
Total	$40,000

Step 3: Calculate the Profitability of the Product Line. With steps one and two completed above, step three is simple. Here is the formula:

$$\text{Profitability of Product Line} = \left(\text{\#Units Sold per Year} \times \text{Gross Profit Per Unit}\right) - \text{Fixed Costs}$$

If your company has only one product or service, then the profitability of your product line should be identical to the profitability of your business, as in the pre-tax profit on your company's annual income statement. If this is the case, then organizing your income statement in a way that will clearly break out variable and fixed costs is recommended. However, if you have multiple products, this analysis is useful to determine what products are contributing to your bottom line.

XYZ Company sells 150 units of the subject product line per year. As calculated above, their gross profit per unit is $500. Therefore, the total annual gross profit from the product line is $75,000. By subtracting the $40,000 of fixed costs required to be incurred annually to maintain the product line, we find that the industrial filter line adds $35,000 to the bottom line each year. The calculation is as follows.

$$\text{Profitability of Product Line} = \left(\text{\#Units Sold per Year} \times \text{Gross Profit Per Unit}\right) - \text{Fixed Costs}$$

$$= (150 \times \$500) - \$40,000$$
$$= \$75,000 - \$40,000$$
$$= \$35,000$$

The Bottom Line Impact of Money-Losing Products

To illustrate the impact that money-losing products and services can have on a company's overall profitability, let's look at a consulting firm that has 20 types of consulting projects. Quantum Consulting spent a year tracking the labor hours and direct costs required to deliver each of their project types. They also know the income that each type of job brings. Here is the simplified 2001 data:

- Total annual revenue was $1,000,000
- Each of the 20 project types contributed $50,000
- Fixed overhead costs were, and will continue to be, $205,000 per year
- Operating profit was a negative $5,000

When each project type was analyzed for 2001 it was revealed that two of the 20 project types lost money. In fact, the money-losing two together cost $50,000 more than the $50,000 in income they generated (i.e. together they lost $50,000). If Quantum were to eliminate these offerings altogether and the labor associated with the delivery of such projects, revenues would decline to $900,000 but operating profit would increase $50,000 to $45,000. Here is the comparison.

INCOME STATEMENT – QUANTUM CONSULTING

	2001 Actual	Performa
Revenue	$1,000,000	$900,000
Costs of Goods Sold	$800,000	$650,000
Gross Profit	$200,000	$200,000
Fixed Expense	$205,000	$250,000
Operating Profit	($5,000)	$45,000
Operating Profit Margin	(5%)	5%

As one can see, by simply eliminating 10 percent (two of the 20) of the project types and 10 percent of \overall revenue, Quantum becomes a profitable company at a respectable profit margin of 5 percent. If fixed expenses could also be reduced, then the bottom line would rise dollar-for-dollar and the operating profit margin would increase sharply.

This example illustrates the significant impact that a small number of money-losing products or services can have on the overall performance of a company. Quantum lost money in 2001 despite the fact that 90 percent of its products were profitable!

The lesson: Analyze your per-product profitability. Have these reports produced on a regular basis, and then use the information to create profitability across your entire produce line. The impact of losers is too great to ignore.

Setting Hurdle Rates for Profitability: As the saying goes, "there is no free lunch". Similarly, companies do not become highly profitable without significant effort to make it so. Coupled with the fact that profitable delivery of products or services is the only means by which an owner may be afforded the opportunity to further his or her other company-supported goals or objectives, every business owner should make profitability the first and highest objective. As such, every business owner should set hurdle rates for the minimum profitability allowable for any product or service offering.

For example, well-managed retailers assign a value to each inch of shelf space, then they measure the gross profit produced by each item. Items that do not meet the required gross profit contribution are dumped for ones that will.

The Power of the Gross Profit Margin: The profitability of a business is very sensitive to its gross profit margin, since it is the gross profit that must cover all of the fixed operating costs of the business. As such, it is important to recognize the affect changes in gross profit margins can have on operating profit when purchasing and pricing decisions are being made.

To illustrate, if a company has a 40 percent gross profit margin (i.e. cost of sales takes 60 percent of revenue) and a 10 percent operating profit margin (also referred to as pre-tax profit), a 10 percent increase in the cost of goods sold will reduce operating profit by 60 percent. Here's the math with percentages:

	Pre($)	Post($)	% Change
Sales	100	100	–
Cost of Goods	(60)	(66)	10%
Gross Profit	40	34	(15%)
SG&A	(30)	(30)	–
Operating Profit	10	4	(60%)

The lesson: Gross profit and gross profit margins must be protected. Keep this in mind every day. Fight even harder that ever to obtain ever lower pricing from your vendors, and find ways to win sales without reducing prices.

