Business Performance Margin$_{SM}$

“Rethinking Net Profit”

An alternative look at managing margins and net profit

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Net Profit and Net Margins.

Ask just about any business leader to define "*Net Profit*" and he or she is likely to tell you that net profit is what is left when you subtract your expense from your revenue. And they would be right. Putting aside complex financial concepts for a moment like cash flows, earnings per share, ratios and the like, net profit is simply the difference between income and expense. And, ask them again to define *"Net Margins"* and the answer will probably be net profit divided by revenue. Pretty simple definitions, right? Well yes, but maybe too simple in today's dynamic and fast paced business world. In fact, there may be a better way to think about the entire concept of net margins and the bottom line. Let's take a closer look.

A closer look.

Okay, we defined net profit in very simple financial terms, the difference between revenue and expense. But let's talk a bit more about what this number represents. Well, first of all, it is a historical value that measures past performance. Albeit, most companies product timely financial statements using state-of-the-art software, the fact still remains that the results that are produced are a historical representation of what a company accomplished - - past tense. Secondly, this metric is a macro indicator based on some baseline assumptions, generally a budget, but this does not tell us the whole story. Third, in order to project or forecast the future, it likely has to be part of a larger sample of historical data. But does this additional data accurately reflect the realities of the market place now and in the future? And, finally, this so called "bottom line" number is simply part of a more complete set of numbers that have to be interpreted, analyzed and dissected to confirm what you probably knew all along in your gut. But, hey, accounting rules, accountants, lenders, regulators, etc., etc. make us go through this drill month after month after month. And we oblige them, over and over again, producing historical snap-shots of our business yesterday, last week, last month or last quarter and then talk about the results.

Similarly, net margin is the relationship of net income to revenue or sales. It is one of the key ratios we typically use to measures the final results of our Profit and Loss Statement and the overall financial health of our company. Some companies approach net margins in a very aggressive manner by managing their business activities to a specific target number. While this approach is commendable and likely appreciated by many of the shareholders, continuously compromising levels of service or sacrificing some form of continuity with the customer inevitably leads to problems.

What continuity you may ask? Well how about providing the customer with consistent levels of quality and customer care. Or what about the breath and levels of key inventory items the customer come to demand. Then there are delivery times or return handling policies that distinguish a good company from a great company. Many of our established customers become conditioned to certain levels of performance. They anticipate and expect timely product enhancements and new product development cycles. For many industries consistency in advertising, promotion and marketing dollars is also key.

When companies really cut to the bone we often see them cutting raw material costs, reformulating products to reduce quality, passing along repeated price increases or stripping away merit or bonus incentives to key employees. Worst of all, we see companies sacrificing invaluable human capital in the name of cost cutting. Human capital in the form of skilled labor, creative thinkers, resourceful problem solvers and gate keeps to invaluable corporate knowledge, the backbone behind most company's success.

Yet, in today's business climate, the latter is generally the first option and far too common place. The list goes on and on and so do the compromises we make to achieve a specific net margin but the results are often the same: higher customer dissatisfaction and turnover, an eroding customer base, eroding market share and eventually a dramatic drop in overall sales. And what is the cost of recouping from all of these losses? That is a topic for another day.

By and large, however, most companies typically view net margins as just another ratio or metric, the byproduct of producing another monthly P&L. A nice to know, but not a very useful statistic in managing a business. In either case the results are the same. We are actively thinking about the past rather than aggressively managing the future.

Business Performance Margin SM

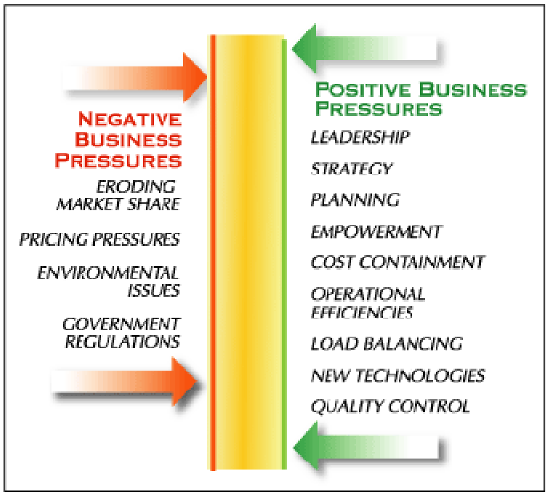


Figure 1

An alternative approach.

So what is the alternative? To borrow from a now famous campaign line, "it's the business, stupid." Just think about this, net profit is really a reflection of the business at hand. It is an important metric used to assess a company's overall financial health and sustainability. Operationally and practically it represents, in part, our abilities to effectively navigate under certain business constraints and the constant change and influences we experience within the market place. But more importantly it is a never ending balance between all of the positive and negative forces that influence the day-to-day performance of a business. Think of it as a safety cushion. And the better we manage this cushion, the more likely we can preserve or expand on our net profit.

