



BrentnallsWA

Chartered Accountants
and Advisors

What you can do to improve the profitability of your business...

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Considered Value

Profit is what's left over after you've paid all your expenses. The important thing to note is that profit is "what's left over". In other words profit is a residual. It is the consequence of what happens in and to your business. Some of these things are within your control and some of these things are outside of your control. If you're going to have any effect on your profit you have to focus on those things of which you have control ... so what are they?

What is profit?

To answer this question it is helpful to understand that there are only four specific factors that determine your profit.

These are:

1. The **price** you charge for the products and/or services you sell.
2. The **quantity** (or volume) of products and/or services you sell.
3. The costs you incur directly in producing or buying the products and services you sell. We call these **variable costs** because they increase or decrease as your sales Increase or Decrease.
4. Those costs you incur whether you make any sales or not. These are best described as **fixed costs** because they do not change with changes in sales volume at least not on a day to day basis.

Let's put these four things together and for simplicity we'll assume you have only a single product but the conclusions we come to will apply whether you have 1 or 1,000 products.

Suppose 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 a variable cost. So if you sell 100 widgets your total variable costs will be \$6,000 whereas 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 then you have 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 then your total gross margin is \$4,000 and if your fixed costs for such things as rent, leases, wages, insurance etc amount to \$3,000 then you end up with a "net profit" of \$1,000. On the other hand, if your fixed costs are more than \$4,000 then you'll incur a loss.

If you're looking for ways to increase your profitability then you have to focus your attention on the four profit determining factors: price, volume, variable costs and fixed costs.

Let's look at each of these four factors under three headings -what factor, what possible action you could take and what conditions would have to occur. It is important to note that profitability can be increased by either taking action to increase or decrease any of the four factors, as long as the required conditions are met.

How to increase Profit

Factor	Possible Action	Required Conditions
Price	Increase	Either no change in sales volume or if sales volume declines, the decline is more than offset by the increase in price so that the total revenue is still increased.
	Decrease	Sales volume increases sufficiently to compensate for the decline in price and/or new customers are won who will be retained in the future as and when price is increased to normal.
Variable Costs	Decrease	No change in product or service quality that could have a consequential effect on sales.
	Increase	Improvement in product or service quality allows a higher price to be charged which is both accepted by the market and which is sufficient to offset the higher variable cost.
Sales Volume	Increase	Price remains constant so the increase in volume translates into higher gross profit.
	Decrease	A saving in fixed costs is achieved by reducing size of the business and the saving is greater than the reduction in gross profit.
Fixed Costs	Decrease	Sales remain unchanged or if they decline the fall in gross profit is less than the decline in fixed costs.
	Increase	Sales increase through better service delivery by an amount which is sufficient to compensate for the increase in fixed costs

The interesting thing to notice about the above summary is that no single factor can be considered in isolation without considering its impact on, or the impact from each of the other three factors.

The second thing to remember is that a profit improvement strategy may involve either an increase or decrease in each of the four factors. There is no standard success formula. It depends entirely on specific circumstances and the relative strengths and weaknesses of your business.

The third thing to notice is that a favourable change in price and/or your fixed costs indicates greater productivity. That is the overheads you incur in running a business are lower per dollar of sales.

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

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

and/or

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

So we can put everything into some sort of perspective let's consider the profit improvement potential that would arise from a modest improvement in each of the four factors. We'll use the previous example as a base and assume a 5% improvement in each of the four factors:

	Base	Change	Result
Price	100	5% Increase	105
Sales Volume	<u>100</u>	5% Increase	<u>105</u>
Total Revenue	10,000		11,025
Variable Costs	<u>6,000</u>	5% Decrease	<u>5,700</u>
Gross Margin	4,000		5,325
Fixed Costs	<u>3,000</u>	5% Decrease	<u>2,850</u>
Net Profit	\$ <u>1,000</u>		\$ <u>2,475</u>

It can be seen that a 5% favourable change in each of the four factors without a consequential unfavourable impact on each of the other three would be more than double your profit from \$1,000 to \$2,475. This is a 148% improvement.

