Boosting the Profitability of Your Business

DoerenMayhew
CPAs AND ADVISORS

Insight. Oversight. Foresight.®

Even if you're an industry leader, there is always opportunity to improve your profitability. But it involves working ON your business. Specifically, it means determining what your customers want, delivering it to them in an extraordinary way and managing the business in a manner that allows you to focus on the factors critical for success.

What are these factors, how do they impact profitability, and how can you measure performance of these critical success factors and make adjustments to boost profits?

If you're going to have any affect on profitability, you first have to understand and focus on the four factors at left, which determine your profit.

Let's put these four things together. And for simplicity, we'll assume you have only a single product. (The conclusions we come to will apply whether you have one or 1,000 products.)

Supposed you sell a thing called a widget. It costs you $60, and you sell it for $100. What you sell the widget for is the price. What you pay for it is the variable cost.

If you sell 100 widgets, your total variable costs will be $6,000. And if you sell 50 widgets, the total variable cost is only $3,000. (It varies directly with your sales volume.)

Now, if you sell a widget for $100 and it costs you $60, you've made a profit of $40 on each sale. We call this the *gross profit* or *gross margin*. We use this term to remind us that we still have to meet our fixed costs before we end up with a net profit.

If you sell 100 widgets and make a gross margin on each one of $40, your total gross margin is $4,000. And if your fixed costs such as rent, leases, wages, insurance, etc. amount to $3,000, you end up with a net profit of $1,000. On the other hand, if your fixed costs are more than $4,000, you'll incur a loss.

Increasing Profit

If you're looking for ways to increase your profitability, you have to focus your attention on the four profit-determining factors. Let's look at each of these four factors under three headings – the factor, the possible action you could take to enact changes and the required conditions that would have to occur to increase profits.

It's important to note that profitability can be increased by either taking action to increase or decrease any of the four factors, as long as some conditions are met.

FACTOR	ACTION	REQUIRED CONDITIONS
Price	Increase	Sales volume could either remain unchanged or decline. If sales volume declined, the decline would have to be less than the offset created by the price and resulting profit increases.
	Decrease	The sales volume would have to increase sufficiently to compensate for the decline in price. If sales volume was to increase, as a result of the decrease in price, there is a possibility of a decrease in the per-unit fixed and variable costs because of increased economies of scale.
Variable Costs	Increase	The increased variable costs should lead to or be a result of improved product or service quality. The market would have to accept a higher price, or the heightened quality would have to attract enough new buyers to offset the increase in variable costs.
	Decrease	The sales volume would have to remain unchanged. The decrease in variable costs could not be allowed to affect product or service quality—which would have a consequential effect on sales. If they did decline, the fall in gross profit would have to be less than the decrease in variable costs.
Volume	Increase	The price could either remain unchanged or decline. If the price was reduced, the reduction would have to be less than the offset created by the volume and resulting profit increases. Another possibility is to achieve a reduction in per-unit fixed and variable costs due to an increase in economies of scale.
	Decrease	A savings in fixed costs would have to be achieved by reducing the size of the business or production levels would have to be evaluated to find variable cost economies of scale. This savings would have to be greater than the reduction in gross profit due to the decreased sales volume.
Fixed Costs	Increase	The increase in fixed costs should lead to or be a result of improved product or service quality. The market would have to accept a higher price, or the heightened quality would have to attract enough new buyers to offset the increase in fixed costs.
	Decrease	Sales 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 they did decline, the fall in gross profit would have to be less than the decrease in fixed costs.

What should you note from the previous chart?

- No single factor can be considered without considering the impact on, or the impact from, each of the other factors.
- A profit improvement strategy may involve either an increase or decrease in each of the four factors. There is no standard formula for improving profitability; it depends entirely on specific circumstances and the relative strengths and weaknesses of your business.
- A favorable change in price and/or variable costs will improve your margin per dollar of sales. On the other hand, a favorable change in your sales volume and/or your fixed costs indicates greater productivity. Therefore, the overhead you incur in running your business involves lower costs per dollar of sales.

In other words, any profit improvement strategy must focus on one or both of two things:

Higher Gross Margin | **Greater Sales Per Dollar**

Let's consider the profit improvement potential that would arise from a modest improvement in each of the four factors. We'll begin with the figures previously given as an example and use them as a base, making a 5 percent improvement in each of the four price-determining factors.

