

Profit Improvement by Unlinking Cost and Selling Prices

In a previous article we made the point that it is increasingly difficult to generate the profitability we need to satisfy the investment community, and continue to attract the type of people and managers who will continue to build manufacturing in the USA.

This article will deal with the fundamental analysis of Costs, Profits, and Selling Prices. We will see that forces outside the organization set real selling prices, and outside forces, such as banks and investors, determine minimum profit requirements.

First. Let's take a look at profit. The formula for profit is deceptively simple. I hope I do not bore you.

$$\text{Profits} = \text{Selling Prices} - \text{Costs}$$

Encapsulated in this formula are the three simple ingredients that I will cover in detail in this article. These three major topics will serve as the backbone for our rethinking and changing our industry. Hopefully, with a return to the profitability we have known.

We know from basic math, we can say:

$$\text{Selling Price} - \text{Profit} = \text{Costs}$$

Or we could say Costs must be \leq Selling Price - Profits

Now in my career, I have seen formula developed to set a selling price which range from the sublime to the ridiculous. In general the formulas revolve around the idea of taking the estimated direct labor cost and multiplying them by a percentage that varies from 100% to 200+% to get the overhead cost, then adding the materials cost estimate to arrive at a basic cost. Then some divisor is then used such as 0.15 to determine the "Selling Price" for the product. The general formula looks like:

$$\text{Sales Price} = \frac{(\text{Direct Labor} + \text{Direct Labor} \times 1.?) + \text{Materials Cost}}{0.??}$$

The problem is that this formula can only determine the minimum price a product will be offered for sale. And, even with this formula, the premise is very wrong.

The absolute fact is that a Selling Price of a product is not dependent on the manufacturer's cost of producing a product. Nor, do Selling Prices depend on the price a manufacturer sets on a product. Normally, that price is where negotiations begin.

The manufacturing company will sell the product, the real Sales Price, for an amount an

experienced buyer and experienced seller agree is a fair price. This real Sales Price will take into account the value, perceived by the buyer, contained in the vessel we call a product. The perception of the value of the product is caused by the ability of manufacturers marketing and sales arm to develop, communicate, and advertise the features and benefits the product offers. The better their effort, the higher the Selling Price and the higher the potential profits.

The value of a product to a retail buyer is a function of the retailer's **TOTAL** cost to rapidly get the product into the hands of a satisfied end user. This value to the retail buyer might include the customer coming in the retail store presold through the manufacturer's advertisement on a particular product, the product being readily or rapidly available in the configuration desired, the product being delivered to the end user 'cross dock' with our any damages or problems, and the customer being satisfied with the purchase so they do not return it..

If both the experienced buyer and the experienced seller have researched the market, they know that a certain normal product, with a standard configuration, will retail for X amount of dollars. They know that this product will wholesale for Y amount of dollars. This retail and wholesale price will have comparable features to others in the marketplace such as: a given features, given utility, and certain perceptions obtained from advertising, and, from others, experiences in using the product. Unless the seller can prove to the buyer, that the product has features exceeding what the normal standard product is worth, and the buyer can convince the end user the features and benefits exceed the normal value, the standard competitive value, the Selling Price, will prevail.

Fundamentally, *a product is worth what it is perceived to be worth*. You might set a wholesale price on a sofa for \$750. Until the retailer buys the product, at the quantity you desire, for \$750, the true value is \$0.00. If the retailer can not convince the customer a product is of a certain value, the retailer will take a mark down until value is perceived by the retail customer, and the product is purchased.

In many, instances, the product is sold by an inexperienced or unprofessional seller for less than its worth. Often, I have witnessed a lazy unprofessional manufacturing seller, who has not taken the time to do their homework in the marketplace, say "Well, our raw cost is \$140. We use a 70 divisors which means we will sell this for \$199.95." What if the quality, the look, the design, the fabric/design combination (perceived features and benefits) would have brought \$250 for a \$499 retail? The manufacturer would have picked up \$50 and the retailer would have picked up \$100 on the product. Who won? The end user won. The end user did not even know they won because no one told them what an excellent value they received for their money. The end user was never sold on the real features and benefits of the product.

To make matters worse, an enterprising person in manufacturing discovers a way to take \$15 out of raw costs in the product while maintaining the features and benefits. The unprofessional seller's conversation becomes, "Wow, \$15 out of costs! Now, let's see \$140 Minus \$15 is \$125. We use the 70 divisors and we can sell the product for \$179.95." No one does the math. $\$199.95 - \$179.95 = \$20.00$. Not only did the unprofessional manufacturing seller simply give away the

potential additional profit of \$15.00 coming from manufacturing's cost reduction, an additional \$5.00 was simply thrown away for no good reason.

That \$5.00 came out of what you had built in the cost to cover your overhead and profit (cost of capital). If your overhead is fixed, to a certain extent, were you able to reduce the overhead by \$5.00 because of a reduction in plant costs? I doubt it. That means you had \$5.00 less profit on each sale of that product. That is the main reason productivity increases and cost reduction in industry seldom benefit the shareholders of the business.

I realize many readers of this magazine are not large "sophisticated" manufacturers. However, this idea applies even to my friends in a reupholstering business. A potential customer asks that you quote a reupholstering job. You take the fabric cost times three and quote the job. What if the buyer is willing to pay two or three times that amount for that job because this is a family heirloom which they want to keep? You just lost good profit.

Step one, in our drive to improve your profitability, is that the professional seller does not need to know, nor should ever be told, what the product costs to produce. In fact, no one knows with a degree of certainty what the product costs to produce anyway, until they have produced it. To demonstrate this concept, let's say your daily fixed cost is \$500. If you produce 10 units one day and 12 units the next, the actual costs will be different.

