Optimizing Profits: A P+CFO Case Study

By Brian Mayville, MBA, DRDA CPAs & Business Consultants

Brian Mayville, MBA
DRDA CPAs & Business Consultants

In our last article we introduced Profit & Cash Flow Optimization ("P+CFO"). P+CFO is a proactive approach into understanding current profit and cash flow levels as well as optimizing them to achieve peak business performance and enterprise value.

When conducting a P+CFO study, we perform an array of analysis on a business' historical performance, to have a better understanding of their books as we project an optimal future. A key exercise to calculate a business' optimal profit level is called an Optimal Profitability Projection ("OPP").

We use the businesses most recent three years' income statements and re-cast them to show the true economic value stemming from business operations. To do this, we need to distinguish the difference between income and expenses that are essential versus non-essential, recurring versus non-recurring to business operations. Income and expenses that are non-essential to business operations need to be addressed. For example, eliminating any related party transactions and adding back/taking out any income or expenses that are non-essential to business operations so we can normalize operating results. More specifically, we add back expenses related to the executives, such as officers' compensation and benefits, deferred compensation, retirement plans, life insurance, etc. Items in the Other Income/Expense section of the Income Statement that are non-essential to business operations can be subtracted or added as appropriate.

Below is an example of an OPP case study:

In this case study, we projected the optimal profitability by using the most recent total sales available from the 2020 Income Statement and the Company's optimized Direct Costs and SG&A Expenses. Rather than benchmarking the case study to industry averages or competitors, we are benchmarking the Company against itself. The OPP results in an achievable target or goal based upon historical performance. The outcome is a potential increase of $469,586 in earnings before tax, by increasing 2020's profits from $171,000 to $640,586.

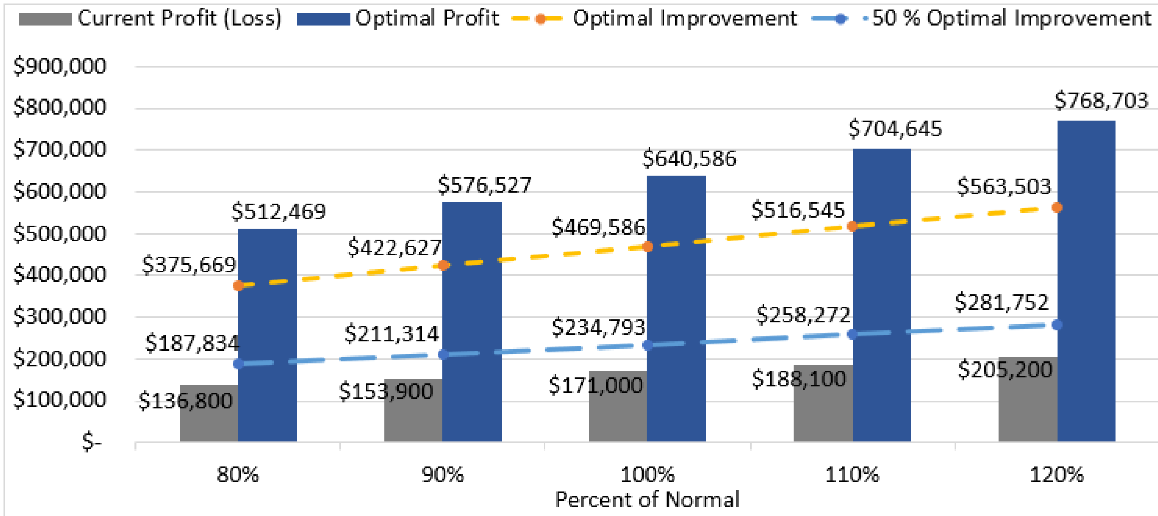
Optimal Profitability Projection

Period	2018		2019		2020		Optimal	
Sales	DOLLAR	%	DOLLAR	%	DOLLAR	%	DOLLAR	%
Total Sales	$ 3,900,000	100%	$ 4,200,000	100%	$ 4,600,000	100%	**$ 4,600,000**	**100%**
Direct Costs								
Material	$ 1,600,000	41.03%	$ 1,800,000	42.86%	$ 1,900,000	41.30%	**$ 1,887,179**	**41.03%**
Direct Labor	$ 723,000	18.54%	$ 824,000	19.62%	$ 676,000	14.70%	**$ 676,000**	**14.70%**
Other Direct Costs	$ 642,000	16.46%	$ 507,000	12.07%	$ 765,000	16.63%	**$ 555,286**	**12.07%**
Total Cost of Goods	$ 2,965,000	76.03%	$ 3,131,000	74.55%	$ 3,341,000	72.63%	**$ 3,118,465**	**67.79%**