Achieving a higher gross margin per dollar of sales by **increasing price** and/or **reducing variable costs.**

Achieving greater sales per dollar of fixed costs by **increasing the productivity** of those things that have a fixed cost.

The Powerful Effect of Small Changes

	Base	% Change	Result
Price	100	5% increase	105
Sales Volume	100	5% increase	105
Total Revenue	10,000		11,025
Variable Costs ($60)	-6,000	5% decrease ($57)	-5,985
Gross Margin	4,000		5,040
Fixed Costs	-3,000	5% decrease	-2,850
Net Profit	**$1,000**		**2,190**

It can be seen that a 5 percent favorable change in each of the four factors, without a consequential unfavorable impact on each of the other three, would more than double your profit from $1,000 to $2,190:

A 119% Improvement

You may want to take issue with the assumption that there are no consequential impacts. However, it's a fact that small improvements made to each of the four factors that determine your profit will combine to give a staggering overall impact.

And of course, the reverse is also true. If you discount your price, allow your sales volume to fall, fail to control your overhead costs or let your variable costs get away from you, then you can destroy a potentially profitable business. This can happen very quickly.

Developing a Profit Improvement Strategy

You'll recall that to improve your profitability you must either make a larger gross margin on each dollar of sales or sell more without increasing your fixed costs. It goes without saying that the biggest improvement will occur if you can achieve both simultaneously.

Improving Gross Margin

Remember, your gross margin is the difference between the price of your product and what it costs you to buy or make it. Therefore, the only way to increase your gross margin is to sell at a higher price or buy/make at a lower price.

In most instances (but not all!) you will have limited scope to buy at a lower price. For this reason, your selling price is the critical variable. Without a doubt, the biggest single barrier preventing some business managers from making an acceptable profit is their refusal to charge a price that will enable them to achieve it. You are not in business to match the price your competitors set; you are there to service your customers.

The following table indicates the increase in sales that is required to compensate for a price discounting policy. If your gross margin is 30 percent and you reduce price by 10 percent, you need sales volume to increase by 50 percent to maintain your initial profit.

If your present margin is ...									
	20%	25%	30%	35%	40%	45%	50%	55%	60%
And price is reduced by ...	To produce the same profit, sales volume must increase by ...								
2%	11%	9%	7%	6%	5%	5%	4%	4%	3%
4%	25%	19%	15%	13%	11%	10%	9%	8%	7%
6%	43%	32%	25%	21%	18%	15%	14%	12%	11%
8%	67%	47%	36%	30%	25%	22%	19%	17%	15%
10%	100%	67%	50%	40%	33%	29%	25%	22%	20%
12%	150%	92%	67%	52%	43%	36%	32%	28%	25%
14%	233%	127%	88%	67%	54%	45%	39%	34%	30%
16%	400%	178%	114%	84%	67%	55%	47%	41%	36%
18%	900%	257%	150%	106%	82%	67%	56%	49%	43%
20%	—	400%	200%	133%	100%	80%	67%	57%	50%
25%	—	—	500%	250%	167%	125%	100%	83%	71%
30%	—	—	—	600%	300%	200%	150%	120%	100%

On the other hand, this table shows the amount by which your sales would have to decline following a price increase before your gross profit is reduced below its previous level.

If your present margin is ...									
	20%	25%	30%	35%	40%	45%	50%	55%	60%
And price is reduced by ...	To produce the same profit, sales volume must increase by ...								
2%	9%	7%	6%	5%	5%	4%	4%	4%	3%
4%	17%	14%	12%	10%	9%	8%	7%	7%	6%
6%	23%	19%	17%	15%	13%	12%	11%	10%	9%
8%	29%	24%	21%	19%	17%	15%	14%	13%	12%
10%	33%	29%	25%	22%	20%	18%	17%	15%	14%
12%	38%	32%	29%	26%	23%	21%	19%	18%	17%
14%	41%	36%	32%	29%	26%	24%	22%	20%	19%
16%	44%	39%	35%	31%	29%	26%	24%	23%	21%
18%	47%	42%	38%	34%	31%	29%	26%	25%	23%
20%	50%	44%	40%	36%	33%	31%	29%	27%	25%
25%	56%	50%	45%	42%	38%	36%	33%	31%	29%
30%	60%	55%	50%	46%	43%	40%	38%	35%	33%

At a 30 percent margin and a 10 percent increase in price, you could sustain a 25 percent reduction in sales volume before your profit is reduced to the previous level … you would have to lose one out of every four customers!