Checking Contribution to Fixed Overhead Expenses: Before an unprofitable product line is eliminated, be sure that you have accurately estimated the indirect expenses that

can be eliminated if the line is killed. If the fixed expense savings are overestimated, the result could be lower overall company profitability rather than higher.

To illustrate, let's look at Rader Corp. Rader has five product lines. In 2000, four products produced $200,000 in annual gross profit and one produced just $50,000 in annual gross profit. As such, gross profit was $850,000 in 2000. Rader's operating costs were $750,000 in 2000 and its net income was $100,000. At year-end, Rader's CFO made a pitch to Sam Rader, the owner, making a case for eliminating the fifth product line. The CFO estimated that $100,000 of fixed overhead costs could be eliminated along with the weak line. Here is the 2000 performance, the CFO's proforma for 2001, and the actual 2001 performance:

	Actual 2000	CFO's 2001 Performa	Actual 2001
Gross Profit	$850	$800	$800
Operating Costs	$750	$650	$750
Operating Profit	$100	$150	$50

On paper, the CFO's idea looked great. However, the staffing cuts were delayed and then never made, and the extra facility space was not leased to a third party as projected. The result was that the fixed costs remained unchanged from 2000 but the marginal product, the one that contributed only $50,000 in gross profit in 2000, was not available to help cover overhead costs. Unfortunately, most of the year went by without Rader management realizing their mistake. In the fall, however, they had to decide whether to: 1) reduce fixed operating expenses as planned, or 2) attempt to replace the lost gross profit by selling more of the remaining four product lines, or 3) add a new product that might be able to contribute more gross profit, or 4) re-introduce the eliminated product.

Mr. Rader decided to re-introduce the eliminated product in a "platinum package" that was expected to perform up to that of its peers. If so it does, the 2002 income statement will look as follows:

	2002 Performa
Gross Profit	$1,000
Operating Costs	$750
Operating Profit	$250

Assessing Return on Marketing Expenditures: For most businesses, marketing and advertising expenditures are incurred to increase sales of already established products. As such, the expenditure of a particular advertising or marketing program is justified by the additional sales and resulting gross profit that it generates. To assess the return on an expenditure of this type simply calculate the number of sales that result, or are expected to result, multiply this number by the gross profit per unit, then subtract the cost of the investment made or required. Finally, divide the result by the investment made or required.

For example, Vintage Wineries spent $100,000 on a series of ads in the Northeastern United States that management estimated would generate 40,000 additional bottles of wine sold at an average gross profit of $3 per bottle. To assess the profitability of the expenditure, the following formula is applied:

$$\text{ROI} = \frac{[(\text{Gross Profit Per Unit} \times \text{\# of Units Sold}) - \text{Ad Cost}]}{\text{Ad Cost}}$$

$$= [(\$3 \times 40{,}000) - \$100{,}000] / \$100{,}000$$

$$= (\$120{,}000 - \$100{,}000) / \$100{,}000$$

$$= \$20{,}000 / \$100{,}000$$

$$= .20 \text{ or } 20\%$$

In this example, Vintage obtained a nice return on their investment – 20 percent.

Every business owner should consider the return on investment of expenditures using an analysis similar to the above. Certainly, Vintage might also consider the present value of future purchases by customers that tried their product during the analyzed period. Regardless, a process of expenditure justification should be applied to investments made in an effort to either project returns or assess actual returns.

Assessing the Attractiveness of Proposed Products or Services: You are considering adding a new product. To run the numbers, you need the following:

Annual fixed costs – Costs that do not change with volume changes such as rent, utilities, insurance, or the annual cost of furniture, fixtures and equipment.

Variable Cost Per Unit – The direct cost of producing a single unit.

Net Sale Price Per Unit – The income per unit after any sales commission.

 # Of Units Estimated to be Sold – The number of products or services expected to be sold during the analyzed period.

The process for assessing the potential profitability of a new product or service is virtually identical to the process for assessing a marketing expenditure – both are investments. To further illustrate this type of analysis let's consider an auto detail business that is considering adding window tinting.

Otto's Auto Detail has the space available in their existing facility. The estimate of fixed and variable expenses is as follows:

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Trade Show: A One of a Kind Opportunity

For many businesses, trade shows offer a unique and powerful opportunity to expose products and services, sharpen brand image and develop personal contacts and relationships. Like advertising, direct mail and sales calls, every business owner should consider including trade shows as a key component of the comprehensive marketing strategy. Trade shows are unique in their ability to deliver a rich and powerful presentation to a focused target group, and they can visibly signal to prospects and influencers that you are a serious player in the industry.

Trade show presentations are so powerful because a single trade booth offers a multi-dimensional communication of your company, its offerings and brand image. Visitors are presented with large signage, colorful logo and tag lines; second tier signage; product samples; marketing pieces; company personnel; the opportunity to dialogue in-person with you or your representatives; and take-away items that can later remind them of you. And it is a terrific opportunity to strengthen relationships with existing customers and gather leads and in-depth knowledge of prospects.

