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Helping You to Develop Your Business with Free Hints and Tips...

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Boosting Profitability

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Boosting Profitability

⇨ Succeeding as a profit-driven manager

Overview

Boosting profitability is a constant leadership challenge and is a task by which most – if not all – business leaders are judged. Whatever the organisation and whatever its stage of development, ensuring profitability requires two things: a focus on the right priorities and an ability to influence attitudes and behaviour. Fostering an outlook among people, so they routinely understand the most significant business issues and are looking to increase profits, is the essence of entrepreneurship. In addition, every business will have its own issues affecting its profitability, and these will be influenced by:

- **The type of industry** – whether it is a service or manufacturing business.
- **The type of business** – the issues that a law firm may face will obviously differ from another service business such as an advertising agency.
- **The maturity of the business** and the stage in development that it has reached – whether it is a business start-up, a small or medium-size enterprise, a large business or a major multinational.
- **The views and attitudes of the business's stakeholders.**
- **The external environment** – notably whether there are conditions of economic prosperity or recession.

Techniques to boost profits can be applied at any stage of any organisation's development but the business thrives best when the need for profitability is constantly understood, guiding people's actions. This 'climate of profitability' really needs to be present from the outset; if not, then it will be harder (but not impossible) to instill later.

Benefits of boosting profitability

There are many reasons why profits matter, some of the most important are:

- Cash is more likely to be present in the business, ensuring its continued success.
- Finance is available for expansion and investment, increasing the long-term value of the business.
- Investors, customers and talented employees are more likely to be attracted and retained within a profitable business, as it is likely to be seen to have a future.

Action checklist: boosting profitability

Focus decision-making on the most profitable areas

Concentrating on products and services with the best margin will protect or enhance profitability. This might involve redirecting sales and advertising activities.

… and decide how to treat the least profitable products

The least profitable products often drift, with dwindling profitability. Decisive action is needed to turn around a poor performer, for example, reducing costs, raising prices, altering discounts or changing the product – or abandoning it altogether to prevent a drain on resources and reputation.

Ensure that new products enhance profitability

New product development often focuses on market need or production process without adequate regard to the issues affecting profitability such as cost, price, sales volume and overall profitability, which are inextricably linked. Interestingly, for certain products in certain markets, lower prices may reduce demand.

Manage development and production decisions

The amount spent on developing a product, as well as the methods used, affect profitability. Too little expenditure may result in larger costs in the long-term. The shelf-life and appeal of a product need to be considered when deciding to continue or discontinue it.

Stepping back from routine decisions and considering how to derive greater value from existing customers and products will enhance profitability.

The number and quality of suppliers or business partners is another important issue. Decide what the buying policy should be (such as a small number of preferred suppliers or a bidding system among a wider number of potential suppliers). Also, consider techniques for controlling delivery charges, monitoring exchange rates, improving quality control, reducing stockholding and improving production lead times.

Consider using price innovations

Price innovations can be achieved by changing any of the factors relating to the product. For example, a food manufacturer may wish to launch a new *size of product* with a new price; a lawyer or accountant may wish to stop charging on a per day rate and start charging a *percentage of the amount saved* for the client. A higher price for an item of capital equipment may be offset by *extended payment terms*. These extra factors are used for a variety of purposes: everything from obscuring the real price to establishing or strengthening the brand.

Increase profitability by managing people

Active, successful leadership is a prerequisite to profitability. People need to feel supported and this means communicating and helping as well as rewarding people fairly for their work, providing training and development opportunities, giving a clear sense of direction and focusing on the needs of the team, task and individual.

Use a simple risk management process

The stages of managing the risk inherent in decisions are simple. First, assess and analyse the risks resulting from the decision through a systematic process of risk identification and, ideally, quantification. Second, consider how best to avoid or mitigate risks. Third, in parallel with the second stage, take action to manage, control and monitor the risks.

