Business
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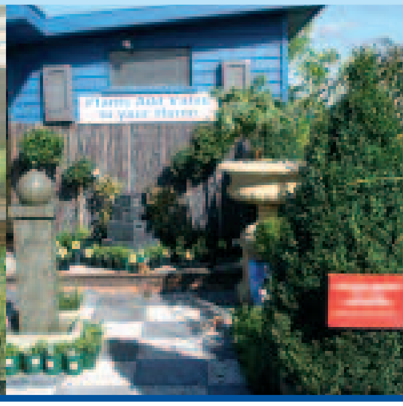

The level of financial management skill and ability in many Australian small businesses is known to be low. However, there are some simple tools that can significantly improve business profitability.

This *Nursery Paper* summarises "The business of profits" presentation delivered by Tim Atterton at the 2005 NGIA conference.

Key messages include:

- Understanding entrepreneurial characteristics
- Focusing on profit, not sales
- Recognising 'breakeven' as the most important performance indicator
- The importance of gross margin
- The loyalty of customers.

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Achieving a profitable business

Many small businesses in Australia fail to achieve their full potential. As a result, proprietors are not being fully rewarded for their efforts, profitability levels are low and working capital requirements and borrowings are often too high.

Information on businesses in Australia supplied by CPA Australia shows that:

- 40% never review financial management statements
- Approximately 50% of all small businesses do not regularly review debtors, chase up late payments or monitor their financial performance
- Many focus on sales growth rather than profit growth
- 35% "stretch" creditors to cover cash shortfalls
- 62% never run credit checks on customers
- 22% never chase up overdue accounts
- 20% of all small businesses use their accounting information only for compliance rather than internal management
- Only 21% believe that "internal management" is more important than "compliance"
- 30% of business related bankruptcies are due to financial management issues.

Traits of Entrepreneurs

In addition, some common character traits of entrepreneurs can inhibit business success. For example, entrepreneurs are usually:

- Optimistic – but generally don't read or write unless they have to
- Practical learners – in other words learn by doing – and making mistakes
- Very independent – but have a high focus on control
- Very strategically aware – but don't plan strategically.

As a result, entrepreneurs often find it difficult to analyse their own businesses and tend to treat symptoms rather than causes. This means they are constantly managing change and chaos and are always putting out bushfires.

Recording and obtaining financial information on your own business is vital for identifying business patterns and behaviour. Such information can be used to identify and obtain 'key performance indicators' and therefore enable comparison between years, enterprises and processes. As this information comes from your business, it is 100% relevant to you. In addition, it can highlight how much more important 'profit' is than 'sales'.

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Figure 1. The critical importance of gross margin

Profit and Loss Account
(Statement of Financial Perfromance)

SALES exclusive of GST
minus
COST of SALES
equals

GROSS PROFIT OR MARGIN

minus
EXPENSES
equals

NET PROFIT OR LOSS

Potential for ***Profit Improvement*** *is theoretically unlimited*

Potential for ***Profit Improvement*** *mathematically limited to zero*

Maximising Profit

When it comes to maximising profit, two key principles are important:

- Increase your earnings from every enterprise (gross margin)
- Reduce your required amount of working capital to avoid cash problems.

Gross margin is the revenue received by a particular enterprise minus the costs involved in its production/sale (such as labour and materials).

Every effort should be made to improve gross margins as this will directly improve profit. Gross margins can be improved by:

- Avoiding the temptation to reduce prices
- Not offering discounts
- Careful control of all variable costs
- Optimizing the sales mix – push high margin products or services and increase your share of existing customers' spend.

The critical importance of gross margin is obvious when you consider that the opportunity for maximising profit from improving gross margin is unlimited. Compare this to the fact that maximising profit from reducing expenses is limited (see figure 1).

The amount of capital required (money invested in machinery, equipment, infrastructure, premises, etc) to own/operate a business has a direct and inverse effect on the amount of cash available for the business. As a result, minimising the working capital required by a business can significantly alleviate cash problems.

In order to manage and maximise business profit, three pieces of information are vital:

- **Sales revenue,** exclusive of GST (remember that all tax is an impost and is absolutely irrelevant to management accounts)
- **Cost of production/sales (variable costs) –** these are the direct costs that fluctuate in relation to sales volume, such as mainly labour and materials

Figure 2.
Cutting prices: percentage that sales must increse to maintain total gross profit.

Current Gross Profit %

Price Cut	10%	20%	25%	30%	35%	40%	45%	50%
-2%	25%	11%	9%	7%	6%	5%	5%	4%
-3%	43%	18%	14%	11%	9%	8%	7%	6%
-4%	67%	25%	19%	15%	13%	11%	10%	9%
-5%	100%	33%	25%	20%	17%	14%	13%	11%
10%		100%	67%	50%	40%	33%	29%	25%
-15%		300%	150%	100%	75%	60%	50%	43%

Figure 3.
Cutting prices: percentage that sales must increse to maintain total gross profit.

Current Gross Profit %

Price Cut	10%	20%	25%	30%	35%	40%	45%	50%
-2%	25%	11%	9%	7%	6%	5%	5%	4%
-3%	43%	18%	14%	11%	9%	8%	7%	6%
-4%	67%	25%	19%	15%	13%	11%	10%	9%
5% -5%	100%	33%	25%	20%	17%	14%	13%	11%
10%		100%	67%	50%	40%	33%	29%	25%
-15%		300%	150%	100%	75%	60%	50%	43%

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- **Overhead expenses (fixed costs)** – these are costs that you incur whether you get out of bed or not.

