The Four Profit Elements and
How They Drive Your Bottom-Line

Most business people will tell you that there are only two ways to improve a company's financial performance; increase sales and reduce expenses.

While technically correct, those two answers fail to tell the whole story. The problem with them is that they're superficial and incomplete Any company that takes them at face value risks paying a steep price in the form of lost profit. Unfortunately, most business people consider them to be the foundation of conventional business wisdom; standard operating procedure for running a business. Blindly following them harms those who do.

Telling someone who's trying to build a business that the keys to success are to increase sales or cut costs is simply bad advice. They're the equivalent of telling someone just learning to drive that all you do is step on the gas when you want to go forward and step on the brake when you want to stop.

What they're not told is that when stepping on the gas pedal it should be pushed smoothly downward, not immediately jammed all the way to the floor. They're also not told that when it comes time to stop that it's usually best to step on the brake smoothly except, of course, in the case of an emergency. What are also not being shared are the rules of the road; such as paying attention to nearby cars, the surroundings, how to interact with pedestrians, other motorists, and bicycle riders.

Randomly chasing after sales and cutting costs are simplistic approaches to increasing profit and are loaded with danger. They only skim the surface of the subject. Blindly following either of these methods can, and often does cause harm. As a business executive, you know that working to increase profitability often ends up in frustration and with little, if any, additional profit.

This paper explains why the traditional methods used by most businesses to add to their bottom lines often fail and leave the company in a worse situation than it was in before starting the profit increase program. In their place it offers strategies that have proven to bring success to quests for more profit.

The Four Profit Elements
Every business, regardless of industry or size, has four distinct financial measures, called profit elements. Each of them must be understood and managed properly for a business to achieve maximum financial success. They are the tools you have to work with when attempting to increase the profitability of your company.

The four profit elements are:

- Fixed costs – costs a business incurs that remain the same in total, regardless of sales volume or sales revenue. Typical examples include rent and administrative payroll.

- Variable costs – costs that remain the same per unit regardless of sales volume but increase in total as sales levels increase and decrease as sales levels decrease. Typical examples include cost of goods sold and sales commissions.

- Sales volume – the number of items sold or the amount of services performed (typically measured in hours).

- Price – the amount charged for the products or services sold.

Note that sales revenue is not a profit element. It's the product of sales volume multiplied by unit price.

To implement an effective profit building program, it's necessary that each of the four profit elements be accurately determined and shared with management for use when making decisions.

Two of the elements, sales volume and price are relatively easy to calculate. Accurately determining fixed and variable costs is more difficult. This is because the income statements prepared by accounting have been compiled in accordance with generally accepted accounting principles (GAAP) which merges fixed and variable costs together. GAAP formatted statements carve out cost of goods sold from total expenses and label the remainder operating expenses.

The only way to accurately determine your company's fixed and variable costs is to segregate operating expenses into two groups; variable and fixed.

The easiest way to do this is to reformat you company's GAAP formatted income statement into a contribution margin statement. *Contribution margin* is the difference between a company's sales revenue and ALL of its variable costs, not just cost of goods sold. Typical examples of variable non-cost of goods sold include sales commissions, many delivery expenses, and credit card fees. Fixed costs aren't considered at all in the calculation of contribution margin.

Many business owners and managers think that the gross margin shown on their income statements represents the amount of excess revenue available to cover fixed costs and leave a profit; almost universally assuming that all of their company's operating expenses are fixed.

They often fail to realize that there are variable expenses included in their operating expenses that will increase or decrease as sales levels change and that they too must be factored into the profit equation. The result of this error is that they tend to charge too little for their goods and services.

Your company's contribution margin is the most accurate measurement of how much margin is being generated to cover its fixed costs and leave a profit.

