

How Much Profit Does the Company Make?

04/24/06

I started a new business last year. Now that the tax season is over I have a better idea what kind money I made my first year out. My revenue seemed so high, but now that I'm done paying taxes there is not much left to show for the year's results. What do I need to do to make next year come out better?

Paying taxes is only one of the bills a business owner must deal with. There are also bills for material and production costs, marketing, and sales efforts, salaries, plus overhead expenses such as rent, telephone, insurance, office supplies, furniture, computers and other equipment. Let's take a look at some rules you can use to help increase profitability, control expenses, and get the business where you want it to go.

Profit results directly from volume of sales plus mark up on goods and services delivered. When figuring out income and costs, don't confuse gross revenue and gross profit. Understand the difference between gross profit and net profit. And make sure that you have enough of both sales and profit margin to cover all your costs, with something left over.

Gross revenue is all of the income you bring in from sales. Gross profit is what's left over, after you pay for all materials and labor directly tied to production of your product or service, or cost of

goods sold (COGS). You need to have enough gross profit to be able to cover sales, marketing and overhead expenses, major investments, and owner's income needs. Net profit is what's left over after all of that. Net profit is typically used to pay off debt, pay for bonuses, taxes, and build reserves.

One mistake many companies make, especially service companies, is to not take the time to track materials and hours against jobs, goods produced, or services delivered. You need to know how many hours of labor, or how much material it takes to produce what you sell. Without that knowledge, it will be very difficult to predict and manage profitability as you grow.

Sometimes too much sales of the wrong product or service can do real harm. Many companies go out of business each year because they increase sales, without making enough profit on each sale. Simply put, they don't charge enough to be able to stay in business and grow for the long term. Save yourself from making that mistake by knowing your costs and having the guts to charge enough, so that you can make a real, substantial net profit.

If you aren't sure that you understand your costs, get someone to help you. It can be confusing, figuring out gross and net profit margins, and how much volume you need to make the net

income you want. Better to spend some money to get advice, than to jump into a black hole that you can't get out of.

Now let's take a look at the role controlling expenses plays in profitability. It goes without saying that you should have a computerized accounting system, starting day one. You can buy a basic system for less than \$200. Use that system to track expenses, build a budget, control spending. Complete monthly bank reconciliations keep records accurate.

In the first year of business, many owners spend too much, setting up the office. Something similar can happen when an established business makes a move into a new location. Develop a list of priorities, based on need, which you use to guide your spending as you grow. Limit purchases to what you can afford as you start out.

The easiest way to control spending is with a budget. Set limits on what you are willing to spend, and stick with it. Using a credit card to cover short falls can be a route to disaster. You burden the future of your business, by taking on the obligation of paying off your first year shortfall, and the cost of interest, sometime in the future. It is better to develop the discipline of holding the line on expenses, and learn to do without until you can truly afford it.

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One basic practice to implement is to reconcile your bank accounts and credit cards, against your accounting system, monthly. This will help you quickly spot fraud, and find expenses that were overlooked. Most accounting systems make it easy to reconcile statements, as long as you enter checks and payments throughout the month.

Owner compensation is one of the biggest expenses of most start up businesses, and one of the most challenging issues for most owners. Just because an owner needs a specific level of compensation, does not mean it will be available. As with all other expenses, owners need to learn to live within limits, in order to insure profitability of the business.

Most owners are paid a base salary, which is usually calculated depending on what the business can afford week to week. In the early days of the business, owners may dock their salary, if the business revenue falls short. They can make up the difference with bonuses when the business expands. What they cannot do is collect a salary, when paying that salary results in a negative net profit.

Keep the business healthy by leaving some of your profits in the business, to fuel future growth and development. You want to have reserves you can invest in capital improvements, as well as

sales and marketing programs. You want to be able to hire staff to help you expand. You will need to cover these costs until they can contribute to additional revenue and profit.

If the business encounters a shortfall, which 95% of all businesses do encounter from time to time, reserves will keep you going. Start with a goal of having 1 month of revenue in reserve. Then grow to 3 months of revenue in reserve, then 6 months.

If you cannot seem to get to the place where you have enough net profit to build reserves, you probably have one of three problems. You aren't charging enough, you are paying yourself too much, or you aren't controlling your expenses enough. Figure out where the problem lies (see above), and fix it quickly, so that you can get, and keep the business healthy.

When planning expenses, don't forget to calculate tax payments. Taxes are a sign of a healthy business, since taxes are calculated based on profits. There are three ways that a business can run into problems with taxes. Many owners don't calculate the cost of taxes when figuring out how much to charge for their products or service. As a result, they don't charge enough. Many businesses don't set aside money throughout the year, to cover the cost of tax payments.

Often business owners get to year end and decide to make a lot of extra purchases, in order to run up expenses and reduce their taxes.

All of these problems mean the business owner runs the risk of coming up short at tax time and having to scramble to cover a tax bill. When that happens, future plans get put on hold, while the focus is on taking care of last year's business. Instead, you want to make a weekly, or monthly, contribution to a reserve fund. Use that fund to cover future bills, including taxes and investments in growth. Give yourself the confidence to make decisions because you know the business has the money it needs to grow.

Having a plan of where you want to go with the business will help you get there. A budget is the financial description of your plan. A budget helps you to have your bottom line in mind when you are considering major expenses. You want to know when it might make more sense to postpone a major expense to another month, quarter or year, rather than strain the business to handle a cost it isn't ready to afford. Always measure major expenses by considering how long, and how big a return they are likely to produce. Focus on investments with shorter range payoffs, typically within 3 to 6 months, as you are starting out.



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Do consider hiring employees to do some of your work. It can free you up to sell and market your business, which is where you will get the most payoff. Your time is better spent moving the business forward than doing filing, errands and even bookkeeping. So long as you are the one doing everything in your business, you are its biggest inhibitor to growth. Look to have \$100,000 - \$150,000 in annual revenue / employee, including yourself. At the lower end of the range, hold off hiring. At the higher end of the range, think about bringing in part timers or sub contractors, until you are ready to hire your next full time employee.

Looking for a good book? Try the millionaire next door series, by Thomas Stanley.

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