Trade shows require a significant investment in time, effort and money, however. Insufficient or ineffective planning can cause a poor return on investment, or worse – damage to your image and relationships.

Trade shows are unique in their ability to deliver a rich and powerful presentation to a focused target group, and they can visibly signal to prospects and influencers that you are a serious player in the industry.

Pre-Show Planning: The most common reason trade show investments fail to return a profit is poor planning and preparation. The first step, then, is to get focused. Begin by answering the following:

- Who will be attending the show? Separate attendees into groups or types of people or organizations. Profile the average or typical person or organization in each group of interest to you.
- From what attendee groups can I win business and how many will attend?
- How does the show fit into our overall marketing strategy?
- Do we have the resources – time, money and labor – to make the show a success?
- Are there other shows that offer a more attractive audience or higher numbers?

Tips for the Presentation: Everything your company stands for, no matter how large or small, is being exhibited on the trade show floor. Great care must be taken that every aspect contributes to the delivery of an image and message that is consistent, clear and focused. A theme should be selected and woven throughout all aspects of your communications, preferably based on a "what's in it for me" message from the target customer's standpoint. The message should be short and simple and set you apart from your competitors. What is it that you offer that is of value to them? Draw them in with catchy phrases, bold colors, sharp graphics and interesting shapes. Then, deliver your value proposition (i.e. what you offer and why they should care).

Before the Show: It is a good idea to warm your audience up to your upcoming participation in the show, message and theme. To facilitate your doing so, trade show organizers will offer a list of the registered attendees. Consider integrating your theme and message into all aspects of your pre-show marketing, including advertising, letterhead, business cards and special promotions. Look into other opportunities to warm-up your audience prior to the show and at the show, such as trade magazines advertisements and at-show sponsorship opportunities.

In-personal meetings or informal social gatherings can be scheduled with existing customers that plan to attend – a great way to "piggy-back" on the travel expenditure that you will incur. Customers might even agree to provide written or personal testimonials for you -- a powerfully persuasive message.

Of course, set-up your booth in its entirety before the show – banners, exhibits, marketing pieces and the attire of your representatives. It's the only way to ensure that it works!

At the Show: Your preparation will pay-off. Now it is time to shine. Be sure to take personnel that shine – those that present themselves well and are personable, knowledgeable and committed to your company and message. Offer prospects easy and fun ways to try your product or service, if possible. When selecting items that will prompt your prospects to think of you after the show, such as give-aways, keep in mind that the most effective are those that are somehow related to your product or service.

Evaluate Results: You strive to make each tomorrow better then today, right? Evaluate the results from the show against your goals. Also, ask booth visitors and your attendees for feedback. Find out what they liked about your booth, products and presentation. Document what worked well and what you will do different next time. Refer to your notes when planning the next trade show. ❑

Six Things Every Business Seller Should Know

You've devoted untold time, money and energy to building and running your business. It may well represent your life's work and net worth. Now you've decided that it is finally the right time to sell. Here are six things you should know.

Financially, You'd Probably be Better Off Keeping Your Business. Buyers buy businesses for the income they can receive. They look at past profit performance to predict the future, then pay a price that will allow a fair risk-adjusted return. Mid-size businesses sell for 2.5 to 4.5 times pre-interest, pre-tax earnings. If your business generates annual benefits to you totaling $500,000, a buyer might pay four times or $2 million. Some seller financing will probably be required as well. If you are paid cash at closing and you invest this sum and earn 10 percent annually, your income will be $200,000 per year. You've taken a major pay cut.

If Your Primary Sales Pitch is "This Business Could …," You're Likely Wasting Your Time. Buyers of private businesses are a very conservative bunch. If they are not, their bankers will require them to be. As such, they must rely on solid historical performance to justify purchase prices. Business sellers that try to peg most of the value on what the business "could" do typically waste their time and lose credibility. Buyers don't have to buy. They only put their money at risk when they find a good deal. If you wouldn't do it … it's likely nobody else will either.

To Maximize Value, Be Open to Providing some Seller Financing. If you ask for 100 percent cash at closing, studies show you'll typically receive a much lower total price. This is because the amount of cash that the buyer has and the amount the bank will lend are usually fixed amounts. The sum of the buyer's cash and bank financing is the maximum you can receive at closing. Now, would you like more? Then offer some seller financing. Worst case is you don't get paid your entire seller-financing portion, but you still received more than the all cash price!

They Won't Appreciate the Work that Went into Building Your Business. Unfortunately, buyers look at your business simply as an investment. They won't appreciate the blood, sweat and tears that you put into building it. You'll always have the pride of knowing what you accomplished and the respect of those who watched you do it. Don't expect any more from a buyer than a fair price.