Gross Margin vs. Contribution Margin

	Gross Margin	Contribution Margin
Sales Revenue	$10.00	$10.00
Less: Cost of Goods Sold		
Product Cost	6.00	6.00
Freight	1.00	1.00
	7.00	7.00
Gross Margin	$3.00	$3.00
Less: Variable Operating Expenses		
Sales Commissions		.80
Credit Card Fees		.30
Package Cost		.05
		1.15
Contribution Margin		$1.85

As the calculation above shows, thinking there's $3.00 per unit available to cover fixed costs (overhead) and leave a profit is in error. The correct amount available to cover them is only $1.85. Basing pricing and discount decisions on gross margin can be very damaging.

Knowing your company's contribution margin is one of the most important pieces of information you can have when making decisions and managing your business. Unfortunately, few executives have this information available so they remain in the dark when it comes to knowing how their business is performing.

How do the profit elements affect my company's bottom line?

Two studies, one by Harvard Business School, and another by McKinsey Consulting were conducted to determine how much a change in each one of the four profit elements affects a company's profitability. They found that the effect of a 1% improvement in each of the four elements produced the following changes in net income.

	Harvard Study Net Income Increase	McKinsey Study Net Income Increase
Fixed costs down 1%	3%	2.3%
Sales volume (units) up 1%	4%	3.3%
Variable costs down 1%	7%	7.8%
Price up 1%	12%	11.0%

Traditional profit improvement efforts often backfire because companies focus on the wrong elements.

Fixed costs

Working to reduce fixed costs rarely brings significant improvement to a company's bottom line. The above two studies shed some light on why these attempts often fail.

First, fixed costs are typically a small % of a company's costs, typically 20% - 25%, and therefore cuts do not bring much return in terms of absolute dollars. Second, the focus on keeping costs down is a fairly strong mantra for most businesses so few excess costs remain to be cut. The push to continue trying to cut them often leads to dangerous excesses.

Excess fixed cost cutting reduces a company's ability to react to threats and opportunities. In these cases, not only are excess costs cut but muscle and bone needed to support operations are also removed.

Sales volume

Programs to increase sales volume also frequently fail to deliver the desired result. Many sales programs rely on offering incentive programs or adding additional sales personnel; both of which cost money. All of the added promotional costs must be completely covered by new sales before an additional penny of new profit is realized from the program.

For example, an increase in revenue of $333,333 is required to cover the costs of adding an additional $60,000 per year sales person, assuming a contribution margin of 30%.

Calculation of sales volume required to cover a salesperson's cost

Annual Salary	$60,000
Payroll Benefits	15,000
Vehicle	9,000
Phone & Computer	4,000
Entertainment Allowance	6,000
Sales Collateral	4,500
Miscellaneous	1,500
	$100,000

($100,000 ÷ 30% = $333,333)

In addition to the direct annual salesperson's costs, the expense of training and the time it takes for a new salesperson to become fully productive also reduce profitability.

Other sales building programs offer discounts or special programs to attract new business. The additional sales required just to cover the profit lost from the discount frequently dooms the program to failure as the lost profit is never fully recaptured.

The illustration below is an example of the profitability (or lack thereof) of a typical "Buy 2 Get 1 FREE promotion."

Analysis of the Profitability of a Typical Sales Promotion:

	Full Price	**Buy 2 Get1**
Sales @ $10.00 per unit	$ 20.00	$ 20.00
Cost of goods sold @ $6.00 per unit	12.00	12.00
Cost of free item @ $6.00 per unit	---	6.00
Gross margin	8.00	2.00
Other variable costs:		
Credit card cost (3%)	.60	.60
Sales commission (8%)	1.60	1.60
	2.20	2.20
Contribution margin	$ 5.80	$ -.20

It's very important that the contribution margin that will be earned from a sales promotion be calculated *before* going forward with it. In the above example, the company lost 20¢ on each promotional sale that was made. The company actually paid its customers to buy this promotion.

Far too often, business executives and sales managers only look at the added sales volume when implementing a promotion instead of analyzing its overall cost structure. Sales that bring in less revenue than was actually spent to acquire them simply don't make sense.

