Delivering Profitability

A Consultant's View

Chapter 5 - Financial Analysis as a Tool to Drive Profitability

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Financial Analysis as a Tool to Drive Profitability

It's not uncommon for a business manager or owner to perform well in many of the critical disciplines needed to succeed in business, but still fall short on making a profit or the income they need to survive. It's particularly frustrating for a small business owner who puts their heart and soul into their business. They see it grow with customers who love their service, but then their business fails (or nearly fails) because they are unable to pay themselves the income they require. Adding to the frustration is knowing they could earn that needed income working for someone else.

Financial analysis is an important topic that helps business managers and owners gain a deeper understanding of how their business is performing. It provides insights not available by looking at the bank statement, reviewing end of year tax statements, or reviewing corporate income statements. It represents a wide range of analyses useful in understanding different facets of the performance of the business. Examples of financial analysis may include: Income Statement Analysis, Cash Flow Analysis, Business Unit Profitability, Product Profitability, Customer Profitability, Geographic Profitability, Return on Investment (ROI) and Sales Force Analysis. Financial analysis and modeling typically includes a look at both revenue and expenses and provides management with insights that enable informed decision making. Individually and together, these insights can make a dramatic difference in the income of the business.

Financial Analysis - the Basics

The building blocks of financial analysis:

- ***Fixed Costs:*** Expenses which remain relatively stable over a wide range of output.
  Example: Expenses often considered overhead expense such as management cost, occupancy cost, furniture and equipment.
- ***Variable Costs:*** Expenses which change based upon the level of output.
  Example: Raw materials used in production.
- ***Semi variable, semi-fixed or step variable:*** Expenses which stay relatively stable over a range of production of products or services.
  Example: Labor used in production. A case in point: An ice cream store might be able to handle up to 40 customers an hour with one employee, but if they have more than 40 customers they might require 2 employees.
- ***Purchase price or capital required for purchase***

Types of data for useful or required for analysis

- ***Units of product or service produced; units of product sold***

- ***Number of customers***
- ***Demographic information about each customer such as location, and/or income (business or consumer)***
- ***Costs per unit for raw materials***
- ***Units of each material used to produce product or service***
- ***Sales and marketing costs***
- ***Activity time for each component of selling and delivering a product***
  Sales activity time
  Production activity
  Distribution or delivery

A common question from small business owners is: "What's the difference between financial analysis and the information prepared by my tax preparer?" Or sometimes the question is phrased: "My tax preparer provides me with a financial statement every year, but I can't use that to run my business. How do I get information that will help me understand how my business is performing and enables me to take actions which will improve net income?

The table below provides a comparison between a Financial Analysis and an Income Statement for Tax Purposes:

Financial Analysis & Profitability Analysis	Income Statement for Taxes
Internal Audience: Management	External Audience: Taxing Authorities
Useful for Decision Making • Business profitability • Customer segments • Product pricing • Capital decision making, investment decisions and allocation of resources	Necessary for correct tax payments; provides a standard view of income.
Understanding of components of business: • Business unit • Product • Customer • Geographic or local variances • Business challenges or opportunities	Understanding of overall performance for tax purposes: • Federal tax • State tax • Local tax
Goal: fairly represent how various products, services or investments / purchases are contributing to the overall well-being of the company.	Goal: minimize taxes by showing the minimum income allowed within the tax code.
Useful in making many management decisions such as allocation of resources to products, marketing, sales, when to hire etc.	Required to pay correct tax to taxing entity.
Guided by management accounting principles. The analysis is intended to provide management insights, therefore how the analysis is performed is often more of an art than a science.	Governed by the ever changing tax code. Audited financial statements are required to meet Generally Accepted Accounting Principles (GAAP).

While nearly all large businesses conduct financial analysis, it may be even more important for small businesses to do so. I love conducting this analysis for small business owners because in my experience the analysis always uncovers at least a few gemstones that have a huge positive impact on decisions, leading to a material improvement in the company's profitability.

Putting it into Practice

Using the building blocks outlined above, let's look at a product profitability analysis and then, based on that information, look at how product pricing might impact total profitability.

Questions --> Gathering Facts/Data --> Answering Questions --> New Questions

How can we increase income?

For this example we will use a fitness coaching business who offers one-on-one personal training and fitness coaching classes. Both classes are offered at the same location.

