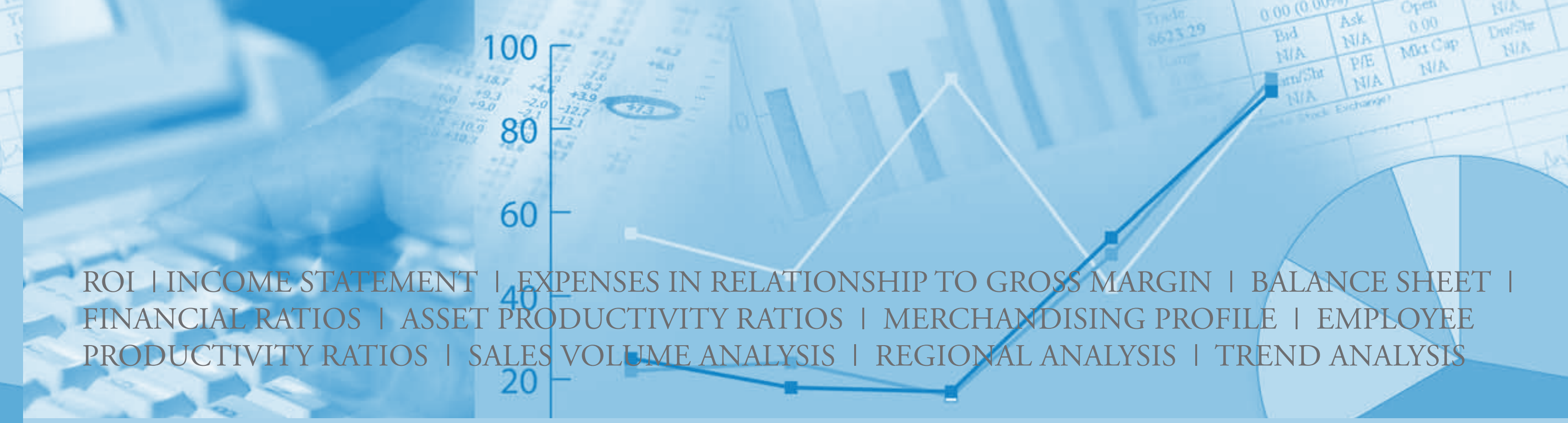

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Profit Improvement Report

"Almost Everything Your Employees Know About Profit is Wrong"

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Almost Everything Your Employees Know About Profit is Wrong

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Over the last ten years the author has taught a number of teleconferences and webinars for various associations. Participating firms were encouraged to have as many employees around the computer screen as possible during those sessions. However, polling almost always indicated that the typical number of participants in the room was one—the CEO.

Similarly, the Profit Planning Group has developed a series of video training programs in conjunction with the PROFIT Report it prepares for DHI. The intent is to help sales people and other managers understand the key financial issues in the firm. The programs are free, yet usage has been minimal.

Discussions with top management suggest the two items above are indicative of a larger issue. Namely, the CEO is reluctant to train anybody outside of the senior management team on financial issues. A small part of the issue is cost. A much more important component is the feeling that nobody really needs to understand financial information except for the CEO and the CFO.

This report will suggest that such an approach is dysfunctional. It will do so by examining two specific issues:

- **Where Lack of Understanding Hurts**—A review of the common misconceptions about profit and what that means to the firm.
- **Pricing Economics**—An detailed examination of how employee misunderstandings about pricing policies decimate profit.

Where Lack of Understanding Hurts

There are three major areas where a lack of financial understanding among employees creates problems for the firm. These involve 1) perception versus reality regarding the firm's actual profit, 2) the profit erosion equation and 3) what constitutes fair and equitable pricing policies.

Profit Perception Versus Profit Reality—<u>Every</u> employee overestimates the amount of profit the firm generates. The further removed the employee is from having access to actual income statement information, the greater the distortion. Sales people, for example, typically think that profits are twice as high as they really are. Operating employees overestimate profits by a factor of anywhere from five to ten times.

The natural result is that employees do not maintain a sense of urgency about profit improvements. In particular, they become less concerned with controlling expenses or eliminating waste and efficiency. They simply don't understand the benefit of such actions in relationship to actual profit.

Profit Erosion—Because of a lack of understanding about the firm's profitability equation, lots of employees spend their time focusing on the wrong issues. As an illustration, few employees are aware that a 5% reduction in expenses actually has a larger impact on profit than a 5% increase in sales.

They are also not aware that one dollar of additional revenue generated via a price increase produces five times the profit of one dollar of revenue generated through selling more products. Worrying about the wrong things slowly, but systematically, reduces profit without any awareness that it is happening.

Pricing Equity—The key to pricing is to be incredibly competitive on commodity items and produce offsetting gross margin enhancements on slow-moving specialty items. This simple concept is almost completely foreign to employees outside of top management.