Sometimes these discount programs are focused on acquiring new customers. Even if successful at acquiring more customers, there is often a more subtle, but nevertheless real, side effect of offering discounts, especially discount coupons. Current customers who are paying full price feel offended when they discover that a new customer is getting a discount that hasn't been offered to them. If the promotion is offered to all, studies find that most existing customers use the discount to buy what they were already going to buy at full price anyway.

One of the biggest problems encountered when chasing new sales is that the customers garnered from the program tend to be problematic, either being expensive to serve because they're out of your trading area, or because they demand special treatment and discounts in order to transfer their business to you. This behavior usually renders them unprofitable. These same customers also tend to be disloyal, switching their business to a different supplier when offered a deeper discount.

Variable costs

Many businesses people make the dangerous mistake of cutting variable costs by reducing either the quality of the products they sell or by lowering service levels. They think that their customers either won't notice or won't mind the reductions. Their thinking is that their customers will live with the cuts, and therefore the company will benefit from the cost savings gained without a loss of business. Thinking this way is a big mistake.

According to several studies, the overwhelming majority of your company's profit comes from about 20 % of its customers. Other studies have shown that most customers will pay a 10% - 15% price premium for good quality and top service. The customers paying the price premium are doing so because they want the high level of quality and service they're currently receiving.

They're your company's most valuable customers, and when you cut quality and service, they're the ones who leave. You not only lose customers, you lose those that are most profitable while increasing your portfolio of those that are marginal at best.

While it may appear that a company can get away with cutting their variable costs for a short while, the benefits they gain rarely last more than a few months for at least two reasons. First, it takes some time before all of the company's customers discover the cuts. Second, many customers give the company a second chance, thinking that their disappointing previous experience was a one-off mistake. During this time, their volume remains steady, giving the false illusion that their cuts were accepted by their customers. Soon after, customers leave, and in the end cause the business to fail.

Cutting your company's variable costs can literally put it out of business.

Price

Setting and quoting prices is a confusing, frustrating, and often fear-filled task for many business executives. When the subject of raising prices is mentioned, they often envision sweeping, across the board price increases that cost them customers, lowers revenue, slows cash flow, and wipes out profit. These feelings tend to make businesses hesitant when it comes to raising prices. The end result is that prices either don't get increased at all, or not raised nearly as much as they could be.

Studies show that at least 90% of companies charge less than optimum for their goods and services. As a result, pricing errors are some of the most common and costly mistakes made.

Not only are pricing errors prevalent and expensive, they're also invisible. For example, assume that a customer pays $10 for an item they would have paid $12 for. The $2 between what was charged and what could have been charged is money left on the table; without the loss even being known by the seller. Because they don't realize that they could have charged more, they continue to make this error over and over again, costing the business thousands, and even millions of dollars year after year.

While cutting costs can seem easier because it's under your direct control (for the most part), that is not where the most leverage is when it comes to improving your profits.

As the Harvard and McKinsey studies described earlier in this paper show, a 1% increase in price is at least four times as valuable as a 1% decrease in fixed costs.

What's ironic is that while skillful pricing often seems to be difficult, in reality it's far and away the easiest and most lucrative way for a company to increase its revenue, profit margins, cash flow and net income. A recent study conducted by The Customer Manufacturing Group asked more than 500 middle market business executives whether or not they would change suppliers if their current suppliers raised prices by 3%. Less than 1% of the people surveyed said they would change.

Where are you going to spend your time when working to improve your company's profitability?

More Information

If you'd like more information about how to apply a process to improve your marketing/sales function, simply contact us, and we'll be happy to help you get started. From sweeping marketing/sales management process strategies to specific branding or product launch services, Fat Margins can help.

If you'd like to learn more about Fat Margins, give us a call at (925) 579-2166, visit our website at www.fatmargins.com, or e-mail us at info@fatmargins.com.