9 Profit multiplier profile

Using CVP analysis to improve profit

In Chapter 8, we saw how to use CVP analysis techniques for routine planning, control and business decision-making through flexible budgets and flexible budget applications.

Now, as indicated in Figure 5.1 *Profit Planning Framework*, we can again benefit from the ripple effect of dropping a stone into water – analysing cost behaviour – by applying CVP techniques to develop an approach to profit improvement.

How can we improve our profit position? What multiplies profit? Should we aim to increase sales or cut costs, or what? These are the questions managers constantly ask themselves in a bid to maintain or improve their profit position.

What influences (multiplies) profit

During the process of profit planning and preparing annual projections, we routinely review strategies for business development opportunities, an important aspect of which is to enhance profits. If, for example, our objective is to improve on the current year's profit, we can consider a number of basic options, such as:

- Raising selling prices
- Increasing sales volume
- Manipulating business mix
- Reducing costs

Clearly, we could consider one or a combination of these options. However, the question is, if we increase revenue and/or reduce costs, will profit increase and, if so, by how much? We may have an intuitive feeling that profits will increase or decrease, but often we have no real idea about the likely amount of the change.

Over a period of time, we can sometimes subconsciously acquire inbuilt prejudices as to which factors have a greater or lesser effect on profit and, therefore, never take the time to determine if this is in fact the case. Alternatively, we may have an impression of how certain factors affected profit in a previous organisation and assume it is the same for other similar undertakings.

One of the constraints to optimising profit is the notion that experience implies efficiency. Managers' experience is vital and valuable in the commercial world, but experience does not, in itself, guarantee informed decision-making. On the contrary, those who argue their claims on the experience platform alone exemplify a misinformed and dangerous arrogance, often rooted in ignorance. This can be particularly so in the area of enhancing profits and profitability. The idea of 'Don't tell me about profitability, I know what drives profit – I've been a manager for twenty years!!' is frequently open to question.

Let us imagine we are sitting in on a budget committee meeting of a hotel property. We hear, amongst other things, the following comments:

General manager 'Our target for the following year is to increase our net profit by 10%'.

Revenue manager: 'Quite clearly, if we want to increase our net profit by 10% we need to increase our sales revenue by 10%'.

F&B manager: 'Food and beverage costs are likely to increase by 5% next year. If my department is to make the same contribution to the profits of the hotel, we must increase all food and drink prices by 5%.'

Front office manager: 'Surely, the easiest way to increase the net profit is to decrease all expenditure by 10%'.

General manager: 'Ladies and Gentlemen, the problem is yours. I don't care whether you raise your prices by 10% or increase the physical volume of business by 10% or cut costs by 10%. This coming year we've got to end up with an increase in our net profit of 10%!'

From the statements made by members of the budget committee it becomes apparent they have little understanding of how profit is influenced by changes in the level of revenue and costs. However, whilst we may ridicule the hotel team's poor knowledge of revenue-cost-profit relationships, would we know any better in the same situation?

Common business sense dictates that various changes in revenue and costs are not generally likely to result in neat and tidy proportionate changes in profit. In order to gain real insights into how changes in revenue and cost affect profit, we can reduce the reactive (subjective) responses by taking a more measured approach to provide better informed decisions.

Key factors affecting profit

If we are to objectively embark on a profit improvement programme, a priority is to determine the influence various key factors exert on the profit of a business. An important first step is to identify the key factors present in the particular business under review and determine the extent to which each factor affects profit. We can then begin to build a clearer picture of the factors which have the greatest influence on our profit and frame profit improvement decisions accordingly.

Most organisations have similar key factors regardless of the kind of products and services they provide. Figure 9.1 illustrates examples of key factors relating to a hotel property.

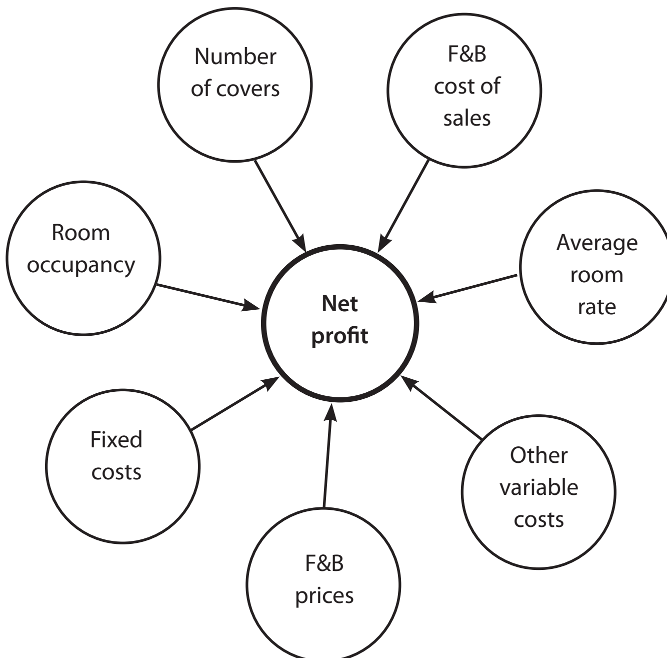

Figure 9.1: Examples of key factors affecting hotel net profit

Since profit is the outcome of revenue and expenses we can turn to the profit and loss statement to identify the key factors. For instance, Figure 9.1 shows examples of key factors present in a hotel business. Notice, room occupancy, average room rate, number of covers and food & beverage prices are revenue factors, whilst food & beverage cost of sales, other variable and fixed costs are expense factors. Once we have identified the key factors, the next step is to determine the influence the key factors have on profit.