Business Solutions

What is the Profit Equation℠?

The changing economy and the fickle stock market have forced businesses across all industries to take a closer look at their performance and the metrics by which they measure their success. Major corporations are spending millions on quantitative and qualitative, financial and non-financial indicators to benchmark and measure their way to newfound profits. Methodologies such as The Balanced Scorecard, Activity-Based Management and Open-Book Management are being implemented in Fortune 100 companies from coast to coast.

But what about the smaller businesses – those that can't afford a $300k consultant engagement to reshape their business performance metrics? Small business owners understand that they would certainly benefit from a broader perspective in managing their company, yet they also are faced with realistic financial restrictions. Their options are certainly more limited, but not entirely unavailable. As a small business owner, you can either hire a consultant or a CPA to help institute your optimal performance measurement strategy, or you can do it yourself. Either way, it is important to focus on *all* available metrics of measuring your company's performance in order to gather the information you need to make important decisions about the future of your business.

A big mistake that many companies make when measuring performance is to focus solely on the bottom line. While an excellent measurement of financial success, the bottom line is but one of many metrics that can be used to gather information on your business's performance. There are alternative scoring methodologies that can transform a reactionary management approach into a proactive, real-time empowering process.

Traditional thinking says that when it comes to *measuring* profit, you generally look at it this way: **Revenue - Expenses = Profit.**

However, when it comes to *improving* profit, you have to look at it somewhat differently. You need to look deeper into the activities that generate your revenue and drive your expenses. You need a perspective like this: **People x Process = Profit.**

This formula is called The Profit Equation℠ and it acknowledges that revenue and expenses are a function of people's behavior as they operate within a company's processes. The Profit Equation℠ recognizes that the key to business success lies in consistently leveraging both your people and your process to maximize the results you achieve.

You can see that there are a string of activities that drive The Profit Equation℠ formula. **People x Process = Profit**, translated into activities looks like this:

 # Existing - Lost Customers + New Customers Gained = Total Customers

x Frequency x Average $ = Gross Revenues - Cost of Goods - Overhead = Net Profit

The idea is that there are activities that are critical to the overall performance of a company – activities that can be measured and leveraged. The Profit Equation℠ creates a link between leading and lagging performance indicators. The lost opportunity lies in *not* measuring, managing and leveraging these areas of performance on a real-time basis. Once you truly have all the information you need to make critical decisions about your business, you can effect small incremental changes in key areas or activities that will have profound effects on the bottom line. The idea is not to just make one thing 100% better, but to make 100 things just 1% better.

In their book, *Transforming the Bottom Line*, Tony and Jeremy Hope discuss the oversight that most companies make by putting greater emphasis on financial indicators:

> To create the right framework for transformation, managers must think differently. They must redesign their management structures to focus on the customer, change the emphasis of their accounting and reward systems from one of control to one of improvement, and create a climate of trust and openness with the work force by developing common purposes and sharing information. Above all, they must challenge the primacy of their financial budgeting systems, and focus their efforts on improving products, services, and processes.

Ultimately, the goal is to create a link between activities and outcomes. That link, and the education inherent within it, creates an environment of empowered, knowledgeable employees who understand how their behavior impacts the financial outcomes of the company. The transparent, real-time feedback a performance measurement program provides gets everyone, from the janitor to the CEO, working in concert to achieve company goals.

For smaller businesses, the simple approach of measuring the following six indicators is a first step in the right direction: Customer Attrition Rate, Customer Acquisition Rate, Average Sale, Frequency of Contact, Cost of Goods and Overhead. These six indicators are a good starting point toward a balanced perspective on the company's performance that measuring Cost of Goods and Overhead alone could not achieve. By applying this simple measurement methodology, one Consulting Accountant helped her client reduce his annual advertising expenditure by over $250,000 without any reduction in effectiveness.

Much of the data you need to track these key indicators is already available to you. By simply setting up a "flash report" or "ScoreCard," you can provide yourself a guide by which to make day-to-day management decisions. Small businesses can benefit significantly from these enhanced performance measurements. By applying The Profit Equation℠ to your business, you will have the information you need to manage your company more effectively, empower your staff and grow your profits.