The Price Trap

If you’re like many owners of small to medium-sized businesses who regard price as the only factor influencing the buying decision of their customers, you may reject the proposition that a high price strategy (and by implication, high value) will work.

But there is no business that does not have the potential to command a premium price for its products and services if—and this is the crunch—it is able to market those products or services in such a way that the customer perceives added value.

> If all of your marketing efforts and all of your sales dialogues focus on price, then you will be beaten on price every time a competitor comes along with a lower one. In other words, if you focus your customers on price as a critical factor, it will be one.

The only way to get out of the price trap is to promote other features and benefits that you can offer your customers (i.e., better quality, longer warrant, satisfaction guarantees, 24-hour accessibility, more convenient location, greater resale value, etc.).

It may be that your competitors already offer all of these things … but unless they also emphasize this in their marketing, how will the customer ever know?

Your job is to create the perception of value and then to back up what you sell with superb services.

Price is only important when all other things are equal:

Some customers only think in terms of price. They are better left to your competitors. What you should be doing is working with those people who are happy to pay for value.

This means two things:

1. You have to deliver value (embody service).
2. You have to educate your customers to be aware that they are receiving value. One without the other will leave you exposed.

Improving Productivity

This is all about more sales per dollar of fixed costs. It can be achieved by either or both increasing your sales at a faster rate than your fixed costs increase or reducing your fixed costs without affecting your sales.

Fixed costs must be incurred for you to remain in business. In the short run, they do not change as your volume of sales changes. Examples include rent, wages, advertising (to a large extent), interest, lease costs and so on.

Some of these costs are discretionary in the sense that you can take a decision to reduce them simply by cutting back. Others, however, are committed, and you can't avoid them.

To determine the critical things about each fixed cost, ask yourself a few questions:

- What service does this cost provide to my business? Can I obtain the same service from another source at a lower cost?
- If so, is it feasible to switch to another supplier of that service? If I did switch to another supplier, would I get equivalent quality and would this affect the quality of my product or services?
- If I were to spend more on this service, would it generate additional gross profit that exceeds the additional cost?

You'll notice that all of these questions are directed toward what you're getting for what you're spending. They are not simply concerned with whether or not you can eliminate or reduce the cost.

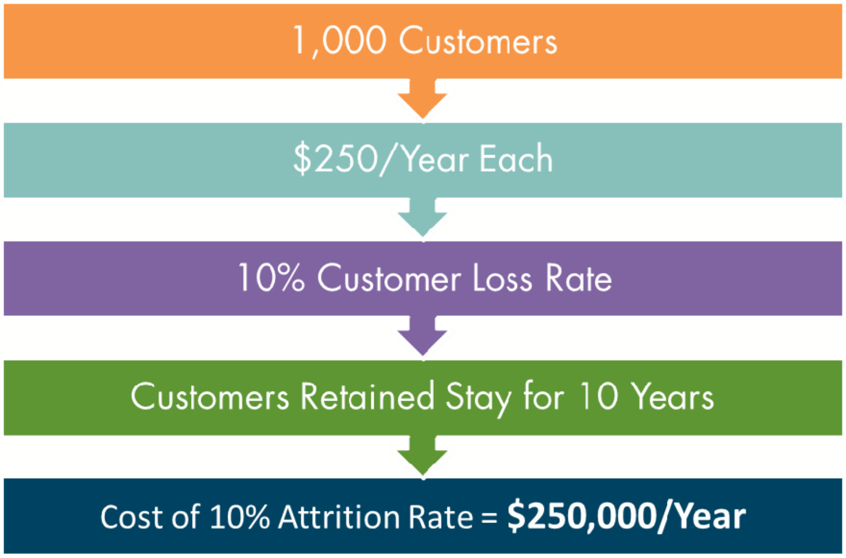
Take wages, for example. In difficult times, you may think of dismissing team members. This may be an appropriate course of action, but it should be considered carefully. Often, the appropriate strategy is to invest *more* in team training to improve customer service and sell more to your customers.

