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Leading EDGE

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ADVICE & INFORMATION TO HELP YOU MANAGE YOUR BUSINESS

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To Generate Working Capital, Look to Your Balance Sheet

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When economic performance suffers, many business owners focus primarily on the income statement and choose to cut costs. This was a common practice during the recession. Businesses cut discretionary spending and reduced head count with the goal of "right-sizing" the organization's cost structure. While these efforts can temporarily boost results, there is often greater value to be found in the balance sheet. Tightly managing the balance sheet can create more cash, preserve options, and increase shareholder value for business owners.

Working capital is the best way to judge how much your company has in liquid assets to build the business, fund growth, and produce shareholder value. Working capital reveals more about the financial condition of your business than most other calculations because it shows what would be left after using short-term resources to pay off short-term liabilities. The greater the amount of working capital, the less financial strain your company will likely experience.

Companies can make poorly timed or ill-advised capital investments, or own unnecessary or unproductive property and equipment. When you focus your efforts disproportionately on the income statement, it can be easy to miss these issues. Some measures designed to manage

costs can actually inflate the balance sheet, consuming cash and reducing value.

Many high performing companies pursue a more evenhanded approach to financial management, managing the balance sheet as tightly as they manage the income statement. They take steps to free up significant amounts of cash, which can be redeployed to generate the greatest returns.

The following steps can help your company achieve this goal:

- **Identify your current use of capital and track it to each product, customer, geographic segment, and activity.**
  Without knowing where your capital is currently invested, you cannot know the true economic profitability of the products and services for which you are responsible. By focusing on the cost of capital, you can assign appropriate costs to each product or service, assess true performance, drive profit improvements, and deemphasize products or services that do not generate adequate return on capital. In essence, you will be making more informed strategic decisions.

- **Actively manage working capital by limiting the resources tied up in funding other operations.**
  For example, using lean techniques to reduce the time it takes to produce finished goods can have a dramatic impact on operations. Also, remove the bottlenecks in your operations that lead to slow collections. Utilizing powerful business process tools such as management dashboards can improve visibility into how effectively your organization operates, providing real-time information to manage the business.

- **Set an implicit or explicit limit on capital expenditures based upon the performance of the business.**
  One key to effective capital budgeting is to set targets for asset productivity. Invested capital should be more productive over time and you should expect greater output. Do not spend more capital without requiring additional output.

- **Explore a new approach to the business and pursue strategies to own fewer assets, or seek third parties to own the assets for you.**
  Assets that were previously considered essential to own can be outsourced, thereby freeing up a significant amount of cash and reducing long-term costs. For instance, instead of owning warehouses and trucks, consider contracting with companies that do so.

Ultimately, managing the balance sheet is all about freeing up cash and redeploying it in the best possible way. It provides a significant opportunity to create shareholder value, in good times and in bad. **LE**

Preparing for a Successful Business Transition

Mario O. Vicari
Director

Studies have shown that as many as 75 percent of business transfers do not meet the owner's goals. This is principally because many owners view only one variable in the transaction– obtaining the highest price. While price is critical, others factors such as terms, timing, effect on employees, and the owner's ongoing role are also very important. We often encounter owners who do not have a clear picture of what they want from the transfer and are not in a position to properly evaluate various opportunities.

In our experience, being prepared for a transfer involves two components: business readiness and owner readiness.

Business Readiness

A business transfer can take many forms, including an outside sale, an intergenerational family transfer, or an ESOP. We often get questions about how to prepare for a certain type of transfer. No matter what type of transfer the owner is considering, our response is always to organize the company in a way that will create the maximum value for the shareholders. Adopting a value creation mindset requires you to change your view from CEO or owner to an investor who requires a return on invested capital.

The best way to adopt this mindset is to organize your business to run without you. This is often a very difficult task because it takes skill and it requires you to step away from the day-to-day running of the business and organize it so it can run successfully with others in charge. In order to move toward an investor mindset, concentrate on:

People – Do you have the right people in place to drive the company forward once you are no longer working in the business on a day-to-day basis? If the answer is no, you need to upgrade your talent. A strong management team that can run the business without the owner adds a lot of value from the standpoint of an outside acquirer.

Governance – The governance structure of your business needs to be strong enough to compensate when the owner is not present. Form a board of directors or advisors to assist your management team and hold them accountable. Make sure you have more formal reporting structures and systems in place to provide increased visibility into the business.

Strategy – We find that companies often spend too much time and attention on tactical execution, at the expense of strategy. Allocating time for strategy at the management and board level will add value to your business.

Owner Readiness

An owner needs to be emotionally and financially prepared for a transfer. To get there, you need to be able to answer two key questions: How do I envision my life after the transition and how much is enough?

Arguably, the hardest part of any transition is the emotional readiness of the owner. You have an emotional attachment to your business and it is difficult to break away from the feeling of owning and running it over a long period of time. I have interviewed several owners post transition and they all admitted that this was the hardest part. There is no playbook; everyone addresses their exit differently. However, being stuck in inertia is not the right answer. Talk to others who have walked in your shoes and learn from them. Having a basic vision of your life away from the day-to-day running of your business is a must if you are serious about transition.