Control costs

This is achieved by:

Focusing on major items of expenditure. Costs should be categorised as major or peripheral items. Often, undue emphasis is given to the majority of activities accounting for a small fraction of costs, rather than focusing on the priorities – those generating the largest of costs.

Reducing costs through greater awareness. Casualness is one of the pitfalls of cost control. While focusing on major items of expenditure, it may also be possible to reduce the overall level of cost of peripheral items. Costs can be reduced over the medium to long-term by influencing people's attitudes towards cost and wastage. In particular, managers' attitudes to cost control and reduction and the effects of expenses on cash-flow and profitability should be examined.

Building profitability can never start too early. When markets are difficult or costly to enter and relatively easy and affordable to leave, firms can achieve high, stable returns, while still being able to leave for other opportunities.

Maintaining a balance between costs and quality. Commercial management and cost control means getting the best value possible. This requires a balance between price paid and quality received.

Using budgets for dynamic financial management. Budgets are valuable for monitoring costs. Budget early so that financial requirements are known as soon as possible. Consider the best time-period for the budget – normally a year but it depends on the type of business. Budgets can be of interest to others outside the normal running of the business, as well as providing a starting point for cash-flow forecasts.

Developing a positive attitude to budgeting. People need to understand, accept and use the budget, feeling a sense of ownership and responsibility for developing, monitoring and controlling it.

Eliminating wastage. For decades, leading Japanese companies have directed much of their cost management efforts toward ‘muda’ or waste elimination. This involves techniques such as process analysis, mapping and re-engineering – important parts of operational decision-making. The value of process analysis is that it enables waste to be identified and eliminated, and costs to be reduced by thinking of activities as a chain of events from the beginning of the process to the end, with each part of the chain comprising discrete, identifiable tasks. The idea of thinking about everything that goes on in a business in terms of processes and in terms of waste elimination is fundamental. In a Japanese factory, you can see how processes have been laid out and almost feel the continuing search for better ways to do things, in the least wasteful way.

Establish and monitor market entry and exit barriers

The ease and difficulty of both market entry and market exit is a crucial factor in managing profitability. Entry barriers include the need to compete with businesses that are enjoying economies of scale, or who are challenging established, differentiated products. Other barriers include capital requirements, access to distribution channels, factors independent of scale (such as technology or location) and regulatory barriers imposed by government or industry associations. When markets are difficult or costly to enter and relatively easy and affordable to leave, firms can achieve high, stable returns, while still being able to leave for other opportunities. Consider where the barriers to entry lie for your market sector, how vulnerable you are to new entrants and whether it is possible to strengthen and entrench your market position.

Avoiding problems

Making financial decisions without reference to other parts of the organisation is unwise. Finance impacts on every aspect of the organisation and the consequences of financial decisions should be considered, particularly in relation to the business strategy, operational issues, cash management and the realities of the market.

Do not ignore or under-estimate the wider impact of finance issues upon other departments and decisions. If cash feeds the business, think carefully before going on a crash diet.

Remember that financial decisions affect everyone. Financial decisions should not be left entirely to the 'experts' in the finance department or among specialist advisers. Financial issues and techniques – such as dynamic cost management, the importance of cash-flow and the time value of money – affect all managers with a financial responsibility and are influenced by everyone. Everyone in the business needs to understand the importance of careful financial management for profitability and success.

Poor budgeting and budgetary control needs to be addressed. Either budgets are used simply to assess performance rather than as an active tool to inform key financial decisions; or, budgets are cut across the board without regard to the business strategy and objectives *and how these will be achieved in practice*.

Cash-flow is unplanned with the result that the business is insolvent and dies, or alternatively cash is hoarded without reason when it could be invested, to the long-term detriment of the business.

Ensure that commercial expertise is widely available. Every manager in the business needs to understand the importance of financial management for profitability and success. People need to feel ownership of their part of the process of financial control, to have the information and expertise to routinely make the best financial decisions and to consider all relevant decisions from a financial perspective.