A Case for Customer Service

The only sure way to get customers to come back and act as advocates for your business is to give them exceptional service. They need to feel that you really care about them and that your goal in business is to exceed their expectations with the way you look after them. Most businesses fall short of this ideal, but it's an objective well worth striving to deliver.

- Almost 70 percent, or seven out of 10 customers, cease to patronize a business because of perceived indifference.
- Most businesses spend six times more trying to attract new customers than they do looking after the ones they already have.
- A study on client satisfaction revealed that a 5 percent increase in customer retention will produce a 25 percent to 100 percent improvement in profit.

Consider the following example:



Another thing that's overlooked by most businesses is the simple act of asking the customer to buy. It's no accident that McDonald's is one of the largest and most profitable businesses in the world. The reason for this certainly can't be found by looking at the uniqueness of their product.

The fact is that at McDonald's, nothing is left to chance. Everything is done according to a plan. Even the question, "… and will you be having fries and a drink with your meal today?" is part of a well-designed system. About 30 percent of the time people say "yes," even though it may not have been in their mind. The effect is a 30 percent increase in sales of fries or drinks and a more than 100 percent increase in profit contribution from those lines.

The Powerful Dynamics of Customer Retention

Sales Components	Present Rate	Present Position	Possible Rate	Possible Position
# of Customers		1,000		1,000
Less Customers Lost	10%	-100	5%	50
		900		950
Add New Customers	10%	+100	12%	120
Total Customers		1,000		1,070
Sales Frequency	10	x10	11	11
# of Transactions		10,000		11,770
Average Sale ($)	$25	x$25	$27.50	x$27.50
Total Revenue		**$250,000**		**$323,675**

This table demonstrates the affect of a relatively small improvement in the critical variables— customer attrition rate, new customer attracted rate, frequency of customer purchasing and the average value of each sale—on total sales revenue.

Perhaps the best-kept secret in the business world is that it's very simple to improve the profitability of a business. What to do is the easy part. Being willing to do it is the stumbling block.

Business success stories have been associated with people who have had the courage to change their way of doing business. In the case of the failures, it has been their refusal to try something different.

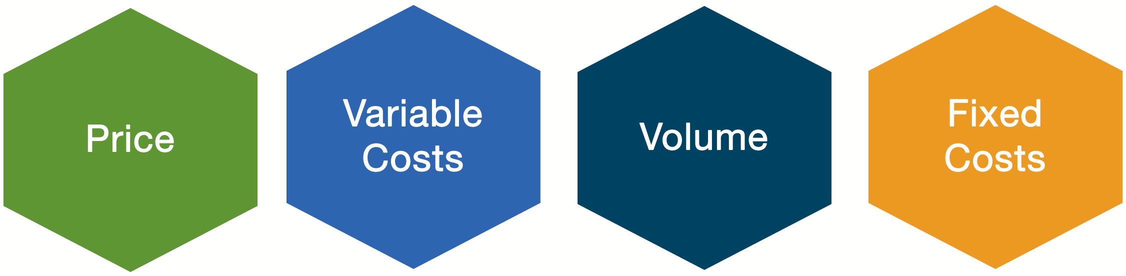
A Profit Improvement Case Study

This example illustrates how small marginal changes, although modest in themselves, can combine to result in a huge difference. The result in the first year was a 58 percent increase in profitability and business value improvement of more than $75,000.