Buyers Love When You Represent Yourself. Few sellers are experienced in business sales or valuation. All sellers are emotional when it comes to selling their "baby." No seller is objective. As the saying goes, "If you represent yourself you have a fool for a client." Do your heirs a favor and hire an expert to assist you.

Your Competitors Aren't Good Buyers. Sure, competitors are logical buyer candidates and quite easy to identify. So you contact the owner of XYZ and ask, "Are you interested?" Now he has a free chance to gather information that will help him compete against you. And even if you don't send him your confidential information, he'll use the fact that you want to sell against you … starting today. Oh, he competes in a different territory? These buyers won't pay as much because the skill, expertise, processes and methods of your company are less valuable to those already doing what you do. The better (and lower risk) buyers are individuals, financial buyers or companies in related or adjacent industries.

The intent of the above is to save the business seller time, money and frustration. If the time is not right, focus your energy on posting solid performance, then enter the market. When you do, keep in mind that selling a business is a sales activity. Even though it is done discretely, selling a business successfully requires the same elements as any successful sale … preparation, presentation, representation and negotiation. It doesn't happen on its own. Be realistic, and play to win! ❑

Unfair Distraction of Employees

Do your employees ever get calls from creditors or collection agencies regarding their personal financial affairs? Certainly, this hinders their productivity. Did you know that under the Fair Credit Collection Practices Act it is illegal for collectors to contact a debtor at their place of employment if the collector is made aware that it is against the personnel policy of the employer for the employee to take such calls?

Smart solution: add to your personnel policy that it is a violation for any employee to accept a call from a creditor or collection agency regarding his or her personal financial or business affairs. Communicate such to your employees and make sure they understand that they are to tell any creditors that contact them at work of the company policy, their knowledge of the Fair Credit Collection Practices Act, and that any violators will be reported to the Federal Trade Commission. For a copy, go to www.ftc.gov/os/statutes/fdcpajump.htm. ❑

PROFIT ENHANCEMENT

Continued from page 7

	Fixed Annual Expenses
Tools and Equipment:	**$1,000 ($4,000 total / 4 yr. payback)**
Advertising:	**$7,000**
Utility Bill Increases:	**$800**
Total:	**$8,800**

	Variable Expenses Per Tint Job
Labor:	**$30 per car, incurred only as needed**
Materials:	**$30 per car, on average**
Total:	**$60**

Now, Otto plans to sell each window tint job for $150 - the market rate in his area. In addition, he estimates that he can sell and deliver one a day, on average. He calculates his estimated profit as follows:

$$\text{Profit} = \left[\text{Units Sold Per Year} \times \left(\text{Income Per Unit} - \text{Variable Cost Per Unit}\right)\right] - \text{Annual Fixed Costs}$$

= [360 x ($150 - $60)] - $8,800
= (360 x $90) - $8,800
= $32,400 - $8,800
= $23,600

To better understand his downside, Otto calculated his breakeven as follows:

Break Even (units) = Fixed Costs / Gross Profit Per Unit
= $8,800 / $90
= 98 units (cars)

He went further and calculated the return on investment (ROI) that he would receive if he hits his sales and cost estimates. To do so, he had to adjust his numbers a bit.The total amount that he will invest at the beginning of year one is $11,800 ($4,000 in fixed assets, $7,000 in advertising and $800 in utility expenses). His annual profit is estimated to be $24,600 – one thousand dollars higher than the profit estimate used above because, in the ROI analysis, we subtracted from expense the $1,000 amortization of the original $4,000 investment in fixed equipment and tools. His calculations are as follows.

ROI = Annual Profit / Invested Amount
= $24,600 / $11,800
= 209%

Otto has a very nice investment at hand with a 209 percent annual Return on Investment.

***What to Do About the One-Time Costs Incurred When a New Product Line is Added:** As we have discussed, to “run the numbers” one must calculate the annual fixed expense and the variable revenue, expense and resulting gross profit for each unit sold. But what about one-time costs that may have to be incurred when the decision is made to begin providing a new product or service, such as the purchase of real property, machinery or equipment?

The answer is that the cost of these items will be a fixed cost, as the cost of these items is not affected by unit volume … at least not within certain capacity ranges. In addition, these up front costs must be turned into an annual cost. This can be accomplished easily by leasing the equipment rather than buying it, or by using the annual debt service requirement of the capital equipment. If the expenditure is made out of internal funds, simply divide the total amount by either the life of the capital items or

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Rolling Back Auto Insurance Costs

Insurance rates, of all types, are rising. Automobile insurance rates are rising as well. When it is time to renew your coverage, check your new quote against your old rate. Is it comparable? If no, talk to your insurer about how you can lower the rate.

Auto insurance rates are influenced by driving record, number of discounts for which you qualify, the dollar amount of deductibles, cost and characteristics of the car and the insurance company.