The professional seller should be involved in the development of the product and be assured the features, requested by the market, are built into the product. In addition, the professional seller must have researched the market, and brought back the price the market will pay for that product. The professional seller must also bring back an expected number of units of that product which will be sold in a certain period, given the pricing the market indicated it would pay.

In a quarterly budget meeting, a professional Sales Manager/ Marketing Manager should come to the meeting and request funding for new products. A new product is expensive to design, engineer, and prepare to produce. Thus, a new product should have the same requirements as any new asset. The truly professional Sales Manager should say, "We plan to sell x number of this new product to the following buyers, with these features, at a selling price of x dollars. We plan to spend x dollars in promotion of this new product during the following 18 months."

With this information, the Operations Manager in cooperation with the Finance Manager must determine, given the units expected to be produced and the time frame the units are to be produced, whether or not the selling price is adequate. If the selling price is not adequate, the features must be reduced, and/or the product constructed at a lower cost, and/or more products sold in a given period, or the product dropped from consideration.

In your organization, who set the prices for your product?

Who sets the estimated costs for the product?

Who has access to those estimated costs?

How are the estimated costs set? Based on what level of contiguous production are they set?

How many of the same products can you build contiguously based on the scheduling, sales, and delivery promises?

Who is the gate keeper who decides whether a product will be sold and produced by your company?

If you are the owner, and are also acting as the Marketing Manager, do you set the price on what the market is willing to pay you for the product? Or, do you use a divisor, and throw the product against the wall to “see what sticks?”

Do you throw products out to the market to see what sells? Or, do you know where a specific niche is in the market, and position a product to fit that niche? Are your marketing people professional?

Now that we have made a point that the market determines the selling prices, we will look at how the investment community decides the acceptable level of your profit.

A few people have told me that profit is what is left over from sales after they take out expenses. Certainly, that is one way of looking at profits. This type of thinking produces what we might call these profits ‘reactive profit’. The profits are unmanaged. (Yeah, I know you will take them any way you can get them.) They just happen, or in many cases, don’t happen.

You have shareholders, bankers, employees, or a spouse who have an investment in the company, they are very interested in profits. They do not necessarily care what your expenses are or have been. They only want a fair return on their investment. The investment can be in dollars, sacrifices, or labor. No matter, the investors want, expect, and are due a fair return for whatever they invested in the business. Your employees know profits mean job security, bonuses, and wage increases.

Your shareholders want to see a percentage of their investment returned as either dividends or/ and improvement in the share value. If you are a small business in a no growth market, the investors should expect 12 to 14 percent return on total invested assets - just for risk. Add four to seven percent for the cost of T Bills, and the total percentage may approach a 20+% return. Thus if they have \$100,000 invested, they rightfully should expect a return on the assets of \$20,000 after the company’s taxes and interest.

Your banker will talk to you about debt coverage ratios. If you have a loan of \$100,000, your banker wants to see about 150% debt coverage. In other words, your banker expects a

conservative value of the assets pledged for the debt to be 1.5 times the debt. The banker also wants to see profits grow, and profits growing consistently.

When your business year is budgeted, you guess the number of products you will produce in a given period, say a month. From the expectations of your investors, you know the profit required to obtain the expected return on the assets of the company. Divide the pieces expected to be produced into the profits mandated. This tells you what minimum profit you must have costed into a product. If you know what profits you must have, and you know what the maximum selling price the market will pay you for a product, you have the first two areas of the equation.

$$\begin{array}{r} \text{Selling Price(Determined by the market)} \\ - \text{Profits(Known and budgeted)} \\ = \\ \underline{\underline{\text{Cost to operate the business, produce, pack, and ship the product.}}} \end{array}$$

By now, you might want to take issue with me. You might want to tell me that talking about setting selling prices and setting profits is hardly step one. You will tell me that step one must be reduction in costs in the plant. “You need to ‘reengineer’ the plant. That is where we are losing money!” In fact, it could be possible that your Sales/Marketing arm has done a lousy job of getting the buyer excited enough about your product that a premium would be paid that would improve profits if cost were to remain constant.

Well, cost reduction in a plant is important, and I assure you we will cover this in depth later. However, if you look at the big picture, the materials used in a product over the past years have dropped in quantity or in type. Some will justifiably argue that they have dropped in quality also. The direct labor hours, in producing a product over the past several years, have declined, if we strictly compare apples and apples. In 1984 the direct labor, on the average for upholstered products, was about 15.5% of sales. In 1994, the ratio had dropped to about 13.5%. It has continued its decline to the 10% range. Arguably, some of this decline is due to price increases.

Assume the cost of labor has increased with your selling prices. This means the labor hour content of the products has declined. In man-hour studies, I have seen a drop in the time required to build a product.

If material usage has remained constant, and direct labor has declined, than we can only assume that we have failed, as an industry, to control our administrative, overhead, and selling expenses. We have also failed to get full value in the marketplace for our products. These are the expenses that are also out of control and are robbing the shareholders of their earnings on their investment.

The first two parts of the equation, profit mandates by your shareholders and selling prices, are not able to be controlled by manufacturing personnel. Costs to sell the products, costs to administer the organization, costs of communication, costs of logistics (delivery, warehousing,

and receiving raw materials), and costs of production are manageable aspects which you can control. I say you, no matter what function you serve in your company, it is your responsibility not only to control, but continuously reduce costs in your company.

It is up to you to change or reengineer your organization. You must continuously research and find market niches you can rapidly exploit for improved profit potential. You must continue to add value to your products in the eyes of your customers. You must continuously find “Better, Faster, more Cost Effective” methods to yield true profits.

In future articles, you and I will look at controlling and reducing those costs you can control.

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