

Product Margin

What Really Pays the Bills

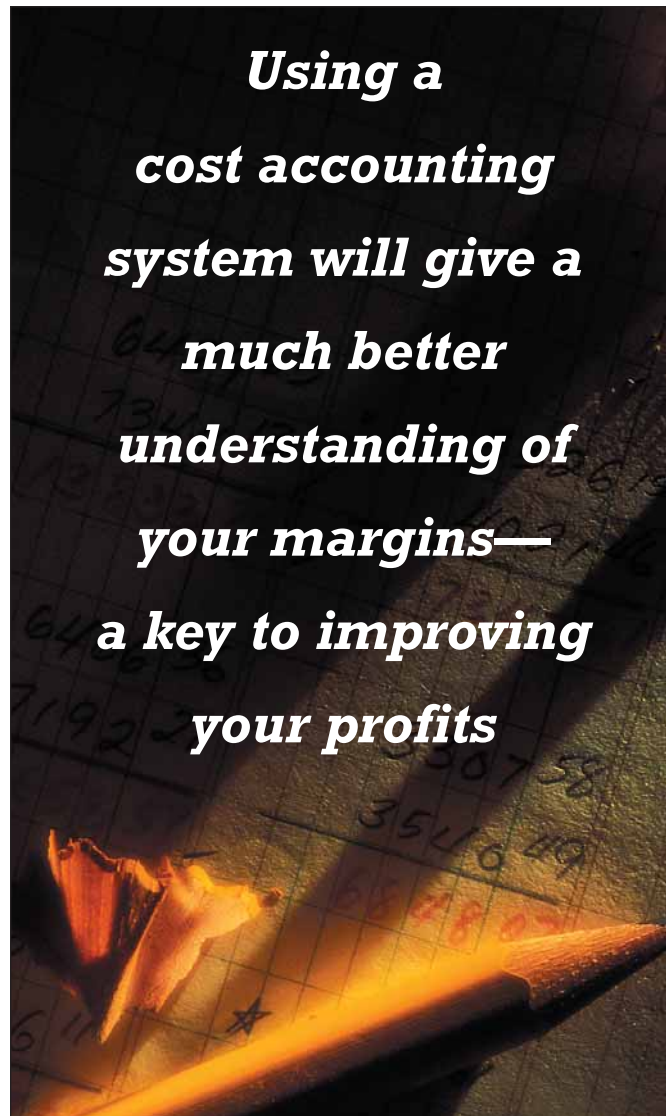
By Mike Hulser

With the implementation of a cost accounting system, you are able to enter a whole new world—the world of product margins. This gives you a whole new opportunity to increase profits. A solid understanding of your margins will give you a real opportunity to improve them, both on the cost side and on the selling price side.

Two to three percentage points of margin improvement go a long way toward maintaining and improving your bottom line. A management team that truly uses the outputs of a cost accounting system will be able to improve its financial performance a lot faster than one that does not.

For production framers, there are generally two types of applicable cost accounting systems:

- **Standard Cost**—Each raw material item has an assigned cost that is believed to be representative of the costs the company is currently paying for the materials (including any incoming transportation, which can add 10 percent or more). Similarly, labor operations have standard times and standard labor and burden rates assigned (burden rates includes both fixed



and variable elements). The differences between actual costs and standard costs are written off monthly to “variance.” Bills of material, which commonly include raw material waste factors, pull together the standard material and labor costs to formulate a standard cost for finished goods. Standard cost accounting systems have been around a long time.

- **Average Actual Cost**—For this cost system, the principal difference lies in raw material costs. Instead of assigned costs, most of these systems compute an average cost based on inputs (receiving). For example, if 10 of an item are already in inventory at \$10 each and 10 new ones are received at

\$10.50 each, a new average of \$10.25 is computed and all subsequent outputs will be at \$10.25 until there is new, additional receiving. Average actual cost accounting systems have been around about 20 years.

Either of these cost accounting systems will work just fine. The preference is generally driven by how comfortable an owner/management team is with a system.

One key point regarding the usage of cost accounting information: In addition to understanding the total cost (including fixed burdens, typically the cost of production facilities) of a product, it is important to under-

stand the “variable cost only,” particularly if you are evaluating a sizable “thin price” deal or attempting to make a solid “make versus buy” decision.

Sales, which often supplies the only data available to a production framer, does not “pay the bills.” Sales potentially provide margin, and margin is what truly pays the bills. Margin directly drives profit, the primary goal of being in business.

To do a quick review of the numbers, assume:

- Margin rates of 60 and 40 percent.
- Selling expense (commissions, payroll tax, benefits, and credit card discount expense) of 15 percent of sales.

	60% Margin	40% Margin
Sales	\$100	\$100
Margin	\$60	\$40
Selling Expense	\$15	\$15
Operating Profit	\$45	\$25
Oper. Profit % of Sales	45%	25%
Oper. Profit % of Margin	75%	62%
Selling Expense % of Margin	25%	38%

Look at the difference between a healthy 60 percent margin rate and a not-so-healthy 40 percent margin rate:

- The absolute dollars of profit are reduced by 44 percent (\$45 versus \$25) on the same \$100 of sales.
- You would have to sell 1.8 times as much at 40 percent margin to achieve the same amount of profit dollars as 60 percent margin.
- Profit as a percentage of sales is reduced by 20 points (45 versus 25 percent).
- Selling expense rises from 25 percent of margin to 38 percent of margin—in effect, more than 1.5 times as expensive.

The bottom line is that there is nothing like margin rate in terms of potentially dramatic impact of profit. So, you ought to have a high level of interest in margins, especially in these factors:

- What they are.
- Where they are and aren't.
- With whom they are and aren't.
- When they are and aren't.

What They Are

The old method of reporting cost of sales and margins is being blown away. Now a business can truly differentiate by buyer and by product line. For example:

- Most commercial business is done at pretty steep discounts. You have traditionally attempted to recognize this on an estimated basis. Now you will have the hard data available so you can make an informed decision.

- If you run a sale you will hopefully enjoy greater volume, but you will also see an impact (decrease) on the margin rate. Hopefully, you will realize a net gain in margin dollars.

Where They Are and Aren't

You need to understand how margin rates compare for one product versus another, where you are relatively strong, and where you are perhaps relatively weak. This will give you a management tool for guiding your customers in what they buy.

With Whom They Are and Aren't

You may know sales by salesperson, but that doesn't mean you know margin and margin rate by salesperson. There is a fair chance that margin rates by salesperson will not be similar. Again, this data gives you an additional opportunity to improve your margin rates and profits.

To do this analysis effectively, you need to understand what each salesperson is selling and how they are discounting. That way you will know whether you have a “mix issue” or a “method issue.”

It is commonplace in industrial businesses to pay sales commissions based on margins, not sales. You will now be able to do that. It is guaranteed that the behavior of your salespeople will change.

When They Are and Aren't

Lastly, here are a few actions you can take to actually improve your margins:

- Negotiate lower raw material prices with your current or new suppliers.
- Via negotiations with carriers and/or better carrier loading, lower your incoming transportation factor.
- Reduce your material waste during the production process.
- Improve the efficiency of your production work force.
- Raise your selling prices.
- Improve your sales mix, from lower margin to higher.
- Pay your salespeople on margins, not sales.
- Increase your sales volume and reduce your fixed burden factor.

This concept applies to both sales and margin. Modern systems give you great reporting capability as to when sales (and therefore margin) occur by hour and by day. You can then make better decisions as to “who should work when” to maximize sales, margins, and profits. ■

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