Avoid weak budgetary control. Often budgets are used merely to assess performance; their real value lies as an active tool to inform financial decisions. Budgets should not be cut without giving sufficient thought to how this will affect other decisions.

The acceptance of risk is an integral part of business, as is the principle that the higher the risk the higher the rate of return needs to be. The willingness to take risks of both a personal and financial nature is one of the defining characteristics of the profit-driven manager.

Know where the risks lie. Understanding where risks lie and what needs to happen to reduce risk is an important part of the process of financial decision-making. For example, it is necessary not only to know where the break-even point is but also how and when it will be reached.

Dos and don'ts

Do:

- Organise the flow of information so you know what is happening, when and why.
- Understand the cause of a problem by adopting a challenging, questioning approach. Think critically, asking 'Why?' 'What else?' and 'What if?' questions to probe thinking. Also, use information, listing what is known, unknown and in need of checking. In particular: look for relationships and trends in the data; investigate conflicting data and determine its relevance; scan information that is not critical, and avoid decisions based on feelings alone.
- Involve stakeholders in decisions and build their commitment.
- Search out information from a variety of sources.
- Look for long-term solutions.
- Ask 'What could go wrong?' and plan preventive actions.
- Think of what you are trying to achieve not how you will achieve it.
- Develop criteria to assess different options.

Do not:

- Limit the sources of information analysed.
- Confuse the issues or fail to work out what is essential.
- Adopt too narrow a perspective, fail to consult or be too subjective or irrational.
- Ignore the mistakes (and lessons) of the past and stick with existing thinking and orthodoxy.
- Fail to see where the risks lie or rush to an obvious decision or solution.
- Make decisions based on feelings alone.
- Procrastinate or let concerns about the outcome delay the decision.
- Let personal preferences or preconceptions cloud your judgement.
- Forget to consider implementation (decisions need to be pragmatic) or fail to monitor or follow-up decisions.
- Overlook the impact of your actions on your customers.
- Fail to discuss or consult on critical issues.

Key questions

- Why is the business in its current position? What forces are driving the future of your business (or team)?
- Where is the business going if things continue as they are?
- What are the priorities for your business?
- What are the resources and capabilities that you need to develop?
- Where is the 'low-hanging fruit' – the business opportunities that can be readily exploited?
- Where are the market gaps? What would ensure that you attract new customers, while retaining and selling more to existing customers?
- How can customer loyalty (and repeat purchasing) be enhanced?
- How can the sales proposition be made more competitive? (Simply improving it may not be enough; improvement needs to be made relative to the opposition.)
- How can existing markets, sales channels, products, brand reputation and other resources be adapted to exploit new markets and new opportunities?
- How can sales expenses be reduced?
- How can the overall effectiveness of marketing activities be increased?

There are many techniques for improving profitability but the most effective is the one that best suits the needs of the business, combining entrepreneurial thinking with leadership and sustained business awareness.

Things you can do

Apply break-even analysis to new projects

The break-even point is the level of sales at which neither a profit nor a loss results. Calculating the break-even point can be useful as a starting point for pricing, calculating discounts and comparing and monitoring costs (and suppliers' performance), as well as for estimating the viability of potential new developments.

Total costs ÷ gross profit per unit = Break-even point (in units)

Review production issues affecting profitability

Costs of production can be one of the biggest costs for an organisation and they need to be closely monitored and controlled to ensure profitability. Production costs also relate closely to issues of quality and delivery time; these have a significant impact on profitability. Major issues to review include:

- Suppliers and the business's buying policy. This can include the number of suppliers, the level of returns, the frequency that quotations are obtained and the availability and use of discounts.
- Number of overseas suppliers used and exchange rate implications.

- Quality processes and reducing waste.
- Customer returns and complaints.
- Amount and value of work in progress.
- Manufacturing and distribution lead times.
- Costs of components and raw materials.
- Stock levels and mix, and stock control processes.
- Customer returns and complaints (as with stock, this is often a sales responsibility).