Driving Record: Begin by making sure your driving record is accurate. Locate yours at www.4safedrivers.com or by contacting your state department of motor vehicles by phone or the web. It is also possible that high-risk drivers in your household or workplace are causing your premiums to rise. Ask your insurer. If this is the case, such as a high school age son with a poor driving record, consider excluding them as insured drivers of your autos.

Deductibles: Ask your insurance company for quotes by deductible level. Your premiums may drop significantly if you agree to be liable for higher up-front amounts. Raising deductibles will mean that you will self insure at lower loss levels amounts. As is usually the case, doing so will save you money over time.

Discounts: Try to qualify for as many discounts as possible. Begin by asking the insurer to provide you with a list of all the types of discounts that they offer and the qualifying criteria of each. Common discounts offered include low-risk occupations, professional organizations, auto clubs, multi-car or multi-line discounts, auto safety features, low usage, “good grades” for school age drivers and defensive driving courses.

Auto Value, Make and Model: The more expensive your car, the more costly the insurance. Also, the more likely your car is to be damaged (accident, vandalism, theft or otherwise), the higher the premium. The only way around this is to get a cheaper and less damage-prone car or truck. Obtain a list of the insurance ratings of vehicles at www.carsafety.org or www.nhtsa.dot.gov. On the other hand, if your car has little value, consider canceling collision, fire and theft coverage. By having it, all you stand to collect is the book value of the car. Unfortunately, book value doesn’t make allowances for the replacement value, condition of the car or its value to you.

Shop Around: Premiums do vary among insurance companies. Shop around for the best rate. Some of the more prominent auto insurance companies are State Farm, Allstate, Northwestern, USAA, Progressive and Geico. Test drive some websites that can help you quickly obtain quotes, such as www.insweb.com or www.insurance.com. Also, consider placing all of your liability insurance – auto, home and business – with one company. This is what is referred to as a multi-line discount.

Minimizing insurance costs is a simple process that only takes a little time, effort, investigative work and creative thinking. Every business owner should review his or her coverage yearly, as he or she should for all competitive services purchased for home and business including: phones, web site, email, shipping and financial services.

If insurance for your business is involved, work through your skilled and experienced insurance broker. If you don’t have one, find one, such as either of the two insurance brokers that are contributing editors of this publication (see inside front cover). ❑

Don’t Let Up on Workers Comp Cost Control

Workers Comp insurance rates have been rising about 15 percent annually the last few years. Although a flattening is expected, cost control measures are necessary to prevent profit margin erosion. Basic cost reduction strategies include implementing, testing and updating facility evacuation procedures, checking and installing effective fire suppression systems, and adding office security programs. Regular checks should also be made to the classifications to which your employees are registered. Your costs are affected significantly by these classifications. You want to select the cheapest applicable classification. Finally, watch for calculation errors on bills. ❑

~~Ide~~Entity Crisis: Choosing the Right Legal Entity

Selecting the most appropriate legal entity for your business can be a confusing task. However, picking the one that strikes a comfortable balance between cost, complexity, liability protection and taxation can give you peace of mind at a time when you have much on your mind. Use this overview to see the big picture and begin to ascertain which will suit you best.

Sole Proprietorship: The sole proprietorship is the most common business type in the United States because of its simplicity and because it is the legal form that is automatically assigned to any business that is started by an individual who does not proactively organize in some other form. No formal registration is required and a sole proprietorship may change to one of the other entity types at any time. Sole proprietorships have only one owner, referred to as a sole proprietor, and all business income and expense is reported on the business owner's individual income tax return via Schedule C. A disadvantage includes the fact that there is no mechanism for sharing ownership, and liabilities of the business are all personal obligations of the owner.

Partnership: The partnership is a very old form of business association that may be formed when two or more persons (partnerships, corporations or other legal entities may also be partners in a partnership) wish to jointly enter into a business for profit. There are two common types of partnerships – general and limited. In a general partnership, all of the owners have full management power and are held personally liable for the actions and omissions of the other partners, and for the indebtedness of the partnership. In a limited partnership, partners are divided into two classes – general and limited. General partners are as described above. Limited partners are essentially passive investors, and are not active in the management of the company. They are not held personally liable for the obligations of the partnership.

Partnerships, like sole proprietorships, are easy to form, require little ongoing paperwork, and are only taxed at the individual (partner) level. Use of the partnership has been in decline, however, as the S-corporation and limited liability company now offer attractive advantages in terms of flexibility and in insulating the owners from the liabilities of the business.

C-corporation: The C-corporation is the classic for-profit legal entity in the United States. It is unique in that it is taxed as an entity in itself, separate and distinct from its shareholders, and it may have its ownership interests (shares) trade on public exchanges. Forming a C-corporation is much more complex, however. The incorporation process requires that the shareholders adopt bylaws, distribute shares and elect officers who oversee corporate functions. There are ongoing requirements as well, such as annual meetings, disclosures and shareholder approval of certain types of actions.