You may want to take issue with the assumption that there are no consequential impacts. However, it is 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 and let your variable costs get away from you then you can destroy a potentially profitable business. This can happen very quickly.

You see it's all to do with **leverage** and this is what brings so many people unstuck. If you get all the little things right, the big picture looks after itself. But if you get all the little things wrong you're going to be in real trouble and its likely you'll never know why.

You'll recall that we said earlier 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.

Developing a profit improvement strategy

Improving your 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 to buy at a lower price, or increase efficiency.

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 doubt, the biggest single barrier preventing small business managers from making an acceptable profit is their refusal to charge a price that will enable them to achieve this. **You are not in business to match the price your competitors set, you are there to service your customers.**

In fact, studies of the factors people regard as important influences on their decision to deal with a particular business indicate that product and price are relevant in only 15% of cases but we'll say more about that in the discussion on sales productivity.

Trying to hold or win market share on the basis of price discounting is the lazy manager's competitive strategy. It is relevant and applicable in only one situation and that is where you have a definite cost advantage (either variable or fixed) over your competitors and your product or service is one where customers are very price sensitive.

The following table indicates the increase in sales that are required to compensate for a price discounting policy. For example, if your gross margin is 30% and you reduce price by 10% you need sales volume to increase by 50% to maintain your profit. Rarely has such a strategy worked in the past and it's unlikely it will work in the future.

If your present margin is

20% 25% 30% 35% 40% 45% 50% 55% 60%

And you reduce your price by:

To produce the same profit your 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, if you adopt a premium pricing strategy the following table shows the amount by which your sales would have to decline following a price increase before your gross profit is reduced below its present level. For example, at a 40% margin 10% increase in a price could sustain a 20% reduction in sales volume.

		If your present margin is								
		20%	25%	30%	35%	40%	45%	50%	55%	60%
And you increase your price by:	To produce the same profit your sales volume could decline 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%

If you're like those many small business people who regard price as the only factor influencing the buying decision of their customers you will undoubtedly reject the proposition that a high price strategy (and by implication, high value) will work. You may accept that perhaps it's right for some businesses but it sure doesn't apply to your business. There is no business that does not have the potential to command a premium price for its products or 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 effort, all of your advertising 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 make price the critical factor, it will become the critical factor.

The only way to get out of the price trap is to promote other features and benefits that you can offer to your customers. For example, better quality, longer warranty, satisfaction guarantee, 24 hours accessibility, more convenient location, greater resale value etc, etc. It might be that your competitors offer all of these things but unless they also emphasise this in their marketing, how will the customer ever know. Think about this for a moment. Your job as a marketer is to create the **perception of value** and then to back up what you sell with superb service. The thing to remember is that 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 for those people who are happy to pay for value. This means two things. First you have to deliver value (embody service) and secondly, you have to educate your customers to be aware that they are receiving value. One without the other will leave you exposed.

A man named John Ruskin once said ...

"It's unwise to pay too much, but it's worse to pay too little. When you pay too much you lose a little money, that's all. When you pay too little you sometimes lose everything, because the thing you bought was incapable of doing the thing it was bought to do. The common law of business balance prohibits paying a little and getting a lot - it can't be done. If you deal with the lowest bidder, it is well to add something for the risk you run and if you do that you will have enough to pay for something better."

Improving productivity

This is all about getting 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.

Let's start by looking at your fixed costs. These 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 a sense that you can take a decision to reduce them simply by cutting back. Others, however, are committed and you can't avoid them.

The critical thing with each fixed cost is to ask yourself the following questions: What service does this cost provide for my business? Can I obtain the same service from another source at a lower cost? If so, is it practically feasible to switch to another supplier of that service? If I did switch to another supplier would I get equivalent equality and would this effect the quality of my product or service? If I were to spend more on this service would it generate a gross profit that exceeds the additional cost?

You'll notice that all of these questions are directed towards 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 people will often think of dismissing staff. This may be an appropriate course of action but it should be considered carefully. More often than not, the appropriate strategy is to invest more in staff training to show them how to improve customer service and how to sell more to your customers.

