What Really Drives Profit?

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One of the most vexing issues in improving profitability is determining exactly what to focus on. Seemingly, everything is important so setting priorities is difficult. Almost every management team is aware that sales, gross margin and expenses are the main drivers of profitability. However, there is serious disagreement as to the relative importance of these profit drivers.

For example, the sales team is certain that increased sales will easily lead to higher profit. While the operations staff also wants a sales increase, it feels that the key to higher profit is improved productivity in the supply chain. Other departments have different priorities. Uncertainty reigns.

This report attempts to provide an objective perspective regarding the degree to which sales, gross margin and expenses, the three key Critical Profit Variables (CPVs) really impact bottom-line profit. It will do so by considering two different aspects of the "what to work on" issue:

- **The Relative Profit Impact of the Critical Profit Variables—**An examination of the relative degree to which changes in sales, gross margin and expenses really improve profit.
- **Integrating the Profit Variables—**Suggestions for establishing a unified approach to profit improvement for the firm by setting logical priorities.

The Relative Profit Impact of the Critical Profit Variables

The first step in setting priorities for the three critical profit variables is to look dispassionately at the impact each of these factors has on bottom-line results. Exhibit 1 does this for an illustrative distributor. It is important to note from the outset that the exhibit examines how profit might have been different during the current year under alternative scenarios.

As can be seen in the first column of numbers, the tfirm generates $20.0 million in sales, operates on a gross margin of 25.0% of sales and produces a bottom-line profit of 2.5% of sales or $500,000.

To understand the impact of making changes in the CPVs, it is necessary to break expenses out into their fixed and variable components. Fixed expenses are overhead expenses that will not change during this year unless the firm takes a specific action to change them. For example, hiring an additional office employee would increase the firm's fixed expenses.

Variable expenses are those that will change automatically along with sales during the year. Items such as sales commissions and bad debts fall into this category. They tend to be a relatively consistent percentage of sales.

Fixed expenses for this firm are assumed to be $3,500,000 while variable expenses are 5.0% of sales. These are, of course, estimates. They do, however, represent a serviceable approximation for many distributors. Of greater consequence, the implications for this firm hold for all firms in all industries.

The last three columns of numbers look at the profit implications of a 2.0% improvement in sales, gross margin or total expenses. In each instance the improvement factor is the same 2.0%.

For the sales increase, the first three lines on the income statement—sales, cost of goods sold and the resulting gross margin—all increase by 2.0% while the fixed expenses remain the same. Variable expenses are still 5.0% of the sales volume. As a result, profit rises to $580,000, an increase of 16.0%.

In the middle column , the gross margin dollars on sales increases by 2.0%. In the example this is done by lowering cost of goods sold. In essence the firm is purchasing merchandise more economically. Both sales and expenses remain the same. As a result, profit rises to $600,000 a 20.0% increase. Gross margin is superior to sales as a profit driver.

In the last column of numbers net sales, cost of goods sold and gross margin remain constant while fixed expenses are reduced by 2.0%. Variable expenses, which are more difficult to reduce, remain the same percent of sales. As a result, the expense reduction drives profit up slightly less than a sales increase of the same magnitude. Specifically, profit increases to $570,000, a gain of 14.0%.

This set of economics represents a truism for managers in all NBMDA firms. The profit hierarchy is gross margin, followed by sales and expenses almost in tandem. The differences are not large, but they are differences.

The reality for most management teams is that they love sales increases, view gross margin increases as ephemeral and hate the very idea of expense reductions. The challenge in today's economy is to integrate the three to increases profit in a way that the whole firm can support.

Integrating the Profit Variables

The key to improved profitability is to determine the actions that enhance gross margin and control expenses without sacrificing sales volume. There are at least three specific ways to achieve this goal.

Problem Account Awareness—Enhanced analytical systems provide the metrics to identify customers that are inherently unprofitable. Such customers typically combine low gross margins with high cost to serve. It is a combination that cannot be overcome even if they account for massive sales volume.

While analysis is great, it does no good if there is no action. The entire firm must be aware of the need to either generate a higher gross margin from these accounts or minimize the costs associated with servicing them. Specific programs must be put in place to implement the steps required to make the challenging customers profitable. Overwhelmingly, the key is to raise prices.

Customer Churn—While some customers are unprofitable, the vast majority of them are profitable. A few are highly profitable. Unfortunately, every firm faces a turnover among its good customers. Such churn not only reduces sales, it leads to problems with both expenses and gross margin.

The expense problem arises because of the inordinately high cost of finding new customers. The gross margin problem arises because firms are too often tempted by the presumed “need” to offer lower prices to attract new customers.

Churn must be avoided by continually interacting with customers to “take their temperature” in terms of their satisfaction with the company’s pricing and service profile. When customers are lost, post mortems are essential to develop the understanding necessary to minimize future defections.

Pricing of Slower-Selling Items— There remains a sales and gross margin opportunity in raising prices on those items that are bought infrequently. On those items concerns about pricing are minimal as availability is the overwhelming value added.

Finding such opportunities must focus on two factors—SKUs with both low sales level and low price. SKUs can be screened on these criteria easily and quickly with any IT system. A few SKUs may be missed, but the impact should be minimal. If identified and re-priced sales volume increases modestly and gross margin increases dramatically. All of this without incurring additional expenses.

Moving Forward

The hierarchy of the Critical Profit Variables continues to be gross margin, then sales and expenses. Careful attention needs to be paid to combining these factors in a way that enhances profitability. This requires increasing gross margin and controlling expenses without sacrificing sales volume.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His latest book, ***Breaking Down the Profit Barriers in Distribution***, is available online at Amazon and Barnes & Noble. It covers concepts that every decision maker should understand.

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Exhibit 1

The Profit Impact on Current-Year Results Of Three Different 2% Improvements For an Illustrative Distributor

Income Statement--$	Current Results	Sales Increase	Gross Margin Increase	Expense Decrease
Net Sales	$20,000,000	$20,400,000	$20,000,000	$20,000,000
Cost of Goods Sold	15,000,000	15,300,000	14,900,000	15,000,000
Gross Margin	5,000,000	5,100,000	5,100,000	5,000,000
Fixed Expenses	3,500,000	3,500,000	3,500,000	3,430,000
Variable Expenses (5% of Sales)	1,000,000	1,020,000	1,000,000	1,000,000
Total Expenses	4,500,000	4,520,000	4,500,000	4,430,000
Profit Before Taxes	$500,000	$580,000	$600,000	$570,000
Income Statement--%				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	74.5	75.0
Gross Margin	25.0	25.0	25.5	25.0
Fixed Expenses	17.5	17.2	17.5	17.2
Variable Expenses (5% of Sales)	5.0	5.0	5.0	5.0
Total Expenses	22.5	22.2	22.5	22.2
Profit Before Taxes	2.5	2.8	3.0	2.9