In exchange for these burdens, shareholders enjoy fairly significant protection from personal liability from company obligations, and ownership interests can be easily be transferred. Moreover, at lower annual income levels, income tax rates are lower for C-corporations than they are for individuals. Dividends, however, are the only means for distributing company profits to non-employee shareholders and are subject to double taxation. Double taxation means that company distributions (dividends) are paid out of the corporation in after-tax dollars (i.e. dividends are not a deductible expense of the business), and then, the shareholder who receives the dividend will owe taxes on the amount received as the IRS requires that such receipts be included as taxable ordinary income to the shareholder.

S-corporation: The S-corporation has similarities to its C-corporation cousin, such as ease of ownership transfer and the shielding of shareholders from the liabilities of the company. However, it has many differences as well. Significant ones include the fact that the number of shareholders that it may have is limited, shareholders may only be United States citizens and it is taxed as a partnership (i.e. there is no tax paid at the corporate level). Benefits, such as life and health insurance and housing cost reimbursements, are treated as tax-deductible expenses in a C-corporation and are considered taxable compensation for shareholders who own more than a two percent share in the S-corporation.

Limited Liability Company: Coming into vogue in the 1990s, the Limited Liability Company (LLC) often appeals to businesses and professional groups that formerly formed partnerships. Similar to the S-corporation, the LLC is a hybrid creature, combining the beneficial tax treatment of a partnership with many of the owner-liability protections of a corporation. It also permits easy changes in ownership. Different from the S-corporation, however, the LLC can have unlimited shareholders (called members), who do not have to be U.S. citizens.

The above is meant to provide a very brief overview of the different types of legal entities. For the very small business, the sole proprietorship remains the most common. For larger, multi-owner businesses, the S-corporation and Limited Liability Company are the common choice today for reasons discussed above. If you need to select an entity type for a new or existing business, take this summary and visit further with your tax advisor about the characteristics and merits of each. Build your knowledge until you find the one that is right for you. ❑

What About the Limited Liability Partnership? (i.e. What will happen to the partners of Arthur Anderson?)

Arthur Anderson is the global accounting colossus that is being pursued by the Justice department for the criminal charge of obstruction of justice in the Enron case. They, like many professional service firms, are organized as a limited liability partnership (LLP).

The LLP is the youngest of legal entities. It arose out of the savings and loan crisis of the 1980's. The state of Texas was the first to created the entity to help protect lawyers that were being pursued by the federal government for their work for S&Ls.

The LLP is a hybrid of the partnership and the corporation. It allows the partners of the professional service firm to have management powers as well as limited personal liability. Before the creation of the LLP, professional service firms were largely limited to operating as general partnerships, due to the need for partners to be active in management and due to the board of accountancy's prohibition of LLC's for accounting firms. This left each partner exposed to liabilities of the company and to liability that arose from the actions of their partners.

The partners of Arthur Anderson, because they are organized as an LLP and not a general partnership, will enjoy protection from the liabilities of their firm. They will also be protected from liabilities that arise from criminal activity of their partners. However, no legal entity can protect a person from liability for their own criminal action. If an Arthur Anderson partner is found guilty of obstruction of justice in the Department of Justice' investigation of Enron, the LLP will not protect him or her personally. ❑

Curtail Energy Costs

Energy costs have been on the rise again. Remember those energy saving tips of the 1970s? Significant savings can be earned at very little cost, such as allowing temperatures to fluctuate more freely in little used rooms and instructing the janitors to turn off lights when they leave. Since the days of Elvis and Earth, Wind and Fire, the cost of electronic monitoring devices has come down significantly. Consider adding energy saving devices like motion detectors for lighting systems to automatically turn off when a room is empty. ❑

Why You Should Consider an Employee Stock Ownership Plan

Question. Besides wanting to share the ownership of my company with my employees, are there any other reasons for doing an ESOP?

Answer. One big one is the tax deduction. If your corporation contributes stock to an ESOP, you get an immediate tax deduction for the fair market value of the stock even though there is no cash outlay by the company. Thus, the result is increased cash flow. Example: Your corporation contributes to an ESOP 10,000 shares of common stock valued at $10 per share ($100,000). In a 34% federal tax bracket, you will save $34,000 in taxes – actual cash savings.

Another big benefit: By effecting an ESOP you will have put in place a mechanism to sell some of your own stock, which will give you more liquidity and potential for diversification. Cautions: Get expert tax advice before buying, selling or contributing any stock of your corporation, and be sure the stock is valued by an independent appraiser. You don't want the plan or tax deductions disallowed because you improperly valued the business.