Monitor sales and customer issues

Markets exert the greatest influence on profits; without revenue, there is no profit. Some of the most important factors to measure and manage include:

- Sales expenses (such as travel costs per sales person).
- The level of prospecting, notably: the number of leads generated, customers served and revenue or profit generated per sales employee.
- Marketing and advertising response rates and marketing effectiveness.
- Image, reputation and quality of the business.
- Levels of customer satisfaction.
- Levels of repeat business from existing customers.
- Pricing and discounts: are these competitive, attractive and viable?

Manage people issues affecting profitability

Clear leadership and direction is vital for profitability. For example, do people know exactly what is expected of them and do they have the necessary support to achieve their objectives? People's attitudes to and understanding of financial issues is of major significance: this means that training in financial management skills may be necessary. Furthermore, ensuring that people feel adequately rewarded will motivate individuals, leading to improved performance and profitability.

Manage cash

Cash management affects profitability. If there is insufficient cash and it needs to be borrowed then this will incur a cost. The time value of money (meaning the fact that the value of money reduces over time) is also a factor that can reduce profitability – this is particularly relevant when ensuring the profitability of investment decisions. Other relevant issues include: the time that customers take to pay debts (the level of debtors and average age of accounts outstanding); credit control policies and procedures, and the number of bad debts (especially their frequency and severity).

Influence attitudes

Increasing understanding and awareness of the issues affecting finance will help to improve profitability. This can involve a range of issues, from employees' attitudes to wastage and to management's understanding of the effects of expenses on cash-flow and profitability. As a leader in the organisation, you need to actively develop *ownership* and *responsibility* for the financial performance of the organisation and for each individual's role in achieving it.

Apply variance analysis

However diligently a budget is prepared, things will almost certainly not turn out as planned. There will be a variance between what was anticipated and what happened. Understanding the differences between actual and planned performance is known as variance analysis. It is used to monitor and manage the results of past decisions, to assess the current situation and to highlight solutions.

The process starts by breaking down substantial variances into their component parts, identifying exactly where and why the variance occurred. Although it is best to focus on the most significant difference first, seemingly small issues can have significant effects. For example, small variances in unit costs or unit prices can have significant effects on volumes, affecting the bottom line. Key performance indicators (KPIs) can be monitored that will regularly track and identify variances.

Ratio analysis supports systematic analysis of suppliers, customers and competitors, as well as market and industry trends.

Common causes of variances include inefficiency, poor or flawed planning (for example, relying on historically inaccurate information), poor communication, interdependence between departments and random factors.

Use ratio analysis

Ratio analysis supports decision-making, enabling leaders to monitor their actions and to avoid inappropriate or damaging actions. A ratio is simply a relationship between two numbers, but when compared to the same ratios for previous periods they can show important trends and patterns in performance. When using ratios ask the following questions:

- Which ratio is most appropriate?
- What is the trend: how is the ratio developing and why?
- How reliable is the data on which the ratio is based?
- What comparisons are desirable in using a ratio?

The following ratios are commonly used to manage profitability:

Gross profit highlights the relationship between *revenue* and *costs of sale*. If gross profit is too low then it could either mean that prices are too low or costs are too high. **Net profit** examines the relationship between *revenue* and *total costs.* If it is too low or falling then costs may be rising or revenue falling. With both profit ratios it is important to closely monitor *trends*, meaning whether profits are falling, static or rising, as well as identifying what part of the business is causing the problem, and then taking immediate action.

Some ratios assess efficiency and indicate the quality of an organisation's financial management, how much working capital is tied up, how quickly outstanding debts are collected and how quickly the business settles its debts. Efficiency ratios include **average debtor collection period**, showing how long debtors take to pay, and is important in managing cash-flow and ensuring that collection periods are as short as possible. **Average creditor payment period** shows how long the business takes to pay its debts, and can be calculated in a similar way, substituting creditors for debtors and costs of sales instead of sales. **Stock (inventory) turnover** is often used in manufacturing and retailing businesses to indicate the presence of slow moving stock or too much stock, which impedes cash-flow.