Gross Margin	$ 935,000	23.97%	$ 1,069,000	25.45%	$ 1,259,000	27.37%	**$ 1,481,535**	**32.21%**
Sales, General & Admin Exp								
Fixed Costs								
Depreciation	$ 39,000	1.00%	$ 69,000	1.64%	$ 98,000	2.13%	**$ 98,000**	**2.13%**
Interest Expense	$ 10,000	0.26%	$ 5,000	0.12%	$ 8,000	0.17%	**$ 8,000**	**0.17%**
Rents	$ 99,000	2.54%	$ 86,000	2.05%	$ 59,000	1.28%	**$ 59,000**	**1.28%**
Taxes & Licenses	$ 36,000	0.92%	$ 44,000	1.05%	$ 49,000	1.07%	**$ 49,000**	**1.07%**
Utilities/Telephone	$ 22,000	0.56%	$ 29,000	0.69%	$ 25,000	0.54%	**$ 25,000**	**0.54%**
Variable Costs								
Advertising	$ 15,000	0.38%	$ 19,000	0.45%	$ 30,000	0.65%	**$ 17,692**	**0.38%**
Professional Services	$ 100,000	2.56%	$ 150,000	3.57%	$ 60,000	1.30%	**$ 60,000**	**1.30%**
Salaries & Wages	$ 242,000	6.21%	$ 293,000	6.98%	$ 326,000	7.09%	**$ 285,436**	**6.21%**
Travel	$ 20,000	0.51%	$ 50,000	1.19%	$ 10,000	0.22%	**$ 10,000**	**0.22%**
Other Operating Expenses	$ 194,000	4.97%	$ 226,000	5.38%	$ 423,000	9.20%	**$ 228,821**	**4.97%**
Total SG&A	$ 777,000	19.92%	$ 971,000	23.12%	$ 1,088,000	23.65%	**$ 840,949**	**18.28%**
Earnings Before Tax	$ 158,000	4.05%	$ 98,000	2.33%	$ 171,000	3.72%	**$ 640,586**	**13.93%**

Brian Mayville, MBA
DRDA CPAs & Business Consultants

The graph below shows levels of optimal improvement from the Optimal Profitability Projection. If the Company were to perform at a level of 100% optimal improvement, they would see a potential increase of $469,586 in profits. If the Company were to perform at a level of 50% optimal improvement, they would still see a potential increase in profits by $234,793, more than twice their actual performance.



The Optimal Profitability Projection allows us to see which Direct Costs and SG&A Expenses can be optimized to improve profits and cash flow. It is a tool that can quickly assess a business so that management can gain insight into which areas of improvement will yield the greatest increase in profits, cash flow and value.

For example:

Our initial observations are that Direct Labor and Other Direct Costs have fluctuated the most. Now that you realize this fluctuation you can investigate why this has happened. The case study was able to get their Direct Costs down to $676,000 in 2020, the lowest over the 3-year period. However, total SG&A Expense has increased year over year, while Earnings Before Tax has oscillated between $158,000, $98,000, and $171,000 for 2018, 2019 and 2020, respectively. Key Costs/Expenses for optimization include Direct Labor, Other Direct Costs, Advertising, Salaries & Wages, and Other Operating Expenses. By optimizing these Costs/Expenses, we could potentially increase 2020 profits by 10.21%.

To optimize profits, the Company can consider the following options:

1. **Increase Sales** – We suggest reviewing the current sales model and developing a sales and marketing strategic and tactical plan to increase sales.

2. **Decrease Direct Costs** - We suggest reviewing/re-negotiating purchase agreements and terms of payment for better prices and payment terms. The Company could consider obtaining proposals from a few manufacturers/suppliers to ensure best prices, where possible.

3. **Decrease SG&A Expenses** - We suggest reviewing key expenses that can be reduced in order to increase profitability. Key expenses include Advertising, Salaries & Wages, and Other Operating Expenses. Optimizing key expenses will increase profits and cash flow.

The Optimal Profitability Projection gives us great insight when looking at a business, almost acting like a super magnet to find a needle in a large haystack. In a future article we will discuss how it is helpful to review the balance sheet and do additional analysis, such as key performance indicators, financial ratios, look at yearly trends, and perform an overall risk assessment to validate our initial observations and ensure that management's understanding and solutions remain valid.

Brian Mayville, MBA
DRDA CPAs & Business Consultants