What about advertising? There is a standing joke in the industry that 50% of your advertising is wasted. The problem is to identify which 50%. In fact the 50% is being generous. It's probably closer to 100% that's wasted - at least you know which 100 % it is - yours! This of course is not to say that some advertising is not extremely valuable.

In a Business Review Weekly article a manager of a major supermarket chain said that..... *91% of readers took very little notice of price and item ads - only 9% looked at them for shopping purposes.* If that's a fact, why do the major supermarkets still persist with this type of advertising? Because the product suppliers pay for the ads and the supermarket gets to (1) promote it's name and (2) create consumer perception that it's a price competitive retailer.

The only organisation to benefit whether your advertising works or not is the media company you use. They're always ready to invite you to participate in special deals and supplements and they're pleased to give advice on how to structure your ads "to get results". But ask them to do a deal where you pay an amount per enquiry and you'll be met with stony silence. How many times have you been contacted by a newspaper or radio rep and asked how your ad worked?

This does not deny the value of advertising. On the contrary, it is one of the best ways to explode your sales. What is folly is spending on advertising that does not work. You can

learn how to create advertising that does work and you can test the results. When we talk about productivity, therefore, we're talking about how to get the most out of your advertising dollar. This is unquestionably one of the most major untapped areas of potential profit growth.

Effective advertising is clearly one way to create new customers. This is a specialised area in itself but there are four absolutely critical things to get right:

1. Target your customers - never try too appealing to everyone. Focus specifically on those people who you know will benefit from your product/services. How you word your headline will be the major factor in accurately targeting your offer.
2. Make your offer compelling and relevant to the market you target. Don't be cute or clever. Say it exactly as it is.
3. Graphics and layout will make your ad readable and noticeable. Don't try to make your ad look like an ad. Make it look like something worth reading.
4. Write your **copy** in terms that your readers can clearly understand. It must be specific and believable. Remember that if you have a clearly defined target market and your offer is compelling and well stated your copy can be poor and you will still get a good response. That is, good copy writing will not sell a poor concept/offer.

Leading small business advertising specialists have used split-run tests to evaluate the relative performance of each of these things. They concluded:

great copy	will give	50% response increase
good graphics	will give	150% response increase
good offer	will give	300% response increase
accurate target	will give	1,000% response increase

In other words, a specific focused target (i.e. people in the market who are predisposed to buy) will be 20 times more powerful than how you express your message. If you know exactly who will be interested in what you've got to offer and you make an offer that is compelling you will find that you don't have to be a brilliant copy writer to get a cost effective response from your ads.

The only sure way to get customers to come back and indeed, to act as advocates for your business, is to give them absolutely superb service. They need to feel that you really care for them and that your goal in business is to delight them with the way you look after them. All of us probably fall short of this ideal but it is an objective well worth striving for.

Almost 70%, or seven out of ten customers cease to patronise a business because of *Perceived Indifference*. When you yourself deal with various businesses aren't you inclined to want to again deal with those who take the trouble to show they care for you. Do you 'shop around' when you're already delighted with the service you get?

It is sobering to note that most businesses spend 6 times more trying to attract more customers than they do looking after the ones they have already got. They have to do this because their existing customers keep falling off the back and new customers are needed to replace the old ones. It's a merry-go-round (perhaps sad-go-round would be more accurate.)

One study on client satisfaction reported, that just a 5% increase in customer retention will produce a 25% to 100% improvement in profit. In other words, it pays to look after your customers.

Let's put some numbers on this. Suppose you have 1,000 customers who spend an average of \$250 per year with you. Suppose you have a customer loss rate of just 10% each year and that a customer who stays with you would deal with you for an average of 10 years. Forgetting about inflation, each customer has a lifetime value to you of \$2,500 and 10% attrition is costing you \$250,000 in potential future revenue each year.

Another thing that is overlooked by most businesses is the simple act of asking the customer to buy. It's no accident that MacDonald's is one of the largest and most profitable businesses in the world. The reason for this cannot be found by looking at the uniqueness of their product. It's the fact that they leave nothing to chance. Everything is done according to plan including the question "... *and will you be having fries and a drink with your meal today?*" About 30% of the time people say yes even though it may not have been in their mind - effect. 30% increase of sales in fries or drinks and over 100% increase in profit contribution from those lines.

