Guide: Your profit improvement potential

It is simple to improve the profitability of a business but there is a catch. What to do is the easy part; being willing to do it is the stumbling block.

Successful people have the courage to change their way of doing business. A refusal to try something different can limit your chances of success. Have you ever said “That sounds okay in theory but it won’t work in my business?”

There are no special tricks to make a business more profitable. People who make a living helping people in business can’t pull rabbits out of hats. But if what you’re doing isn’t working, do something different.

In every industry, irrespective of the state of the economy, there are some businesses that consistently out-perform others, not by small amounts but by staggering amounts. This is called the margin of excellence. They have got it right and the others have got it wrong. It’s as simple as that.

Close enough is NEVER good enough. Improved business performance comes from a willingness to do something different and then to get the detail right.

Let’s look at some areas with potential to improve your business profitability.

Estimate your potential

It’s quite amazing what effect relatively small changes can make to your bottom line with modest changes in key variables that make up sales, fixed costs, and margins. This example shows how you can quantify the profit improvement potential of your business. After you’ve had a look at the example think about what the result could be for your business.

Example	Now		Change factor	Plan
No of customers	1,000	x	1.05[1]	1,050
Frequency of purchase	10	x	1.05[1]	10.5
No of sales transactions	10,000			11,025
Average value/sale	$62.50	x	1.05[1]	$65.60
Total sales	$625,000	x		$723,240
Gross margin %	40%	x	1.05[2]	42%
Gross margin $	$250,000			$303,760
Less fixed costs	$220,000	x	1.10[3]	$242,000
Net front	$30,000			$61,760

There are several assumptions made for the purpose of the example. Change factor notes:

1. These variables improve by 5% therefore the change factor is 1.05. A 20% increase would require a factor of 1.20, etc.
2. Gross Margin improves by 5% through higher prices and/or lower variable costs therefore the change factor is 1.05.
3. Fixed costs go up by 10% therefore the change factor is 1.10.

Result

Net profit increased to $61,760 — more than double the present profit.

Unless you are already the leader in your industry there will be scope to improve your business profitability. It is not always easy but it’s certainly not impossible.

For more detail, let’s look at a case study. In the following, the result in the first year was a satisfactory 58% increase in profitability. The business itself increased in value by more than $75,000.

Today the business is generating well over $100,000 in net profit. It's a bigger business today than it was, but it is also much more profitable in terms of return on capital employed and in absolute dollars earned for the owner.

Factor	**Before**	**After**	**% Change**	**Note**
Sales	$242,750	$279,462	15.1%	1
Gross profit margin	36%	39%	8.3%	2
Fixed overheads	$61,358	$67,886	10.6%	3
Capital employed	$194,885	$201,179	3.2%	4
Net profit	$26,032	$41,104	57.9%	5
Return on capital employed	13.4%	20.4%	52.2%	

Analysis

Increased sales volume and prices	$14,317
Improved gross profit margin	$7,283
	$21,600
Less – increased overheads	$6,528
Increase in profit	$15,072

1. Sales

Strategies:

- More effective advertising — budget was established, market was segmented and targeted, analysis of advertising effectiveness was undertaken and ads that pulled more were developed.
- Attention to team training to improve product knowledge, selling skills and customer courtesy.
- Performance standards and targets were established and closely monitored.

Result:

15.1% increase in dollar value of sales, some of which was due to selective price increases on key products.

2. Gross profit margin

Strategies:

- Detailed analysis of the major profit contributors was undertaken looking at both the product lines and customer segments.
- Products which were not achieving required margins and/or which do not fit the business were dropped.
- Staff were acquainted with the major profit contributors.
- More selective purchasing was put in place and greater attention to quantity discounts.
- Selective price increases improved margins and enabled better service to be delivered at the point of sale.
- Advertising and selling were orientated to higher profit lines and targeted to properly qualified customers.

Result:

8.3% improvement in gross margin.

3. Fixed overheads

Strategies:

- All costs were analysed as a percentage of sales over last three years using available information — the major cost areas were identified.
- Each area of cost was examined on a cost/benefit basis to determine whether the same result could be achieved at a lower cost from an alternative source or whether it was appropriate to increase costs to deliver more customer-orientated service value.
- Detailed cost budgets were prepared on a cash flow basis.
- Actual costs were monitored against budget monthly and detailed reviews undertaken quarterly.

Result:

Fixed costs increased by 10.6% which was in line with normal inflation at the time — basically, in real terms fixed costs remained constant even though sales increased by about 5% in real terms and 15% in nominal terms.

4. Capital employed

Strategies:

- Post-sale credit control was put in place. Customers who failed to pay within the prescribed term were politely brought into line. Some customers left but returns improved overall.
- As part of the gross margin analysis (see (2)) stock lines that were not achieving turnover targets were rationalised and some duplicate lines were dropped.
- Tighter control over stock and, in particular, stock purchasing, looking at the lead time for orders to be filled.
- Old slow-moving stock was disposed of quickly. This released valuable space and increased cash flow.

Result:

Stock levels and debtors were reduced relative to the increase in sales. This released cash that was then used to reduce overdraft finance and creditors. Although actual capital employed increased by 3% the volume of sales it supported increased by 15%. In other words, a 3% increase in resources supported a 15% increase in sales volume.

5. Net profit

The final result:

Improved by $15,072 — a 58% increase over the previous year.

This example illustrates how small marginal changes, though modest in themselves, can make a huge difference. Profit turnarounds this size cannot be achieved year-in-year-out, but every business has room for improvement. The choice is up to the owner/manager.

It is worth noting that on the basis of a capitalisation rate of 20% the improvement in this business' profit increased the value of its goodwill as a going concern by $75,360 — not bad for a year's work and certainly worth the management consultancy fees that were charged.

But the advice and assistance given would have been useless unless the client has been prepared to make a total commitment to the task. In the final analysis, it's up to you!

Plan: marketing, operations, management control

You need a plan of attack. Specifically, you need to find out exactly what your existing and potential customers want (it's not always the lowest price) — this is the basis of your marketing plan.

You need to organise your business so that you can delight your customers — this is the basis of your operations plan. It requires equipping your team members with the resources and skills they need to excel in what they do — you must systematise your business.

And finally, you need a management control plan in place to make sure everything's working the way you designed it to work. This focuses on the things you must get right to succeed. These are your "Critical Success Factors" and we measure how your business is performing in relation to them with the use of Key Performance Indicators (KPIs).

The reason most businesses don't work is that the people who are supposed to be managing them are too busy working ***in*** them rather than working ***on*** them as Michael Gerber, author of the excellent book "The E-Myth" said. That is, they're doing the technical work. They're working with their hands rather than their head. There's a limit to what the hands can do but no limit to what the head can do.

We can help you to improve your profitability. If you're interested to explore this, begin with the table below. How many of these metrics do you monitor now? Contact us if you want to take it further.

Your profit improvement potential

The Components of Profit		**Your Present**		**Change Factor**			**Your Possible**
Number of customers you start with							
							-
Less attrition rate	%					%	
							+
Add new customers attracted	%					%	
							=
Equals your net customer base							
							X
Multiplied by their purchase frequency					=		
							=
Equals the number of sales transactions							
							X
Multiplied by the average value of a sale		$					$
							=
Equals total sales revenue		$					$
							X
Multiplied by Gross Margin%		%	X		=		$
							=
Equals total Gross Margin		$					$
							-
Less Overheads		$	X		=		$
							=
Equals Net Profit		$					$

		=
Your Net Improvement Potential		**$**

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