Why Don't I Make a Profit?

By Chuck Walsh

I have worked with a number of companies that proudly tell me of the fact that they make 30-40% margin on their various services, or they mark up their services 50%. Ask them what their profits were last month or last quarter and they can't tell you. And if they do draw their numbers, they see they are barely profitable or are at a loss. Needless to say, this is not good.

1. Financial Control

Your financial statements tell you whether you are being successful. That is not to say that money is supposed to be everything. But all of your decisions produce certain results, and, in general, they all come together in one place: your financial statements.

Reality: if you continue to make less than you bring in, your business will eventually not exist. If you are willing to take a loss, that is fine --- provided you know you are taking a loss and you have made the decision to do so.

There are many reasons to have losses on certain operations, for certain periods, for certain clients, etc. But that should be a conscious decision. And you should know what that impact is financially. If you are taking losses and you do not know why, you have a problem.

2. Separate (verb) Businesses

I have worked with a number of businesses that produce multiple products/ services or are running multiple businesses and do not know it. Examples: If you are running a restaurant and are supplementing it with a catering service, you are running two businesses. If you are running a retail store and you are providing special pricing and service for bulk customers, you are running two businesses. And if you are providing different pricing based on circumstances, you may be running more than two businesses.

If you are running operations that produce different financial results, you need to track them separately to determine what the true impact is to the bottom line. Small business accounting packages do permit this to happen. But you have to do it, or you may, without knowing, have one operation supporting the other.

And even within a "business", you may need to track services, etc. so that you know what contributes to your profit and what does not. Again, if you are making a decision that a service is going to be a loss leader, that is fine --- as long as you truly understand what the impact is to your bottom line.

3. That "Nut"

A number of owners with whom I have worked talk about "cracking that nut". It is basically the amount of sales they need in a given month in order to break even. For businesses with relatively simple business models, this is a relatively well defined number. To obtain that number you need to understand your ***Business Model***.

4. Business Model

There are different aspects of a Business Model that need to be understood in order to be successful. These aspects let you understand what occurs as your business grows or shrinks.

- ***Capacity*** of a business at any point in time is defined by what you can accomplish with your current resources: buildings, people, support, etc. It basically is how much business I can handle if I make no changes to my current situation.
- ***Fixed (Overhead) Costs*** are the costs that need to be paid, regardless of what happens. That would include any *salaries* you pay, as well as monthly rents, marketing expenses, vehicle payments… That means any expense that does not change when sales go up or down. Any base pay is fixed. Taxes and benefits not directly related to percentage of sales are fixed.
- ***Variable Costs*** would be any expense that would change as a result of a sale being made. If you are paying your sales people based on their sales, that commission is variable. If you are paying your production employees based on piecework, that is variable.
- ***Unit Cost*** is the Variable Cost divided by the number of units.
- ***Unit Profit*** is the price minus the variable cost. Divide the result by the number of units.
- ***Net Profit*** is the Income minus the Fixed and Variable Costs. Note that net profits must cover unit ***and*** fixed costs, while unit profits only cover unit costs. That is why many owners do not make a net profit, even though their unit profits are good.

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5. Prerequisites for Making a Profit

Here are the prerequisites for making a profit:

- Unit price exceeds unit costs
- Number of units needed to cover overhead does not exceed capacity of the operation.
- Number of units needed to cover overhead does not exceed the number of units you are able to sell.

6. Improving Profitability

6.1. Trade-offs

There are always trade-offs to any decisions:

- ***Fixed vs. Variable*** - Anytime you move costs to the variable side, you reduce the breakeven point, and improve survivability; however, as volumes increase beyond breakeven, you reduce profitability.
- ***Personnel Considerations*** – While commission and piecework match the income stream, the lack of stability in personal income may cause a higher turnover. At the same time, commission and piecework have a tendency to provide incentive for additional production. Alternatives include a base salary plus incentive.

6.2. Strategies

Here are some strategies for improving profitability:

- ***Matching Costs to Income*** – Examples include paying commission and paying for production on a piecework basis. This reduces fixed expense.
- ***Matching Capacity to Needs*** - Your capacity, in large part, defines your fixed costs. If your capacity matches your forward sales, you are in your most profitable situation. If your capacity significantly exceeds your forward needs, you are carrying fixed costs with no benefits to you. An operation that exceeds capacity may increase unit costs because of overtime, etc.: affecting your unit profitability.
- ***Unproductive Activities*** - Eliminate unproductive activities. If the activity does not contribute to the bottom line, eliminate it. I know of at least one case where a person, who retired, was found to have spent at least one third of her time in activities that were literally being thrown away.
- ***Process Refinement*** - Document your processes and take the "best practices" from those doing the work. Then begin improving them. If you don't document the activities first, you do not have a baseline from which to improve. That also means different people are doing different things, which results in varying productivity and quality.

CW Business Support Associates, LLC, through Chuck Walsh, provides a Business Support Program sponsored by the Institute for Independent Business using a few hours a week to assist Small and Mid-sized Businesses (SMB's) with their ongoing development.

- ***Paradigm Shift*** - Paradigms are models. The way you do things today is one model. A "paradigm shift" is pursuing a completely different model. An example would be buying equipment to replace manual labor. In general, a paradigm shift assumes a complete re-evaluation and re-engineering of the process. The results are frequently a significant increase in capacity with less unit labor, generally increasing fixed cost or initial investment in exchange for significantly reduced per unit cost.

6.3. Growth

As your business grows, the change in size may drastically affect the Business Model with which you are working. Because of added management (fixed expense) or improved efficiencies (reduced unit costs), you may be more or less profitable. You need to know which.

7. Risk Factors

While we would like to plan based on favorable factors, we really need to plan for all factors:

- ***Seasonality*** – How do you compensate for that?
- ***Product Cycles*** – Products go through stages from development, through growth, into maturity. Markets and competition change throughout. How are you planning for the contingencies?
- ***Economic Changes*** – Times are good and bad. How can you adjust?

Other risk factors may exist for your particular circumstances. What are they?

8. Financial Controls

Some basics should be in place to ensure success:

- ***Budgets*** – How much are you expecting to sell and produce in any given period? How much will be the income and costs? If targets are not met, why?
- ***Metrics*** – Beyond budgets, how much are your unit costs? Are your fixed costs a continually smaller percentage of total costs? If not, why not?
- ***Cash Flow*** – Are you controlling your Accounts Receivables (income)? And your Accounts Payables (credit rating)?
- ***Review Periods*** – Your budgets, metrics and cash flow must be reviewed frequently enough to ensure stability and understanding at any point in time. You should know whether you are or are not making a profit at any point in time and by how much.

9. Summary

The intent in this discussion is not to cover every possible situation. There are books on this topic. It is meant to give an overview of what you need to consider in the very broadest analysis. Sometimes, with the overwhelming day-to-day activities of running a business, a little help with a different perspective can prove advantageous in organize the thinking.