And a client in the restaurant business used to ask guests at the end of the main course (without really thinking) "Would you like anything else?" - Frequent answer, "No, just some coffee thanks." He changed this to "... Now can I offer you a beautiful platter of cheeses or would you prefer to make a selection from our new dessert menu, they are absolutely delightful"- result, he instantly tripled dessert and cheese platter sales and still got to make the coffee sale. It's all in what you say and how you say it.

Word of mouth referral is the best means of creating new customers. But satisfied customers do not become advocates for your business - Delighted customers do!

Most people don't fully appreciate the powerful dynamics of customer retention and frequency of contact. This is reflected in the table below. It shows the effect on total sales revenue of a relatively small improvement in the critical variables: customer attrition rate, new customer attraction rate, frequency of customer purchasing and the average value of each sale.

The Components of Sales	Present Position	Possible Position
Number of Customers	1,000	1,000
Less Attrition	10% <u>100</u>	5% <u>50</u>
	900	950
Add New Customers	10% <u>100</u>	12% <u>1,120</u>
Total Customers	1,000	1,070
Sales Frequency (times pa)	<u>10</u>	+10% <u>11</u>
No of Transactions	10,000	11,770
Average Sale (\$)	<u>\$25</u>	+10% <u>\$27.50</u>
Total Revenue	\$250,000	\$323,675

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

In every case, business success stories have been associated with people who have had the courage of changing their way of doing business. In the case of the failures it has been a refusal to try something different. Have you ever said that "*That sounds okay in theory but it won't work in my business?*"

There are no special tricks to make a business more profitable. Those of us who make a living helping people in business can't pull rabbits out of hats. However, there is one overriding consideration that must be accepted:

If what you're doing now isn't working then you must do something different.

In every industry and irrespective of the state of the economy there are some businesses that consistently out-perform others in their industry, 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 getting the detail right. If you get all the little things right...the big picture looks after itself.

The following example is an actual case in point. 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 net profit. It's a bigger business today than it was but it is also much more profitable in terms of Returned on Capital Employed and in absolute dollars earned for the owner.

CASE STUDY

	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 of profit improvement

Increased sales volume and prices	14,317
Improved gross profit margin	<u>7,283</u>
	21,600
Less - Increased overheads	<u>6,528</u>
Increase in Profit	<u>\$15,072</u>

NOTES:

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 with respect of both 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 having regard to both the profit lines and customer segments;
- Products which were not achieving required margins and/or which did 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 was 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 3 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 5% in real terms and 15% in nominal terms.

4. Capital Employed

Strategies:

- A 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, that was an added bonus;
- As part of 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 having regard to 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. Relationships with bank and creditors improved significantly. 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 graphically how small marginal changes, although modest in themselves, can together result in a huge difference. Profit turnarounds of this magnitude cannot be achieved year-in - year-out but every business has room for improvement. The choice is up to the owner/manager.

It is worthy to note that on the basis of a capitalisation rate of 20%, the improvement in the profit of this business, increased the value of it's good will as a

going concern by \$75,360 - not bad for a years work and certainly worth the management consultancy fees that were charged. But there is a rider.

The advice and assistance that was given would have been absolutely useless unless the client had been prepared to make a total commitment to the task.

In the final analysis, it's up to you!

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

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 will form the basis of your marketing plan.

Then you need to organise your business so that you can delight your customers - this forms the basis of your operations plan. This will require giving attention to your team members and equipping them 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 is working the way you designed it to work. This will focus on the things you must get right to succeed. We call these things your Critical Success Factors and we measure how your business is performing in relation to them with the use of Key Performance Indicators.

The reason most businesses don't work is that most people who are supposed to be managing them are too busy working in them 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 believe that as your consulting accountant our job is to help you re-engineer your business so that it runs like a well oiled machine and once that's achieved, to help you keep it there.