Components	Before	After	Change	Strategies & Results
Sales	$242,750	$279,462	15.1%	• Advertising budget established, market segmented and targeted, advertising effectiveness analyzed, and ads that “pulled” more developed. • Team trained on product knowledge, selling skills, customer courtesy. • Performance standards and targets established and closely monitored. • Selective price increases on key products. **Result:** 15.1% increase in dollar value of sales.
Gross Profit Margin	36%	$39%	8.3%	• Major profit contributors analyzed (product lines and customer segments). • Products not achieving margins nor fitting the business dropped. • Team members acquainted with major profit contributors. • More selective purchasing, focus on quantity discounts established. • Selective price increases improved margins and enabled better service at point of sale. • Advertising and selling directed to higher profit lines and targeted to qualified customers. **Result:** 8.3% improvement in gross margin.
Fixed Overheads	$61,358	$67,886	10.6%	• Costs analyzed as a percentage of sales over the last three years; major cost areas identified. • Each area examined on cost/benefit basis to determine if same result could be achieved at lower cost from another source, or whether value was appropriate. • Detailed cost budgets prepared on a cash-flow basis. • Actual costs monitored against monthly budgets; detailed reviews quarterly. **Result:** Fixed costs increased by 10.6%, in line with inflation. In real terms, fixed costs remained constant (even though sales increased by 5% in real terms and 15% in nominal terms).
Capital Employed	$194,885	$201,179	3.2%	• Post-sale credit control established. Customers failing to pay brought into line. Some customers left, which was a plus because they increased servicing costs. • As part of gross margin analysis inventory lines not achieving turnover targets evaluated, some duplicate lines dropped. • Tighter control instituted for inventory and lead time for purchasing orders. • Old, slow-moving inventory disposed of quickly, freeing up valuable space and increasing cash flow. **Results:** Inventory levels and receivables reduced relative to sales increase, releasing cash to reduce bank loans and payables. Actual capital employed increased by 3%, and the sales volume it supported increased by 15%
Net Profit	$26,032	$41,104	57.9%	Net profit improved by $15,072 – a 58% increase.
Return on Capital	13.4%	20.4%	52.2%	

Monitoring Profitability Variables

Businesses can measure their performance in relation to the four profit-determining factors ...



… through the use of Key Performance Indicators (KPIs). By setting up and reporting on a KPI system, you can monitor how well various areas of the overall business are performing, such as:

- Operational performance
- Financial performance
- Product/service quality
- Customer satisfaction
- Employee satisfaction

The resulting high-level perspective on the factors that drive your profitability can help you to:

- Identify adjustments that could potentially boost profits.
- Pinpoint existing or emerging issues, as well as negative trends, before they become a problem.
- Align long-term goals with short-term performance.
- And more.

KPIs are measures of business performance. They are used to check performance against targets, or as benchmarks to signal areas of performance in need of improvement. They are, therefore, measures of a firm's critical success factors. In any enterprise there may be dozens of critical success factors and literally hundreds of KPIs to track their performance. Which ones are significant for any particular firm at any particular time depends on its current situation and what the business is planning to achieve. A table of the most frequently used KPIs follows on the next page.

Most Frequently Used KPIs

Number/Amount
$ Dollar Figure
⌛ Time
% Percentage

BUSINESS AREA	CRITICAL SUCCESS FACTOR	KPIs
Products & Services	Employee productivity	• Output per employees (#, $)
	Inventory control	• Inventory turnover ratio (%)
	Production efficiency	• Manufacturing lead time (6)
	Service quality management	• Cost for administrative error/management revenues ($) • On-time delivery (%)
Marketing & Sales	Customer activity	• Number of customers (#)
	Customer satisfaction	• Satisfied customers index (#)
	Market penetration	• Time spent on customer relations (6)
	Sales operations	• Direct contact with customers per period (#, 6) • Sales closed/sales contracts (%)
	Sales volume	• Annual sales per customer ($)
People & Culture	Employee satisfaction	• Absentee rate (6) • Leadership index (#) • Satisfied employee index (#) • Turnover of full-time employees (#)
	Training and development	• Training time per employee (6) • Training investment per year (total $) • Training investment per customer ($)
Systems & Processes	Information technology	• Investment in IT ($)
	Occupational health and safety	• Days lost to injury (6)
	Sales and credit system	• Average collection function per customer ($)
Finance	Administrative service costs	• Administrative costs ($)
	Cash management	• Cash flow
	Income	• Gross margin ($) • Profits per employee (%) • Profits to total assets (%)
	Revenue	• Revenues per employee ($) • Revenues to total assets (%) • Revenues resulting from new business operations
	Yields	• Return on investment

Monitoring your profit variables is an important first step toward making decisions that can boost your profitability. Doeren Mayhew can help you apply this concept within your business.

Sources:

RAN ONE

DoerenMayhew
CPAs AND ADVISORS

Florida • Michigan • North Carolina • Texas
doeren.com