Liquidity ratios show the business's ability to meet liabilities with the assets available. **The current ratio** should normally be between 1.5 and 2; if it is less than 1 then current liabilities exceed current assets and the business could be insolvent. For some industries it should be over 2 on the grounds that half the assets might be stock. **The quick or acid test ratio** is a more rigorous test of liquidity. It takes into account the fact that some current assets, such as stock or work in progress, may be difficult to turn into cash quickly – deducting these from the current assets gives the quick assets. The quick ratio is normally between 0.7 and 1; if the quick ratio is 1 or more then quick assets exceed current liabilities and the business is safe. (Note: if the current ratio is rising and the quick ratio is largely unchanged, there is almost certainly a stockholding problem.)

Price/earnings (P/E) ratio is simply the share price divided by the earnings per share (EPS). This ratio is the one that investors and analysts focus on and it forms part of the valuation of a company during acquisitions and disposals. The higher the ratio, the more the company is deemed to be worth, although there are several points to note. P/E ratios vary across industry sectors and in different countries and they are relative to those of competitors. They rise when the share price rises – for example, when there is speculation about a merger or take-over. Also, they can lag behind events, combining current share price with past earnings. A P/E ratio may, for instance, be too high compared to likely future growth.

Return on equity. One of the key tests is how much money a business makes for its investors, who therefore pay considerable attention to it. It is calculated as net profit after tax divided by equity capital.

Suppliers' prices and performance can be monitored using ratios. Fluctuations in suppliers' prices are measured by dividing a supplier's current prices by their prices at a previous date. The time that suppliers take to deliver is calculated by dividing the value of outstanding orders with suppliers by the value of average daily purchases. An indication of a supplier's reliability can be obtained by dividing the value of overdue orders from the supplier by the average daily purchases from all suppliers.

Employee productivity can be measured in a number of ways. Profit per employee is calculated by dividing profit by the number of employees. A more interesting ratio of value-added per employee is calculated by dividing sales less material costs by the average number of employees. Employment costs can be measured and monitored for a range of criteria. For example, training costs can be related to profit for budgeting purposes and is calculated as training expenditure divided by profit.

Focus on ratios relating to markets and products

Sales growth is measured by dividing sales for the period by sales for a previous period. The period that is chosen can be highly significant: the shorter it is (a day or week) then the more sensitive the ratio becomes. Shorter periods are more relevant for reflecting seasonal demand.

Value of work in hand highlights the size of a firm's order book. It is calculated by dividing the value of orders in hand by the average value of daily sales. Analysis of this ratio over an extended period highlights trends in sales performance – large fluctuations may indicate instability or vulnerability.

Marketing efficiency (sales to cost ratio) is calculated as a percentage of revenue and is marketing spend divided by revenue. When budgeting, for example, it is useful to know how much money needs to be devoted to marketing to generate a given level of sales.

Market share. In highly competitive situations, sales growth should be read alongside the market share ratio. This is calculated by dividing current market share by previous market share. If market share is being taken together with sales growth, the periods need to be similar. Ratios of the market share of each product (that is, the product as a percentage of turnover) can be compared between periods to see which markets and product groups are most profitable. This highlights strengths and weaknesses in a product portfolio and can be used to gauge a product's position in its life cycle. If it is declining it is important to decide if it is a long-term trend or a short-term blip, in which case corrective action could improve the situation.

Apply financial and other data (including balance sheet dynamics) for major decisions

List the techniques of greatest value to you. These may include:

Balance sheet analysis	Cash-flow forecasting
Cost control and profit management (including costing and pricing)	Discounted cash-flow and investment appraisal
Asset and Liability (ALCO) Reports	Customer data
Budgeting	Employee data
Ratio analysis	Managing risk

Check your understanding of key financial techniques. This can be achieved either by reading, attending a training course and forming a business review group with colleagues. This group will discuss business challenges, assess current and future challenges, help solve problems, share experience of financial analysis techniques and establish key performance indicators.

