There's more to profits than sales

BY TERRY SOIFER

Business owners often come to me with the situation that their sales have increased, but profits have remained the same or decreased. They don't understand why this occurs. Their attempt to increase profits is based solely on increasing sales. The business owner needs to understand there are two components to the profit equation: sales and cost. The fastest way to increase profits is to work on both components at the same time, rather than just one.

The XYZ Corp. is losing money; experiencing tight cash flow; and operating in a stagnant economy. Its income statement is as follows:

	ACTUAL	CASE I
Sales	$100,900	$146,600
Cost of goods	65,600	95,300
Gross profit	35,300	51,300
Operating expense	51,300	51,300
Pre-tax profit/(loss)	(16,000)	0

Case I demonstrates that in order for this company just to break even, sales have to increase by 45 percent, or $45,700, if only the sales component is addressed.

Instead of just addressing sales, look what happens when both sales and costs are considered.

	ACTUAL	CASE II
Sales	$100,900	$114,300
Cost of goods	65,600	74,300
Gross profit	35,300	40,000
Operating expense	51,300	40,000
Pre-tax profit/(loss)	(16,000)	0

By reducing operating expenses by $11,300, sales in Case II only have to increase by 13.3 percent or $13,400 in order for this company to break even. Every $1 reduction in operating costs equates to a $2.87 increase in sales. With a tight cash flow situation and stagnant economy, this is a more realistic and achievable goal compared to increasing sales by 45 percent.

How does a business owner deal with the cost component? Traditionally, owners view costs as either being fixed or variable and tend to typically deal with just the variable component, which is usually the larger of the two. This type of thinking prevents owners from finding ways to reduce a large portion of their costs which many owners refer to as overhead. The objective is not only to control costs, but to reduce them.

Just like owners receive competitive quotes for their major purchases, they need to apply the same philosophy to overhead. It is easy for owners to fall into the trap of paying more for overhead than is necessary because of comfortable relationships established with vendors over the years. It is the owner's job to improve the company's profitability, not the profitability of suppliers. To avoid this trap, owners should obtain competitive quotes for significant overhead items at least once a year.

Another way to reduce costs is to adhere to the established budget for new hires. Hiring someone for 25 cents per hour more than planned, not only costs the company $520 more per year in wages, but also increases the company's FICA taxes, workers' compensation premiums, and profit sharing and retirement costs. Hiring that person at a higher base salary also escalates costs in future years. For example, giving that individual a 5 percent raise in the second year of employment will increase costs by $540.80 over the original budget as well as increase FICA and other employee benefit costs.

Employers can use payroll systems as a management tool for controlling costs, not just as a means to pay employees. On a weekly or monthly basis, the payroll system can be used to monitor headcount and costs by department, by position, and by project. For example, the budget may dictate that one secretary is to be used for a project; yet the secretary is working an excessive amount of overtime at time and one-half salary. By utilizing the detail of a payroll system, owners will become aware of this situation and can take corrective action before costs are out of control.

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In today's market when workers' compensation costs are skyrocketing, owners also can use the payroll system to ensure that workers are properly classified and that premiums are not being paid for the half-time portion of overtime.

The fastest way to increase profits is by working on both sales and costs simultaneously. An important part of the cost component is the recognition that overhead costs must be reduced if owners are to improve their profit objective.

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