Gathering Facts/Data

Below is the high level overview of the income statement the accountant used for taxes.

Revenue	$220,000
Personnel Expense	$99,392
Other Business Expenses	$12,424
Facilities Expense (Club Lease, Utilities etc.)	$40,000
Business Insurance, Professional Services	$10,000
Marketing & Sales	$10,500
Equipment Maintenance and Depreciation	$16,000
Total Business Expenses	$188,316
Net Income	$31,684

Although this statement is useful in understanding overall business profitability, it fails to provide insight about which products are producing the most income or give information that enables the owner to make informed decisions about how to increase her income.

Drilling Deeper - Financial Analysis

	Fitness Coaching	**Classes**
Revenue	$112,200	107,800
• Price per 1 hour session per student	$51	$8.5
• Students per instructor	1	10 to 18
• Sessions/Classes per year	2,200 (8.5 per Day)	906 (3.5 per day

Variable Expenses	$87,700	$34,616
• Salary Per Instructor Per Hour (Instructors only paid per sessions led)	$32 * 2,200	$32 * 906
• Other business expenses (Instructor related expenses per hour such as taxes, payroll processing etc.)	$4 * 2,200	$4 * 906
• Marketing Expense Allocated based on Advertising of specific service	$8,500	$2,000
Contribution to Fixed Expense and Profitability = Revenue minus Variable Expenses	**$24,500**	**$73,814**
Gross Margin %	**22%**	**68%**
Fixed Expenses Allocated based on Revenue	Allocated based on revenue	Allocated based on revenue
• Facilities	$20,400	$19,600
• Business Insurance, Professional Services	$5,100	$4,900
Fixed Expenses directly attributable to the service	Coaching Equipment Expense	Class Equipment Expense
Maintenance and Depreciation Related to Coaching and Training Equipment	$15,000	$1,000
Total Fixed Expenses	$40,500	$25,500
Product Profitability: Total Profit = $31,684	($16,000)	$47,684

With this information the owner or business manager now has some meaningful financial information about each of the two products.

Answering Questions

What do we do with this information?

Following are some questions and answers which illustrate decision making that is supported by analysis:

1. **Should the business owner stop providing one-on-one fitness coaching?**
   a. **No.** If the owner discontinues fitness coaching the fixed expenses [Facilities and Professional ($25,500)] would fall upon the coaching classes. As a result, that product profit would decline to $22,184, assuming the equipment used for fitness coaching could be sold or disposed in such a way as to eliminate the equipment expense related to coaching. If that equipment could not be disposed of, profits would be anticipated to decline to $7,184.
2. **What changes might the owner consider to improve profitability?**
   a. The owner seems to be spending more to market the less profitable product. Since the margins are higher on the training classes, I might recommend that she focus more of her marketing efforts on the more profitable product. Assuming the same overall investment in marketing, the immediate impact

would be that the coaching product became less unprofitable and the training product would be slightly less profitable. However, if the shift in marketing efforts is effective, over time we would expect the owner to attract a more customers to classes which would increase total profitability.

b. The margin on coaching classes is too low. Salaries account for 71% of the revenue she is earning and appear to be too expensive in proportion to total coaching revenue. Unfortunately, knowing this does not make it an easy change. Typically once a salary is set, an employee naturally only expects it to increase, and will protest if the owner attempts to decrease it. The strategy in this case may be to offer new hires a lower rate and try to average the salary down over time.

   i. If the owner revises her salary policy for new hires such that they accept $20 an hour for one-on-one coaching, her average salary expense would decrease as well as related employment expenses of taxes etc.

   ii. Over the next 12 months if she lowers her average salary from $36 (including taxes etc.) to $27.5 for coaching, she would realize an $18,700 increase in profitability. $36 - $27.5 = $8.5 * 2,200 = $18,700.

   iii. The change in rate paid would make the coaching product minimally profitable $-16,000 (loss) + $18,700 (improvement in net income) = $2,700 profit.

c. The gross margin on the coaching product is low in comparison with the margin on the training. A question to ask: Is the product priced correctly? Research of local competitors showed that the market price per hour of coaching was $60 to $65 and also revealed that their most of their coaches were inexperienced. Therefore, the owner might comfortably increase prices to $60 or even $65 an hour, with $65 an hour based on the fact that her business employed highly trained coaches.

   i. What is the impact of increasing the price per hour from $52 to $60?

