Making the Most of Your Money

By Kelcey Thompson

Using proper pricing techniques to ensure profitability

True or false: Making more money is not as important as making the most of the money you have. The answer is true! If you are not profitable, making more money does not mean that you will become profitable; it means you are making more work—or, to look at it another way: You are buying yourself more work.

How do you make the most out of the revenue you are already generating? The simple answer is costs and expenses. Knowing your actual costs and reviewing your expenses weekly is the place to start.

Income Statements

Most of our clients already know their basic costs and expenses, and they have learned how to use their income statements to control their costs and expenses. This gives them the ability to be proactive in pricing, allowing for profit and growth.

To review, an income statement consists of:

- Revenue: income received from the sale of goods or services;
- Cost of goods sold: charges incurred that are directly related to the sale/production of your goods or services (parts, equipment, commissions, etc.);
- Gross profit: revenue minus the cost of goods sold;
- Expenses: overhead charges that are directly related to running your business (rent, salaries, office supplies, etc.); and
- Net profit: the gross profit minus expenses.

An income statement is a critical management tool. It shows you how much money you have made and where that money has gone. Management accounting takes the income statement one step further: It shows you how much you have made and spent in each department within your company.

Departmentalization

In the March issue of *Water Quality Products*, my article, “A New Era for Financials,” discussed departmentalization as a means of identifying the profit centers within your company (service, sales/installation, rentals, etc.), which then are used to classify your revenue, cost of goods sold and expenses. Departmentalizing means then affixing revenue, costs and expenses to a specific department. A departmentalized income statement allows you to take control of your costs and expenses, resulting in accountability for each department.

An income statement that is not departmentalized is like a map of the U.S. without any states or roads defined: You know it is the U.S., just like you know your company costs and expenses, but neither will tell you where you are or how to get where you want to go. Departmentalizing is your GPS.

The process starts with a comprehensive chart of accounts, which is a list of all accounts to which your money is allocated. There are different types of accounts—bank, fixed assets, liabilities, income, cost of goods sold and expenses are some examples. Verify that your accounts are assigned to the proper type—many companies lump everything into expenses instead of properly breaking them out into cost of goods sold. This practice has a direct effect on the gross profit.

The next step in the departmentalization process to is to define your departments—profit centers that are critical to the growth of your company. Service, sales/installation and rentals are examples of valid departments. Remember, products are not departments—they are commodities. This is where you find the leaders and the bleeders in your business.

Once departmentalization is complete, you will know the gross and net profits for each department. Instead of simply having an income statement, you will have a management tool—a complete map. This process is your link between knowing your actual costs and expenses, and making the most of your money.

Profit & Labor Pricing

Continuing to move through the process leading to profitability and growth, you must take control of your pricing structures for both products and labor, each of which requires its own strategy.

By referring to your departmentalized income statement, it is easy to determine your costs. Your predetermined profit margin percentage is the level of profitability you have set for your products and services. To calculate your retail price, add your costs to your predetermined profit margin percentage.

Labor pricing is a more in-depth process—it takes more time and effort to properly calculate. Labor pricing includes:

- Burdened labor costing: the sum of direct labor costs, associated indirect labor costs, vehicle costs and an adjusted percentage of overhead costs associated with your service technicians and vehicles;
- Direct billing efficiency percentage: the total billed hours of your direct labor employees divided by total hours worked; and
- Predetermined profit margin percentage: the level of profitability you have set for your products and services.

The pricing of products and services is a major component of your public image and is crucial to securing and keeping your customers. Having determined your cost/profit pricing, you then will need to perform a competitive position/valuation analysis. This analysis will provide you with the information needed to compare your pricing with current market pricing and the perceived value of your products and services by your customers. Any adjustments to pricing now can be made with full visibility of costs and the direct effect on profit.

When profitability is built into your pricing structure for both products and labor, you will make the most of the money you already have.

Another way to maintain your profitability is to adjust your prices in smaller increments more often. This allows for greater profitability and less resistance. A price increase of 1% to 2% can mean as much as an 11% increase in profitability, while making a minimal change in the overall pricing structure. This permits you to make changes more often to keep up with rising costs.

By dedicating your time and completing the work required, your products and services will be priced properly. Your departmentalized income statement enables you to track the profitability of each department. The gross and net profit for each department will show you the results of the changes you have implemented. Benchmark those results, and use those benchmarks to determine when the next price increase should be applied.

Now you understand the truth in the statement: Making more money is not as important as making the most of the money you have. Use your financials to make informed decisions to increase profitability and growth. Base your revenue generation on accurate costs and profit margins. Ensure that more work means more profit. *wqp*

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