The effect of cutting prices on gross profit is easily seen when you consider a 10% price cut requires a 33% increase in sales if a gross profit of 40% is to be maintained (see figure 2). Also, to maintain a gross profit of 10%, sales need to increase by 100% to cover just a 5% price cut (see figure 3).

Key performance indicator – breakeven

'Breakeven' is the most simple and important performance indicator. It identifies the amount of sales required to cover fixed and variable costs.

Reducing your breakeven is an effective way to improve business viability. This can be done by:

- Increasing prices
- Reducing the costs of production/ sales by improving efficiency through effective purchasing, optimising resources, minimising wastage and/or quality control
- Controlling (minimising) fixed costs.

Figure 4.
Breakeven: sales ready reckoner

Fixed Costs (weekly, monthly etc) / Gross Margin %	50%	45%	40%	35%	30%	25%	20%	15%
$5,000	10,000	11,100	12,500	14,300	16,700	20,000	25,000	33,300
$4,500	9,000	10,000	11,300	12,900	15,000	18,000	22,500	30,000
$4,000	8,000	8,900	10,000	11,400	13,300	16,000	20,000	26,700
$3,500	7,000	7,800	8,800	10,000	11,700	14,000	17,500	23,300
$3,000	6,000	6,700	7,500	8,600	10,000	12,000	15,000	20,000
$2,500	5,000	5,600	6,300	7,100	8,300	10,000	12,500	16,700
$2,000	4,000	4,400	$5,000	5,700	6,700	8,000	10,000	13,300
$1,500	3,000	3,300	3,800	4,300	5,000	6,000	7,500	10,000
$1,000	2,000	2,200	2,500	2,900	3,300	4,000	5,000	6,700

Determining your breakeven (the amount of sales required to cover all costs) for each enterprise is the most simple and important performance indicator. In this example, a gross margin of 40% and $2,000 in fixed costs requires $5,000 in sales.

The strategy of all businesses should be to reduce breakeven and keep it down, in both good times and bad. The lower the breakeven point of the business, the better the profitability and the stronger the balance sheet. A well managed business will maintain or even reduce the level of breakeven with a view to achieving maximum benefit from increased sales.

Sales can be improved by increasing the:

- Number of customers (of the type you want!)
- Frequency of transactions
- Average value of a sale
- Effectiveness of each process.

The effect on gross profit of putting prices up is easily seen when you consider a 5% price rise enables an 11% fall in sales while maintaining a gross profit of 40% (see figure 5). Also, to maintain a gross profit of 10%, a price rise of 5% means that sales can fall by 33% (see figure 6).

Figure 5.
Putting prices up: percentage that sales can fall before total gross profit reduces

Price Rise / Current Gross Profit %	10%	20%	25%	30%	35%	40%	45%	50%
+2%	17%	9%	7%	6%	5%	5%	4%	4%
+3%	23%	13%	11%	9%	8%	7%	6%	6%
+4%	29%	17%	14%	12%	10%	9%	8%	7%
5%	33%	20%	17%	14%	13%	11%	10%	9%
+10%	50%	33%	29%	25%	22%	20%	18%	17%
+15%	60%	43%	37%	33%	30%	27%	25%	23%

Figure 6.
Putting prices up: percentage that sales must increse to maintain total gross profit

Price Rise / Current Gross Profit %	10%	20%	25%	30%	35%	40%	45%	50%
+2%	17%	9%	7%	6%	5%	5%	4%	4%
+3%	23%	13%	11%	9%	8%	7%	6%	6%
+4%	29%	17%	14%	12%	10%	9%	8%	7%
5%	33%	20%	17%	14%	13%	11%	10%	9%
+10%	50%	33%	29%	25%	22%	20%	18%	17%
+15%	60%	43%	37%	33%	30%	27%	25%	23%

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Three types of businesses

Tim Atterton believes there are three different types businesses: The Lion, the Donkey or the Turkey.

The Lion type of business is growth focused, dynamic & innovative. The Lion seeks partnerships, new markets & value added products or services. Its owner is in control of the business, rather than the business in control of the owner. The Lion often emerges leaner and stronger from a period of economic difficulty.

The Donkey business is stubborn and resistant to change. While The Donkey business may appear to be relatively successful, the owners often work until they drop down dead!

Finally, **The Turkey** type of business lacks clear focus & direction. The Turkey is usually price driven with little interest in new ideas or the external environment. The Turkey type of business usually dies quickly during an economic slow-down.

"It is unwise to pay too much, but it's worse to pay too little. When you pay too much, you lose a little money – that is all. When you pay too little, you sometimes lose everything because the thing that 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.

John Ruskin, 1819–1900

Remember, cutting prices to attract customers means you actually have to sell a lot more product to simply break even.

How loyal are your customers?

Tim Atterton believes there are three different types of customers who have either monogamous, polygamous or promiscuous loyalty.

Monogamous loyal customers voluntarily stick with one brand or supplier and will forgive minor disappointments.

Polygamous loyal customers are only willing to buy from a subset of all available brands or suppliers.

Promiscuous loyal customers like to try new brands or suppliers and are easily attracted by price promotions.

As a result, the aim is to increase your percentage of monogamous and polygamous loyal customers, which can be achieved by ensuring:

- Ease in placing orders
- Informative and speedy response to enquiries
- A contact name is always provided
- Quotations are provided quickly
- Customer problems are resolved
- Staff are friendly and helpful
- Deliveries are reliable
- Regular on-going communication with customers
- Accurate invoicing
- Customers are delighted with an extraordinary response to their needs/desire.

A warning on cutting prices

Cutting prices has the effect of lowering gross margins and leads you down the busy fool path. It also encourages existing customers to trade down and attracts new, price sensitive customers who are not loyal and will defect quickly.

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