Cash Method Now Available to More Businesses

The IRS will now allow businesses with annual revenue as high as $10 million per year to use the cash method of accounting. Owners of businesses with revenues below this level that are not currently using the cash method should consider doing so as it generally allows for greater control of when revenue and expenses are recognized. The primary benefit of having such control is the ability to delay the recognition of income and thus delay when income taxes are due and payable.

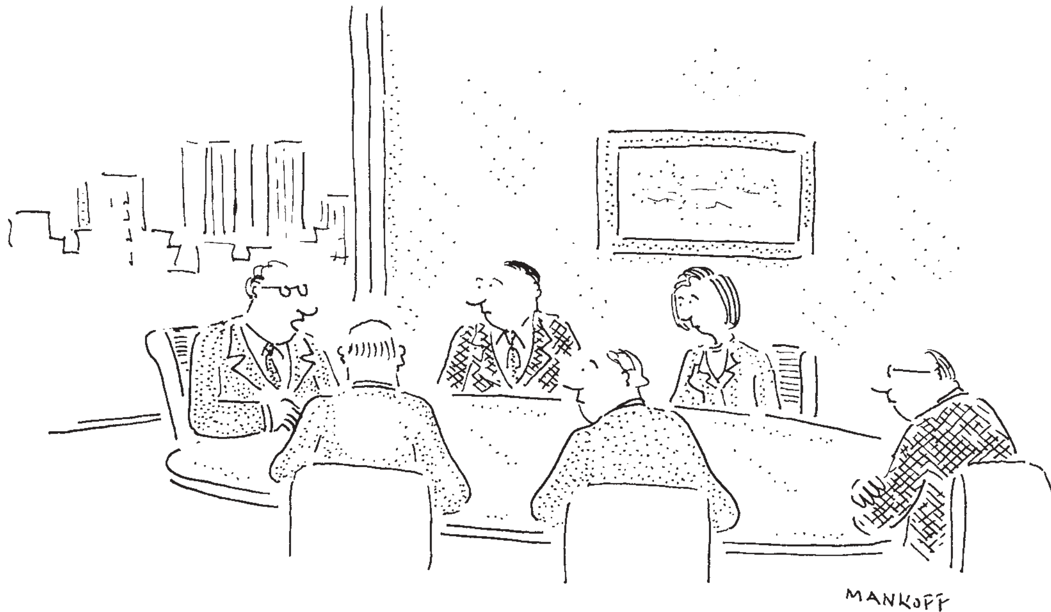
To review, two primary accounting methods exist – cash method and accrual method. The cash method is very simple. Revenue is recognized on the income statement when money is actually received (not when the product is shipped), and expenses are recorded when bills are actually paid (not when the purchase order is issued or the bill is received).

The accrual method is a little more complex, but accounting software has eased the burden significantly. Revenue is recognized when it is earned (i.e. when the sale is made) and expense is recognized when the liability is incurred (i.e. when the purchase order is issued). This method was developed to more accurately report the financial performance of a business. Generally, it does so, rendering more useful and informative statements.

For many businesses, however, the accrual method causes income to be recognized earlier than it would under the cash method. This can be particularly true in businesses that purchase large quantities of products in advance of customer purchases or payments such as retailers and contractors. This can cause income tax to become due before cash is actually received from sales, causing a cash flow burden.

The IRS has a longstanding bias towards accrual accounting, and until 2002, required all businesses with revenues in excess of $5,000,000 to use it. The threshold has now increased to $10,000,000, allowing some 500,000 additional U.S. businesses the freedom to choose which is best for them.

For more information, contact your accountant or tax advisor. See also section 448 of the Internal Revenue Code; Notice 2001-76 in Internal Revenue Bulletin 2001-52; and IRS Publication 538, Accounting Periods and Methods. ❑



"And, while there's no reason yet to panic, I think it only prudent that we make preparations to panic."

 Continued from page 10

the desired payback period in years. If the equipment is financed and a down payment is made, the down payment amount should be treated similarly.

For example, if the equipment is expected to last 10 years but the owner wants a five-year payback, the down payment would be amortized over five years. As such, one-fifth of the down payment amount would be added to the annual fixed costs to arrive at the total.

