

Profitability of the **business**

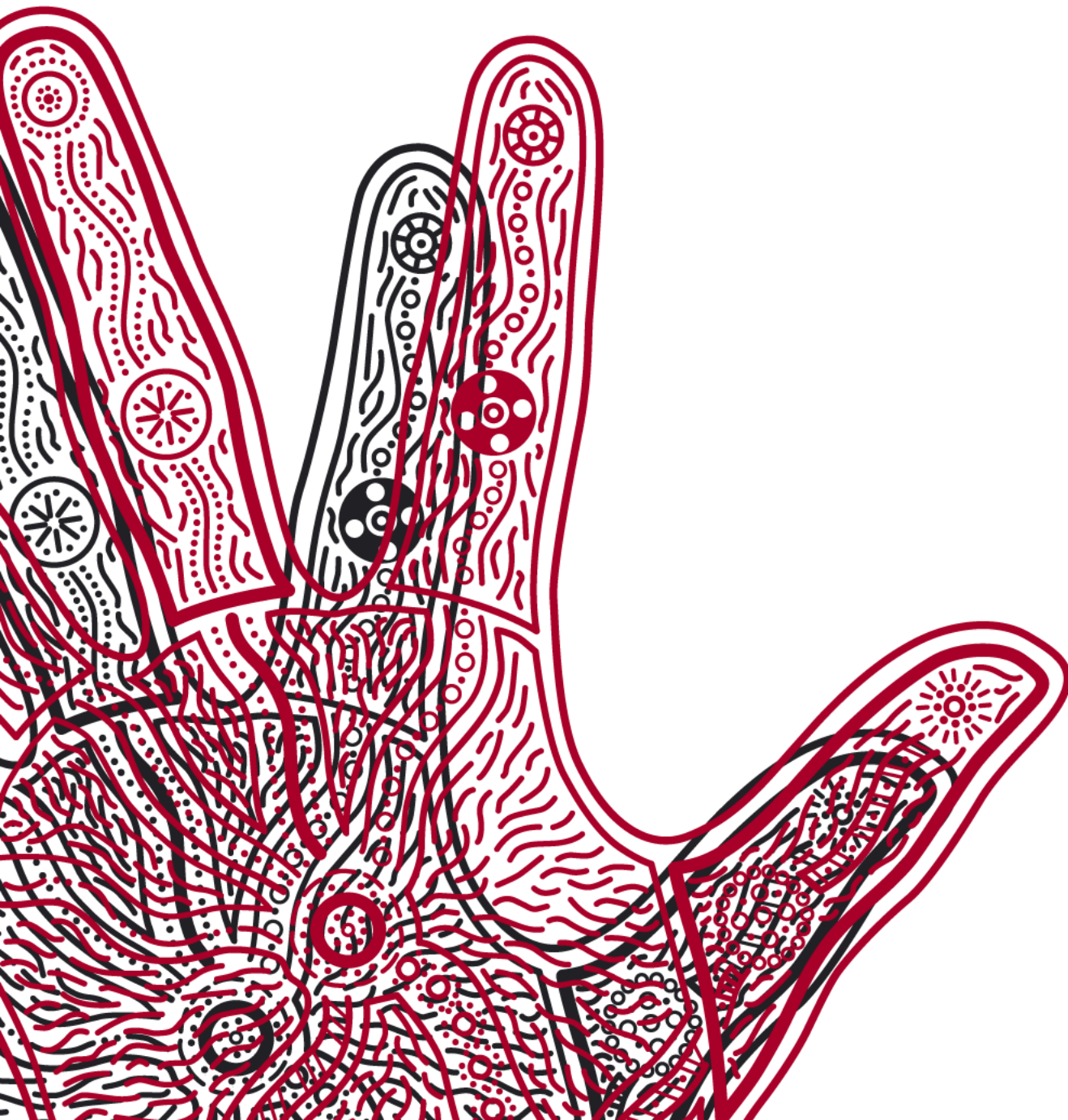
This chapter looks at achieving profits and includes:

Costing and pricing

Break even analysis

Cash flow management

Business performance.