Use ratios to inform decisions and manage performance. Decide which ratios best suit your priorities. A ratio is simply a relationship between two numbers, but when compared to the same ratios for previous periods they can show important trends and patterns in performance. Ratio analysis is valuable for three reasons: to analyse, to monitor and measure performance and to facilitate planning. Ratio analysis is often used to support systematic analysis of suppliers, customers and competitors, as well as general market and industry trends.

Set performance targets

Performance targets are at the heart of entrepreneurial thinking. This applies not only to your team but yourself as well. When setting performance targets it is important to:

- Possess a clear view of the desired outcome.

- Be challenging, prepared to stretch the bounds of the possible.
- Set clear targets and, where appropriate, agree these with others. Targets should be specific, attainable, relevant and time-related
- Understand what resources and other actions may be needed for you or your colleagues to achieve these targets.
- Consider how to incentivise individuals to achieve their performance targets.
- Provide additional help and support to team members, following through with any commitments.

Balance revenue growth with risk and cost control

To do this:

Review a successful business case. How was it presented? Why did it succeed? What were the potential problems and how were these overcome? Focus on the presentations and discussions that were involved, as well as the written material.

Find an initiative that will increase revenue and profit without being too risky. This should be done together with your manager, mentor or team members. Discuss with your manager the initiative: what it is and why it is important.

Assess the current commercial situation, reviewing market developments and budgets, looking for trends in how costs and revenues have been managed. Where is the best commercial opportunity? When is the best time to exploit this? What is needed to make this happen?

Review the business strategy and use this as a guide to identify areas in which you can increase revenue, while controlling cost and risk.

Monitor implementation of the business plan and report regularly on progress. Whether the plan is achieving its objectives or not this is vital, so that people understand the situation and have confidence in the actions and adjustments you may need to make.

Create a positive climate for managing risk

By itself, simply recognising the need to manage risk is inadequate. The ethos of the entire organisation should recognise and reward behaviour that manages risk, grows revenue and controls costs. This requires a commitment by senior managers and needs the resources (which includes training) to match. Too often, control systems are seen only as an additional overhead and not as something that can add value by ensuring the effective use of assets, the avoidance of waste and the success of key decisions.

Look for product, service or customer gaps (opportunities) in your business and find ways that they can be exploited.

Seek and seize commercial opportunities

Discuss with your manager and mentor opportunities and priority ideas for increasing profitability and the value of the business. Also, add 'profit-boosting initiatives' to regular meeting agendas, and discuss (or brainstorm) commercial ideas. You might also form a commercial team with colleagues to identify and progress commercial initiatives, as well as learning from other initiatives around the business. Find ways to share expertise and experience, and encourage your team to develop ideas.

Undertake a SWOT analysis

SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis is an effective method of understanding where commercial opportunities lie, as well as areas where weaknesses need to be addressed. Strengths and weaknesses are typically found within an organisation, whereas opportunities and threats are most often external.

Further action

Assess the extent to which you are commercially focused by asking:

Issue	Response	Further Action
Are the most effective and relevant performance measures in place to monitor and assess the effectiveness of financial decisions?		
Do you analyse your business ratios regularly?		
Is there a positive attitude in your organisation to budgets and budgeting?		
Is decision-making focused on the most profitable products and services or is it preoccupied with peripheral issues?		
What are the least profitable parts of the operation and how can these be improved?		
Are decisions affecting customers concerned with improving profitability? Too often, attention is given to non-financial objectives, such as increasing market share, without adequate consideration of the financial risks and alternatives.		
How efficiently is cash managed? Do your business decisions take account of cash considerations such as the time value of money?		

For Further Information or to Arrange a Consultation

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