Balance is a primary business strategy

Functions and resources must be kept in line

By Richard P. Morgan

As the owner or manager of a tire business, you have a lot on your plate every day. As you resolve one issue, another pops up to replace it. You generally have very little time to think strategically about your future moves.

Does all that sound familiar? I want to help you change how you act and react to such issues.

There are just a few basic factors, common to all businesses, which really count. If you stay on top of them, other dependent strategies and tactics, unique to your own business, will work better.

Three profitability factors

Three factors determine your break-even point and your level of profitability. They are:

1) Your level of sales revenue.
2) Your variable cost of products and services (cost of materials, direct labor, etc.).
3) Your fixed expenses (rent, insurance, utilities, administrative wages, etc.).

Track and work with the three factors properly and you can dramatically improve your bottom line. Unfortunately, left alone, all three factors affecting your profitability will go in the wrong direction. Your job, as owner or manager, is to actively manage and balance those factors to enhance results rather than let them set their own level.

I am getting ahead of myself. First, let us discuss a bit of scientific philosophy. I am a history buff, and I am addicted to early naval history. Here is an insight from Richard Woodman, the author of a historical naval fiction series:

"Everything everywhere is either passive in equilibrium, or else active in collision, in the process of transition ending again in balance and equilibrium."

You will hear similar thoughts in a physics class. Change is a constant. Events move, reach equilibrium for a time, then forces work to change again, creating new movement, reaching a new equilibrium at another point, better or worse than before.

Now, let us return to your business situation. Wouldn't your business be great if you could reach a profitable point of balance and keep it there for a long time? It seldom works that way, does it? Customers come and go, suppliers change products and prices, expenses increase, people retire or quit, etc.

My key point is this: A business that is seriously out of balance cannot sustain profits, growth, or customer satisfaction over the long term. Business management is all about coping with the myriad changes that inevitably occur.

When I see a company in a state of balance, I also find an organization with a firm foundation that is profitable and capable of maintaining its balance as it grows. When I find a company struggling just to survive, I usually see an organization that is out of balance one way or another.

To gain and maintain balance between the three break-even factors mentioned earlier, you must balance your functions and resources.

Functions:

• Marketing and sales.
• Finance and administration.
• Operations and distribution.

Resources:

• Physical resources (plant and equipment, inventory, etc.).
• Financial resources (cash, receivables, lines of credit, etc.).
• Human resources (capable people).

Give equal attention to the three primary functions of marketing, finance and operations. You also need to balance your physical resources with your financial resources and human resources to give your customers the outstanding satisfaction that they demand.

Common signs of business balance:

• Positive reputation in the community and industry.
• Sales well above break-even point.
• Healthy cash flow and a good bank relationship.
• Taking all worthwhile cash discounts.
• Low employee turnover.
• Above average inventory turns.
• Healthy accounts receivable and few bad debts.
• Assets well-maintained and adequate.
• Employee benefit plans in place.
• Growing customer base and few complaints or returns.

Continued on page 62...

Continued from page 60...

Out-of-balance situations:

- A lack of working capital to support growth.
- Poor cash flow.
- C.O.D. with major suppliers.
- Slow-moving inventory.
- Past due accounts receivable.
- Little or no money to promote the business or keep employee education up-to-date.
- Overloaded physical facilities and overworked employees who cannot properly handle customers, producing sloppy work, customer irritation and lost sales.
- Over-investment in facilities or employees without added marketing and sales effort also creates problems. Additional interest and depreciation expense or larger payroll cost kills the company's earlier operating profit.

You get the idea. Stressing one function or resource without consideration for the others creates imbalance, and imbalance soon leads to trouble. You stop moving up and begin moving out.

Corrective steps

Here are some immediate steps you can take to enhance your ability to cope with change and create greater profitability.

1. Obtain current financial statements. The first step is to find out where you are right now. If you do not have regular operating statements, you are really flying blind. A lack of up-to-date financial statements is a sure sign of trouble.

> A business that is seriously out of balance cannot sustain profits, growth or customer satisfaction over the long term.

2. Study your financial statements in detail. Get a clear picture of your sources of sales revenue along with your major costs and expenses. The usual accounting statements, prepared mostly for tax purposes, often mix variable costs and fixed expenses to a degree. You may need to reorganize your chart of accounts to properly reflect costs that vary with the volume of business versus expenses that remain about the same each period. Treating variable costs, like sales commissions or freight costs, as overhead expenses overstates both your gross margin and fixed expenses and skews your break-even point.
3. Use your operating statements as a real management tool. Financial statements are not just to satisfy the IRS. When you have a good breakdown of your variable costs and fixed expenses, you can see how changes affect your break-even point and profitability.