      1. Impact of Price Change: $52* 2,200 = $114,400 (current price). $60 * 2,200 = $132,000 (profit at new price provided there is no loss of customers.)

         Our fitness club client offered their current customers the opportunity to make an advance purchase at the old price. This allowed customers to lock in the old rate and increased the owner's current cash flow.

         The plan worked. She didn't lose a single customer as a result of the price increase.

      2. Increase of Net Income of $17,600 to ($31,684 + $17,600) = $49,284 (56% increase in profitability).

   ii. What is the impact of a $1 an hour increase in price on classes (from $8.5 to $9.5)?

      1. Impact of Price Change: $8.5 (price)* 14 (avg students) * 960 (classes per year) = $107,814 (current price). $9.5 * 14 * 906 = $120,498.

      2. Increase of Net Income of $12,684 to ($31,684 + $12,684) = $44,368 (40% increase in profitability).

iii. **Combined impact of price changes = $31,684 + $17,600 + $12,684 = $61,968 (96% increase in profit.)**

iv. **Why does a small change in pricing make a big change in net income?**

1. Price changes typically don't change fixed expenses or variable expenses. Therefore the full impact of the price change is realized on the bottom line.

Word of Caution: Price increases are not always the answer. Price increases work best when a product is priced at or below the competition for a similar quality of service or in cases where customers are not price sensitive.

Business Unit Profitability Analysis

Example: Product Profitability and Sales Force Profitability

We recently conducted a profitability review with a community bank that had an innovative business model heavily focused on purely commissioned sales people who sold a variety of non-banking financial products (insurance annuities etc.).

The first part of our analysis indicated the bank was earning enough revenue to cover their variable costs across all products. Further our sales force analytics indicated that the 3 year old team had not yet reached its potential. While the product was not yet covering all fixed (management, occupancy etc.) and variable expenses, our analysis indicated the break-even point was obtainable, provided that both fixed and semi-variable costs were tightly managed.

As a result of the study, the fully commissioned sales team was expanded. However, the team then requested additional space, which would result in an increased occupancy expense. Unmanaged, this significant expense could easily make the break-even point nearly unobtainable. The bank choose an more innovative approach and decided that all sales people would work from home offices, supplemented by virtual shared work sites offered by companies like Regus and the Intelligent Office. The solution was a win for all and the business unit soon generated profits.

While typically thought of as a larger company issue, many successful small business owners add a second, third or even more businesses once they have an established success in their first venture. As each new business is added, the complexity and importance of understanding the contribution of each to the whole becomes more important in guiding good decision making. Often a profitable business can hide an unprofitable business, which can also hide problems that could be resolved if the underlying profitability issues were known.

1. Small Business: Business Unit Profitability

A small business owner was running a DVD movie rental business that he and his partner had started many years before. A few years ago, they expanded and added what appeared to be a very successful coffee house and bar. Their main method of understanding profitability was to look at their checking account. If it had money, they believed they were profitable. When it was running low, they assumed profitability was low. With one checking account for both businesses and some real estate they managed on the side, this method produced a challenge because they were not clear which business was actually producing income.

For someone in a large corporate environment this story may sound far-fetched, but it's actually quite common among small businesses. When a business is just beginning, a business owner has a sense for every aspect of the business and often only pays themself when there are excess funds in their bank account. If the account runs dry they tap into their personal savings account to fund the business.

While there may be financial reports, the typical very small business owner doesn't have a financial staff, so reports may only be done on an annual basis. The bank account is updated with every deposit or withdrawal, so the owner soon becomes dependent on those figures to gauge their financial well-being.

Unfortunately, the bank statement doesn't identify which source of funds is the primary contributor, nor does it reveal which products and services are using the most resources.

For our DVD / Restaurant / Real Estate client, the restaurant was actually very profitable and came along just as the DVD business was beginning to fail. While the owners undoubtedly knew the restaurant was busy, it's success hid the magnitude of losses that were occurring in the DVD business as services like Netflix and Apple TV took away profitable customers. The DVD business had siphoned off $150,000 of profitability in the previous year, leaving the entire business at risk. Further complicating matters was the fact that real estate prices had declined, and while the rental income was still covering their monthly expenses, they no longer had significant equity. As a result, banks would no longer lend to them based on the value of those assets.