The Make or Buy Decision: Considering making a part internally that you currently outsource? You are facing what is referred to as a "make or buy" decision. To run the numbers you simply need to estimate annual fixed cost that will be incurred by making the product internally, and the per unit cost. With this data, you can calculate your breakeven point and the profits to be earned at your current or projected sales levels. This will require a slight adaptation of the typical breakeven equation. In the make-or-buy decision, the "breakeven" point is the point at which the cost of making the parts internally equals the cost of buying them outside. Therefore, the equation is as follows:

$$\text{Breakeven} = \frac{\text{Fixed Costs}}{(\text{Internal Cost Per Unit} - \text{External Cost Per Unit})}$$

To illustrate, let's assume that your company, ABC, now purchases 225,000 units annually from an outside source at an average cost of \$0.25 per unit. Your calculations say that your per unit variable cost will be \$0.20 per unit at the same annual volume, and that an annual cost of \$10,000 will have to be incurred to rent the required machine and staff it part-time. The breakeven point for the proposed project is as follows:

Breakeven = \$10,000 / (\$0.25 - \$0.20)
= \$10,000 / \$0.05
= 200,000 units

Therefore, we see that we cover our fixed costs and "breakeven" at 200,000 units. If our projected usage requirement is greater than 200,000 units, money will be saved by making the component in house. If our usage requirement is less than 200,000 units per year, it will be cheaper for us to continue buying the parts from the vendor. At 225,000 units, our annual saving is calculated as follows:

Savings = (Unit Volume x Per Unit Savings) – Fixed Costs
= (225,000 x .05) – \$10,000
= \$11,150 - \$10,000
= \$1,150

ABC Company would save \$1,150 by making the part internally as opposed to buying the parts from their vendor at the 225,000-unit level. ❑

BUSINESS OWNER'S TOOLBOX

International Business Brokers Association (IBBA): www.ibba.org
The International Business Brokers Association (IBBA) is the largest international non-profit association operating exclusively for the benefit of people and firms engaged in the various aspects of business brokerage and mergers and acquisitions. Today, the IBBA has more than 1,100 cooperative business brokers and intermediaries across Canada, Mexico, Asia, Europe and the United States.

Free Business Forms: http://www.officedepot.com/BusinessTools/forms
This website has document templates that are free to download and customize for your own professional use. Balance sheets, income statement, business plan templates, fair credit disclosure act notice, sample interview script, sample safety policy, checklist for evaluating used cars, family monthly budget form, sample collection letters and much more.

Heller Capital: www.hellercap.com
This site will help you find venture capital funding, create a business plan, locate consultants and form legal entities.

National Federation of Independent Business: www.NFIB.org
The National Federation of Independent Business (NFIB) is the largest advocacy organization representing small and independent businesses in the United States. NFIB was ranked as one of the most influential business organizations by Fortune magazine. NFIB's website has a wealth of information on current and proposed legislation, legislators, and a wealth of informational resources designed to help business owners succeed.

Lower Your Phone Bills: http://momentumtele.com/calculate.cfm
Long distance phone service is a commodity. Go for the lowest rates. Find out where at this website or by searching on the Internet with the key words "Bottom Line Best Rate Calculator." It's free and it takes very little time.

Low Cost Market Research: www.ITpapers.com
Looking for market intelligence or new perspectives, for cheap? Here there are currently 33,000 "papers" available to you on a wide variety of topics. These papers are academic in nature, but go in-depth on an immense variety of topics and could provide interesting perspectives that could be utilized in your business. And they are free!

Action Needed to Defeat Death Tax

Last year's historic tax-relief act set about a scheduled phase-out of the estate tax – the spurge of private business. Celebration was premature, however, as an automatic expiration was written into the act such that on January 1, 2011 the entire act will expire and the tax law will revert back to its original state (see "The New Estate Tax Laws: Here Today, Gone Tomorrow" in the Nov./Dec. 2001 issue of ***The Business Owner***). That is unless Congress passes new legislation that makes the relief permanent.

As an owner of a private business, you probably don't want your estate to face federal tax rates of as much as 55 percent when the wealth you build is passed to your children. In addition, the uncertainty of whether the estate tax will rise from the dead makes it almost impossible for small family business owners to effectively plan.

If you are like many private business owners and want the estate tax eliminated, the only solution is for you to take it upon yourself to eliminate the uncertainty and push for the passage of legislation that will make the relief permanent. Unfortunately, the effort to put the estate tax away for good suffered a setback in early June as a vote in the United States Senate failed to garner the supermajority required. Sixty 'yes' votes are needed and 54 were received.

Contact your U.S. representatives today, and tell them that you want the death tax to be eliminated for good. Write a letter to the editor of your local newspaper explaining your position. To simplify the task, the National Federation of Independent Business (NFIB) has created www.YesToGrammKyl.com. Go there and type in your zip code. You will instantly be given the names and contact information for your representatives and the names of your local media outlets. You can even type the letter on the website and it will be sent via email! You will find additional information about the legislation as well.

The Senators that voted against the bill in June were Cleland (Ga.), Durbin (Ill.), Harkin (Iowa), Landrieu (La.), Levin (Mich.), Wellstone (Minn.), Reed (R.I.), Carnahan* (Mo.), Johnson* (S.D.), and Torricelli* (N.J.). The ones with the "*" by their names supported the measure last fall but switched their votes in June. ❑

THE BUSINESS OWNER
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ADDRESS SERVICE REQUESTED

DATED MATERIAL

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