For a typical DHI member with an overall gross margin percent of 30.0%, commodity items may well sell for a gross margin that is less than one-half of the company average. Conversely, slow-selling items may have a gross margin percentage that is three times the overall average.

Frequently, when employees compare the gross margin percentages on commodity items and slow-selling items, they conclude that the firm is overcharging customers on the slower-selling ones. This seeming incongruity reduces the level of support for the firm's pricing actions.

Only accountants should be accountants. However, all key managers and sales people should fully understand the profit implications of their actions. At the operating employee level, there should be at least a minimal awareness of what hurts and what helps the firm. This can be a relatively easy process through some of the programs already available through DHI.

Pricing Economics

By far the largest profit drain associated with poor employee understanding is in pricing. Specifically, there continues to be a long-held conviction that a modest price reduction that drives substantial additional volume will lead to higher levels of profitability. For the typical DHI member that is simply not so.

Exhibit 1 contains a pricing analysis that has been seen by top management so many times that they will scream if they see it again. However, the problem is that top management has almost certainly not shared it with the sales force and other employees that make frontline pricing decisions on a day-to-day basis.

The first column of numbers in the exhibit reviews the performance of the typical DHI member based upon the latest PROFIT report. As can be seen, the typical firm has sales of $10,000,000 at a gross margin of 30.0%. This produces a pre-tax profit of $300,000, or 3.0% of sales.

The last two columns reflect the results of a 5.0% price cut. In Scenario 1, no increase in physical sales volume is realized. the middle column there is no resulting increase in sales. The firm simply sells the same quantity of merchandise at reduced prices. As a result, profit plummets by 158.3%, producing a loss of $175,000.

Scenario 2 presents the increase in sales that would be required to maintain profits at their current dollar level. The answer is that sales must rise to $11,728,395, an increase of 17.3%. Most employees are shocked to find that such a large increase is required.

It is important to note that in Scenario 2 the fixed expenses did not rise in spite of the substantial increase in sales. Every effort was made to make the effects of a price reduction as positive as possible. In reality fixed expenses would increase and the sales challenge would be even greater.

If employees with pricing responsibility do not understand the mechanics of Exhibit 1, there is very little chance that they will change their behavior. Simply hounding employees to do better on pricing is not good enough. It is essential to make sure that pricing economics are ingrained in every employee.

Moving Forward

Virtually every employee wants to contribute to making the company more successful. However, if they don't know what helps profit and what hurts profit, there is no way they can act in the best interest of the firm. Too often they think they are helping when they are not. Firms need to spend more time and effort on driving profit understanding throughout the firm. There is no need to share every financial figure. There is a need to share the basic concepts.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Triple Your Profit!*** is available at: www.tripleyourprofitbook.com.

A Managerial Sidebar:
Unlinking Inbound and Outbound Prices

One area of continued pricing confusion, even among senior management, is the extent to which opportunistic buying should be converted to price reductions. The intuitive response is that if merchandise can be bought for 1.0% less than previously, then the selling price can be reduced by the same 1.0% with no negative profit impact.

The following exhibit demonstrates what actually happens to profits when a 5.0% price reduction (See Exhibit 1) accompanies a 5.0% reduction in cost of goods sold. The results are still disastrous as profit declines by 41.7%. Buying things more effectively should not necessarily lead to charging lower prices.

The Impact of a 5% Reduction
In Both Buying and Selling Prices

	Current Results	5% Price Reduction
Net Sales	$10,000,000	$9,500,000
Cost of Goods Sold	7,000,000	6,650,000
Gross Margin	3,000,000	2,850,000
Variable Expenses	500,000	475,000
Fixed Expenses	2,200,000	2,200,000
Total Expenses	2,700,000	2,675,000
Profit Before Taxes	$300,000	$175,000

Exhibit 1
The Impact of Price Cutting Under Two Scenarios
For the Typical DHI Member

Income Statement--$	Current Results	Scenario One	Scenario Two
Net Sales	$10,000,000	$9,500,000	$11,728,395
Cost of Goods Sold	7,000,000	7,000,000	8,641,975
Gross Margin	3,000,000	2,500,000	3,086,420
Variable Expenses	500,000	475,000	586,420
Fixed Expenses	2,200,000	2,200,000	2,200,000
Total Expenses	2,700,000	2,675,000	2,786,420
Profit Before Taxes	$300,000	-$175,000	$300,000
Change in Sales--%		-5.0%	17.3%
Change in Profit--%		-158.3%	0.0%
Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	70.0	73.7	73.7
Gross Margin	30.0	26.3	26.3
Variable Expenses	5.0	5.0	5.0
Fixed Expenses	22.0	23.2	18.8
Total Expenses	27.0	28.2	23.8
Profit Before Taxes	3.0	-1.8	2.6

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