

Behind the Counter

Taking Advantage of Opportunities

It can be really exciting being an Entrepreneur especially if your idea is cutting edge technology or something totally unique. Some small business owners can be overwhelmed at all the opportunities that may become available for growth. Do we add that new product line? Do we add that new salesperson? Do we add that new equipment? How do we decide whether we can afford to go down a new direction with our business?

The answer is found by crunching numbers. First you need to know what expenses you would need to pay regardless of whether or not you have any sales. These expenses would be considered your fixed expenses or your overhead expenses. Then you need to know how much it costs you to generate your product, these would be your variable expenses also known as Cost of Goods Sold. Then the difference between your sale amount and your variable expenses is your gross margin on your product. You could divide this number by the number of items sold during the period you are analyzing to get a total margin per unit.

If you were to assume that your business was going to end at the end of the month, you could take a realistic look at your profits. So at month end make sure all your revenues and expenses have been entered into your accounting system. Then take a look at where you can trim the fat and make your business more efficient and develop a plan for achieving this result.

Usually with the fixed expenses, they are fixed, so there is not much room for change other than negotiating a better lease or a better insurance policy. Looking at the variable expenses, you would need to determine what your margin on your product/service or products/services would be. If you sell a product for \$100 and it costs you \$70 to make the product your profit is \$30 or 30%. If you have a number of products all with different profit margins, you would probably want to put more effort into the production and sale of the product with the highest profit margin and figure out ways to make the other products more profitable or get rid of that product line entirely. The other question to ask yourself is whether your product is priced competitively. If not, then that could be the reason why your profit margins are low.

When we look at expenses, some of us only consider if we have enough sales to cover the cost of the new expense, but we forget about the cost of producing the product and then we wonder how our cash flow got messed up. So to figure out if we can afford that new expense the following formula is handy.

“Amount of new sales needed = Annual Sales/Annual Gross Profit x New Expense”

For example: If you were considering hiring a salesperson at an annual salary of \$30,000 and currently your annual sales are \$150,000 and your annual profit margin is \$90,000. If we plug these numbers into the formula;

Amount of new sales needed = $150,000/90,000 \times 30,000 = \$50,000$

So in order to achieve the same level of profits, you would need to generate another \$50,000 in sales to cover this additional expense. So if you think this new salesperson would be able to generate these additional sales for you, then it makes sense to hire the new person.

What if you determine that you might only be able to increase your sales by \$25,000, you can use the same formula to figure out what you might be able to afford to pay the new salesperson.

$$\text{Salary} = 25,000 / (\$150,000/\$90,000) = \$15,000$$

In this case you would only be able to pay the new person \$15,000.

We can simplify this more by creating a profit multiplier. Assume that your fixed expenses are \$10,000 per month or \$120,000 per year, your annual sales are \$250,000 and your gross profit on your sales is \$150,000. The formula would be:

“Profit Multiplier = Annual Sales/(Annual gross profit – Net Profit)”

$$\text{Profit Multiplier} = \$250,000 / (150,000 - 30,000) = 2.08$$

Using percentages the formula would be $100\% / (60\% - 12\%) = 2.08$

What this means is that in order to cover your overhead expenses and make a 12% profit, you would need to make \$250,000 in sales (rounding is occurring, the actual number is 249,600). So you could now say that for each dollar of expense that you add, you need to generate \$2.08 in sales.

Of course these examples use numbers for annual sales, so what happens if you haven't been in business that long or if you are just working on a business plan? You can still use the formulas, but you will need to annualize your results. For example, if in 2 months your sales were \$20,000 you would take that number x (12/2) to get the annual sales amount of \$120,000. Usually a business plan is for an entire year, so you would just use the annual numbers from the plan.

All this number crunching can be overwhelming for the new Entrepreneur, but you could always ask your accountant to help you out with some business planning for the various expansion opportunities that may come your way.

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