Your financial readiness will be determined by how well you understand your personal financial situation and your lifestyle needs. This should provide an indication of your financial needs in retirement. A good financial planner is critical to this process. Knowing your financial needs and resources will help you identify how much is enough for your business. Knowing your required minimum will give you the flexibility and clarity to evaluate all your options and make a decision when the time is right.

While transitioning a business is difficult, you can increase your chance for success by considering the famous quote of Louis Pasteur, "Chance favors the prepared mind." **LE**

Take a Long View to Build Shareholder Value

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To build shareholder value, companies need to concentrate on the long-term. At times, this can mean reporting earnings that are not as good as the prior year or not in line with original budget projections. Too many public companies appear to be more focused on short-term earnings than on creating real long-term value for shareholders, probably due to stock options or other bonus-related agreements for senior executives. Remember, company buyers are purchasing the future potential of the business. You sacrifice value when you overinvest in items below their cost of capital or underinvest in long-term opportunities.

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Ask yourself the following questions when making an investment decision for your business:

- Can the company afford to make the investment? Is it necessary to preserve or enhance value?
- What long-term value would be created?
- Are there alternatives that would create more value?
- How risky is the investment? Could it be impacted by competitor decisions? Could it become obsolete before creation of all the value? Would other variables impact the potential value?

Studies have shown that approximately 60 percent of total shareholder value is created through top line revenue growth, nearly triple the contribution of cost reduction. Many companies have achieved growth through acquisition, yet many acquisitions fail to meet their initial objectives. You need to clearly communicate expected value creation from an acquisition to the management team and measure the incremental cash flows against the original projection.

Here are three more ways to enhance shareholder value through top line revenue growth:

1 Customer Segmentation

Consider breaking down sales into logical units such as sales territories, product/service offerings, or customer segments. For each unit, track the percentage of new customers, lost customers, and customers who have decreased, maintained, or increased their business.

2 Pricing Strategy

Determine whether there is too much price disparity between existing customers. Upon analysis, many companies are surprised to learn that a significant percentage of their margin is generated by a few customers. There are often a number of "smaller" customers who would qualify for price increases. Create a graph with gross profit percentage on one axis and business volume on the other, and then plot each customer on the graph. You would expect to see a graph that starts high and moves lower as the volume for each customer increases. It can be eye opening to discover how many plot points do not follow this logic.

3 Proposal Process

Understand what makes your business unique in the marketplace to quickly determine whether a prospect is "qualified." Streamline your pricing, and then customize your proposals based on their potential size. Track the number of touch points from the date you are selected to submit a proposal until the date the proposal is accepted or rejected. We think you will find a direct correlation between the number of touch points and the success rate of the proposal.

Focus on decisions that will create long-term shareholder value and make sure your management team is clearly focused on profitably growing the top line. **LE**

An Alternative to GAAP for Small and Medium-Sized Entities

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What if there was alternative to Generally Accepted Accounting Principles (GAAP) that allowed you to amortize goodwill, did not require you to record deferred taxes, and had no concept of variable interest entities (VIE)? What if this alternative framework permitted a choice of certain options for your accounting policies? Would you be interested?

In July 2013, the AICPA released the Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs). FRF for SMEs is another special purpose framework, such as cash-basis or tax-basis financial statement, and is referred to as another comprehensive basis of accounting (OCBOA). FRF for SMEs draws upon many traditional accounting principles, which under GAAP have become increasingly complex. Although FRF for SMEs has many similarities to GAAP, there are some distinct differences:

- No concept of Variable Interest Entities
- Simplified reporting and disclosure of pension plans
- No concept of other comprehensive income
- Option to record deferred income taxes or just current income taxes
- No impairment testing of long-lived assets
- No recognition of stock-based compensation to employee

The framework is not for every business. It is geared toward owner-operated companies that do not need the additional disclosures and reporting requirements typically provided by GAAP. Also, it is designed for privately-held companies that have no intentions of going public and do not engage in complex transactions or have significant foreign operations. It is not available for not-for-profit organizations.

A foreseeable challenge to the use of FRF for SMEs will be its impact on the lending community. Financial statements prepared in accordance with GAAP are required as a condition of many lending agreements. In order for a company to use FRF for SMEs, bank agreements will need to be rewritten or amended to allow for the new framework.

Renewal time may present a good opportunity to discuss your use of the new framework with your lender. However, keep in mind that lenders have become accustomed to GAAP over time and a significant change like this will require proper due diligence. Before any lender will be willing to accept FRF for SME financial statements, they will need to become comfortable with its rules and understand how it differs from GAAP.

If FRF for SMEs interests you, it may be beneficial to have a conversation with your accounting service provider to learn how the framework could impact your company's financial statements. Depending on the nature and complexities of your operations, it could create significant change. On the other hand, the framework may have little or no impact on your financial statements and, in some cases, would only simplify financial statement disclosures. Connecting your accountant with your lender may also assist with traversing the two frameworks and determining how it may impact the credit and underwriting of any impacted debt arrangements.

As with anything new, it will take some time for FRF for SMEs to become more widely used. The framework may not be right for every company and it will require a certain level of understanding before implementation. However, FRF for SMEs can be a viable alternative to GAAP and can offer simpler disclosures, fewer requirements, and additional accounting policy options. **LE**

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