Profitability of the business

Profit is one of the main purposes of being in business.

Many small businesses fail because owners do not understand three simple principles:

- It is necessary to set prices, which cover all costs, but attract sales, leaving enough money for the repair or replacement of equipment, and still make a profit.
- It is necessary to have a minimum level of income from sales (the break even point) to cover costs.
- It is necessary to make enough money (or have other money, such as a bank overdraft) to pay accounts or debts when they are due (cash flow management).

Costing and pricing

If costs (bills paid, debts due, etc) are more than revenue (sales), then the business has made a loss. Failure to put enough money aside to cover future costs (such as replacing old equipment) could lead to future losses and financial problems for the business.

Elements of cost

There are two main types of costs – fixed and variable:

Fixed costs must be paid even if there is no business activity. These include: rent, council rates, licence fees, interest on loans, and may include wages for permanent staff. (Remember staff must be paid even if there is no business).

Variable costs change according to how the business develops, including how many orders are on the books or the number of sales made. These costs include the purchase of raw materials and finished goods if you are a manufacturer or retailer. For a service provider, you need to add direct labour costs to materials and other service costs.

Note: some costs can be described as ‘semi-fixed’ because they have both fixed and variable elements at the same time. Telephone costs, for example, include both a fixed charge for having the telephone and variable costs depending on calls made.

Factors which affect business costs

Try to find out about the things which could affect the cost of running a business. These include:

- The location of the business – this can affect things such as rent, the cost of transport, and the availability of government programs such as regional programs
- The number of staff employed and their skills and experience (well-trained and experienced workers are more productive and efficient, helping to lower costs for a business)
- The amount of technology needed to run a business
- The way the business is put together and run
- The source of funds being used in the business. (The more a business uses its own money, the lower the costs which means no interest payments). The more money borrowed, the more interest paid
- The maximum amount of goods produced or services provided. For example, a manufacturer may find plant machinery can only produce 1,200 items a month, or a plumber may decide to work for a maximum of 45 hours a week. This information or ‘intelligence’ puts a brake on over-promising to customers which loses their trust and confidence.

Setting prices

There are different ways of setting prices. A method used by many successful businesses is 'mark-up' pricing. This simple formula takes account of all business costs, and includes the amount of profit the business owner wants to achieve.

The formula for mark-up prices is:

$$\begin{aligned} &\text{Fixed costs per unit*} \\ &+ \text{variable costs per unit**} \\ &+ \text{desired profit margin***} = \text{price} \end{aligned}$$

* Fixed costs per unit are worked out by dividing the total fixed costs by the number of products or services being produced or supplied.

** Variable costs per unit are calculated by dividing the total variable costs by the number of products or services being produced or supplied.

*** The desired profit margin is calculated as a percentage of total costs (fixed costs + variable costs).

This is an example of mark-up pricing:

Fixed costs per unit	\$50
Variable costs per unit	\$250
Total costs per unit	\$300
Desired profit amount or margin (30 per cent)	\$90
Selling price per unit	\$390

Other methods used to set prices include:

- **Target return pricing** – the selling price is based on the return on the investment the business wants to achieve (how much money you want to make back from all the money invested in the business)
- **Value pricing** – the selling price is based on an estimate of the value customers place on the product or service of the business
- **Going-rate pricing, also known as 'price taking'** – the selling price is based on competitors' prices.

In setting a price for a product or service, take into account what the customer is prepared to pay, and the features that make it different to anything offered by competitors.

Many businesses offer discounts to entice people to buy their product or service. However, discounts do not necessarily bring great increases in sales. If you sell a product or service more cheaply, your business must make more items, or do more work, to make the same amount of money as when the product or service was at its original price.

Consider 'value adding' to customers instead of offering discounts. This means providing them with an extra benefit (such as an extended warranty or free repair). This may increase the price of the product or service, but make it more attractive than anything offered by your competitors. An increase in price, while possibly reducing the number of sales, may actually increase total profits.

Review prices and costs regularly to make the most out of the business. Caution: Changing prices too often can frustrate customers.