Fortunately, they were able to sell off the DVD assets and sell the retail location, stopping the losses. These changes allowed them to continue to operate as a small business and to reinvest in the restaurant. They were able to rebuild their profitability to over $250,000 a year.

2. Large Business: Business Unit Profitability

A division of a large manufacturer was profitable but the division couldn't seem to increase profitability. Upon deeper analysis of the business units within the division, it became clear that some of the units were using more scarce resources than their return merited. By reallocating capital and other resources to the units with higher margins and greater potential for growth, the business unit was able to significantly expand profitability, resulting in a major win for shareholders and the division's management team.

Cheap or Good: Geographic/Location/Branch/Channel Impact on Profitability

Location, location, location. Many business owners and managers are tempted to save expenses by renting a cheaper location, rather than pay the price for a prime location. For a consumer based business, this can quickly spell disaster. One of my clients, a premium pet food store business owner, moved from a moderately priced visible location in a busy mall to a very cheap location a block off the main street. To her disappointment, only a few of her customers followed her to the new location. The business never fully recovered and by the time she called for help, she didn't have the resources to relocate back to the mall.

Not only is the specific location of a business often a critical factor in its profitability and sales, but also variations between management style, geographic differences in customer preference, and variations in expenses and volume of purchase by location can all be important drivers in profitability. Likewise, traditional brick and mortar channels, telephone, internet, mobile devices etc. all typically have different cost structures, varying customer demand and often competitive pricing attributes. Two key considerations in channel include both customer demand / value of channel and also the channels cost or revenue characteristics. Each element of a business can be studied through financial analysis with an eye on understanding how changes can impact the bottom line.

Example: ATM Channel

As a classic channel example, banks took a high cost branch channel, introduced a lower cost ATM channel and then found customers demanded both. In the near term, this increased costs. However, over the long term, many banks have been able to reduce direct branch costs and added on non-customers as an ATM revenue source.

In a few exceptional cases banks have effectively used the ATM as a competitive differentiator to attract customers. For example, in the Mid-Atlantic States PNC teamed up with a convenience store (Wawa) to offer free ATM access. Free ATM access is a huge positive for customers, building good will and positive brand reputation for both Wawa and PNC.

When thinking about financial analysis, keep in mind that best practices include a regular review of all aspects of the business and an understanding how each aspect of the business contributes to the whole. In addition to a regular review of financial performance, deep analysis of specific attributes of business profitability can be useful to underscore issues and/or opportunities to improve profitability.

About ClarityFI

Clarity FI is a financial business management consulting firm offering Strategic and Financial Consulting, Part-time / Time Sharing Chief Financial Officer (CFO) Services and Financial Dashboards. We help organizations understand financial decisions and mine information and data to chart the clearest path to success. We partner with management to optimize customer experience, optimize product pricing, reduce costs, and engage employees and customers to produce tangible, achievable results. The bottom line? We want to help you increase income, save costs, and watch your profits soar.

About the Author

Mr. David Wagstaff has twenty years of leadership, financial management and consulting experience providing business insights, strategic financial analytics, and executive leadership.

He is the Managing Principal and Founder of Clarity FI, focusing on strategic financial management, CFO Services and financial dashboards, analysis and insights. He has experience working with companies that range from large Fortune 100 businesses to entrepreneurial start-ups. Previously, Mr. Wagstaff served as a Managing Consultant, Senior Manager, Enterprise Business Solutions. His corporate responsibilities have been well balanced with successful personal ventures.

Mr. Wagstaff earned his MBA from the University of Maryland, Smith School of Business in College Park, MD, with a concentration in Finance, Accounting and New Venture Creation. He earned his BS in Economics and Business Management from Ithaca College in Ithaca, NY. He is an outstanding member in his community as an active member of the social services organization having served on the Board of Directors and Executive Committee of the board at both Time Out Youth and Family Services of Montgomery County. He is also proud to have been a NJ Foster Parent.

He currently resides in Collingswood, New Jersey with his Partner. He enjoys hiking in the mountains, the beautiful scenery of nature, swimming, water and snow skiing and sailing.