Continued on page 64...

Continued from page 62...

Here is a simplified example showing how to calculate current break-even and then track the interaction of sales, variable costs and fixed expenses (see chart below).

The beauty of using this break-even model in addition to your regular tax statement is that you can quickly predetermine the effects of a major business decision on your overall profitability.

For example, you might want to test a proposed decision to hire an additional sales person with a fixed salary of $36,000 plus T&E and benefits of $10,000, plus commission at 2% of additional sales. You expect the new person to generate $25,000 in added sales per month, or $300,000 annually. Using your assumptions, sales revenue increases to $3,300,000, variable costs increase by the same percentage of sales plus $6,000 and reach $1,986,000. Gross margin rises to $1,314,000 and your margin factor becomes slightly lower at 0.3982. Fixed expenses rise by $46,000 to allow for the new person's salary, T&E and benefits.

Based on your assumptions, hiring the new sales person will increase your bottom line by $68,060. Changing the sales assumption and re-computing based upon only half the new sales volume would show a positive effect of about $11,000, so the proposed decision appears to be a good one.

This break-even model equips owners and managers with a useful tool for projecting the effects of a decision on the bottom line before making the move. Use the same model to look at the benefits, the cost, and the effect on profitability of price changes, expanding physical facilities, buying new equipment, etc.

Little improvements or declines in each number dramatically impact your bottom line. As you work up your own break-even decision model, you will soon see that rather small percentage changes in the three factors, sales, variable costs and fixed expenses create much larger changes in your bottom line. If you continually make minor adjustments on a day-by-day basis, you will be amazed at the end result.

In the two brief examples above, the current operating profit improves by 34% on a 10% sales increase. The original profit percentage is 6.67%. The proposed case with a new sales person improves operating profit to 8.12%, a jump of 21.7%.

Consider the human element. Although there are only three factors that determine your level of profitability, there are an infinite number of strategies and tactical moves you can make to impact the various factors. That is where experience and management leadership makes the difference. It is wise to consider the people behind each of the numbers. Cost cutting that affects customer service and satisfaction may be "penny wise and pound foolish."

Additional marketing investment may reap rewards, but not if you overwhelm your resources and fail to handle customers promptly. Supplier relationships often affect your cost and availability of materials. Too few employees may affect both customer satisfaction and turnover. Too many people reduce productivity and gobble up profits. If you are experiencing a lot of "comebacks" on wheel alignments, you might want to estimate how a new alignment machine and up-to-date technician training would affect service productivity and customer satisfaction.

Decision model	Current situation	Add a sales person?
Sales revenue	**$3,000,000**	**$3,300,000**
Less: Cost of materials	**$1,000000**	**$1,100,000**
Direct labor and other variable costs	**$800,000**	**$886,000**
Total variable costs	**$1,800,000**	**$1,986,000**
Gross margin (sales revenue - total variable costs)	**$1,200,000**	**$1,314,000**
Gross margin factor (gross margin / sales revenue)	**0.4000**	**0.3982**
Total fixed expenses	**$1,000,000**	**$1,046,000**
Break-even point (total fixed expenses / gross margin factor)	**$2,500,000**	**$2,626,821**
Sales above or below break-even (sales revenue - break-even point)	**$500,000**	**$673,179**
Operating profit (sales above or below break-even x gross margin factor)	**$200,000**	**$268,060**

Peace of mind

Consider your personal peace of mind. When you have a good handle on operations, and when you are making sound business decisions, you will be able to gain and maintain good business balance. Running a balanced, profitable operation allows you more time to focus and think about long-term objectives for the business and about your personal goals. Today, can you honestly make these statements?

"I've got up-to-date business and personal plans in place to accomplish my specific goals."

"I've got all my bases covered. I've got peace of mind."

"I've balanced my business, personal, and family needs and obligations."

"I've taken care of the future for me, my family, and my employees."

If you cannot make these statements, I hope you will take a little time to try the business model that I have described. You will soon see how valuable it can be when you use the tool regularly to track the course of your business and consider ways to cope with and harness the many changes that inevitably occur. ■

About the author

Dick Morgan is a Certified Management Consultant. He founded Morgan Marketing Solutions Inc. in early 1989. Morgan has more than 32 years of tire and retread industry experience, working with manufacturers, retreaders and tire dealers.

He is the author of Marketing Facets, The Market-Focused Guide to Company Analysis, *a practical resource for those involved in determining the current health of a company and gauging its future prospects. He also speaks on marketing and management topics at industry conferences and for state and local business organizations. Contact Morgan at (972) 931-7993 or rpmorgan@morganmarketingsolutions.com.*