According to research, buyers will almost never buy a product or service on price alone. Other factors which influence a person's decision to buy include:

- Convenience
- Quality
- The availability and delivery time of the product or service
- Most importantly, whether or not the business operator seems to be interested in the customer (customer service).

The Department of State and Regional Development runs a workshop on costing and pricing, *Decision making for profit*. Phone the nearest Business Advisory Service on 1300 650 058 to see when the next workshop will be held. The Department has also developed an e-learning tool called *Pricing and Costing: managing for a profitable business*, which is available on the Small Business Website in the section on Starting in Business – Finance.

When will the business turn a profit?

Break even analysis

The break even point happens when total sales (or revenue) equal total costs. This means every additional sale above this point produces a profit for the business. Operating below break even point means the business is not making enough money and is operating at a loss.

However, calculating break even point is a little more complex than this.

The formula for calculating the number of units needed to sell to break even (known as break even unit sales) is:

$$\frac{\text{Total fixed costs}}{\text{Selling price per unit} - \text{Variable costs per unit}}$$

The formula for calculating the value of the sales needed to make it to break even (break even \$ sales) is:

$$\text{Break even unit sales} \times \text{selling price}$$

An example:

Company XY has

- Total fixed costs of \$1,500 per year
- Variable costs of \$4 per unit, and
- A selling price of \$10 per unit.

For company XY, the break even unit sales = $\$1,500 \div (\$10 - \$4) = 250$ units

In addition, the break even \$ sales = $250 \times \$10 = \$2,500$.

This means the company must sell 250 of its product or service for a total of \$2,500 in order to break even. Its 251st sale means it has made a profit.

Cash flow management

The difference between profit and cash flow

Profit is what is left over after all costs are subtracted from sales or revenue. Cash flow is the actual money coming in and going out of the business. For example for sales, payments to creditors and purchases of stock (not just cash, but all payments including cash, cheques, bank deposits, etc).

Problems in cash flow management arise because of the difference in timing between making payments to creditors and suppliers, and receiving payments from customers. Usually the business must pay suppliers, banks and others before receiving payment for products or services sold. For example, stock might need to be bought now, only to be sold later. The customer may have credit terms, which permit 30 days to make a payment. This means there is a long period between purchasing the stock, and selling it to a customer. This is where cash flow management is important.

Every business needs to prepare a table showing forward cash flows (into and out of the business). Every business needs to look at ways of increasing or speeding up cash in-flows, and delaying cash out-flows wherever possible. Make sure there is enough money to cover the gap between money going out of the business and money coming in, such as a bank overdraft or a line of credit. (See Chapter 2 – *Finding the money for your business.*) This is important because the business might need more cash than is being generated through sales, especially when starting or growing the business.

It may be necessary to show a bank or a financial institution a cash-flow projection or business statement especially when applying for finance. A sample cash flow projection is in Appendix 4.

Managing cash flow

There are several ways a business might manage cash flow. These tips may also help reduce business costs and change pricing policies:

- Manage creditors and debtors effectively. (See the Section in Chapter 3, *Managing creditors and debtors*)
- Don't carry too much stock because it ties up cash in unsold products, and it costs money for storage, and
- Put money aside to make accurate and timely GST and PAYG tax payments.

The Department of State and Regional Development (DSRD) has developed a workshop about cash flow management called *Budgeting for success*. Phone the nearest Business Advisory Service on 1300 650 058 for the dates of the next workshop.

Business performance

Starting and running a business is a relatively complex activity which needs planning. As well as keeping a watch on cash flow projections, it is wise to review items such as:

- Sales turnover (the total value of sales)
- Number of customers
- Value of average purchase per customer
- Gross profit margin (how much money the business is really making, calculated by subtracting total costs from total revenue)
- Fixed and variable costs
- Return rate of customers (a measure of product quality and customer satisfaction)
- Stock (the volume and how often it is turned over).

An accountant or a Business Advisory Service can provide advice on key performance measures, and how to understand their meaning. The Business Advisory Services provides free access to *FMRC Business Benchmarking* to compare other firms in the same industry as yours. Phone 1300 650 058.

Complete Appendix 2, Part D