What am I suggesting? What I am suggesting is that we begin to adopt a more aggressive and proactive approach toward managing this cushion or buffer between positive and negative business drivers. In essence we can and should begin to think about net profit more as a real time, dynamic and malleable part of a big money pump. A business function that has options and alternatives and something we can change as conditions may dictate.

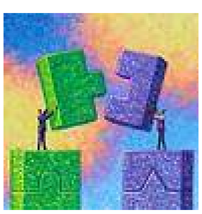
Take a look at figure 1. Think a moment about the negative forces that can directly impact net profit. They could easily include pricing pressure, eroding market share, regulatory constraints, raw material costs or just the general economic climate. Now think about the positive forces that we can control, that are in our reach and can counter many if not all of the negative drivers that eat at our bottom line. They are likely to include our own creative abilities to adapt to market conditions with new products or services in record time; our resourcefulness in seeking out new or undeveloped opportunities in untapped markets; our ability to adapt or leverage proprietary technology or other underutilized assets; constructively exploiting (yes I said exploiting) our own internal human talent pool and skills to plan, strategize and lead more effectively, or; the never ending cycle of optimizing overall operational elements within our business.

Said another way, it is the day-to-day process of balancing profitable ideas, untapped talent, and unbridled creativity with unsettled market conditions, fierce competition and other external pressures. The more effective we become at managing this buffer or *"Business Performance Margin"* (BPM), the greater the comfort zone we can create. And, the greater the BPM, the more likely we are to achieve consistent, if not higher, net profits. In effect we manage and maximize each individual dynamic of our business as aggressively as possible rather than wait to the end of a month to see if we came close to our desired financial objectives.

But shifting our focus or mode of operations to BPM is not just about business stability or achieving higher profits. Let's go back to my earlier comments. It really should be about creating and maintaining a stable business environment month after month that allows us to experience that all important consistency the client wants and expects. It is that consistency that stabilizes net profit and cash flows; it is that consistency that helps to offset the potential for creating a negative customer experiences, and; it is that consistency that lends itself to good old fashion organic growth.

What else is there to gain from this approach? Well, for one thing, we become better critical thinks. We are also likely to become much more resourceful when it comes time to identifying the root cause of a problem (or opportunity) and applying effective problem solving. Managing risk more effectively is also a likely outcome when we consider all of the pieces on the board. On the sales side, we are likely to identify customer needs much quicker, adapt faster to market demands and recognize opportunity before it passes us by. Internally, continuous process improvements and operational efficiencies become second nature and a natural way of life. And finally, it is about building a team, accepting each challenge head on with purpose and focus and achieving measurable results by empowering people. Ultimately our most valuable resources of all, our people, learn to manage, lead, problem solve and think outside the box.

Look for Alignment.



So far we have talked much about aggressively managing business at the tactically level. We have talked about leaping on opportunity and navigating adverse conditions. But if we remain truly responsible to our leadership position we also have to ask a bigger question. How does all of this fit together? Is there real synergy or alignment between our purpose, our people and our process? Fighting day-to-day battles is certainly important. But, it is equally important to step back periodically and ask if our strategic direction or purpose is consistent with are abilities or people and supported by our internal procedures and processes. Anything short is likely to place us at a disadvantage.

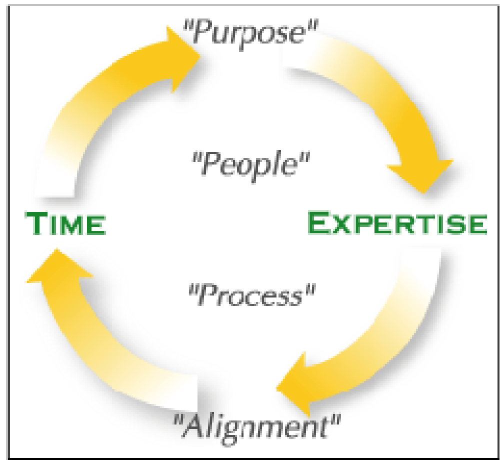


Figure 2

How many times have we seen *"The Wall Street Journal"* or the financial news channels report on some major multi-national corporation who just announced a staggering quarterly loss? Growth strategies that seemed like "winners" at the time were in reality inconsistent with the core business, stated growth objectives or the core competencies of the organization. From a resource standpoint, many companies employ an inordinate amount of "raw talent." But raw talent alone does not always get the job done. Given the right coaching, mentoring and professional development, often raw talent can mature into real talent. And real talent can turn lofty corporate goals and objectives into reality. And at the end of the long corporate food chain, process is what holds it all together. Process is what defines us and process is often the difference between success and failure.

So ask yourself this question. Are your overall strategic objectives consistent with your team and is your business rooted in best-in-class processes? If the answer is yes adapting to BPM should be easy.

Ferrara Consulting Group *is a Management Consulting firm, helping clients balance business strategy with tactical implementation.*

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