# How to increase profit

## Four profit determining factors

- price,
- volume,
- variable costs and
- fixed costs.

You can increase profitability by either increasing or decreasing any of the four factors if the required conditions are met.

| ***Factor*** | ***Possible action*** | ***Required conditions*** |
|---|---|---|
| Price | Increase | Either no change in sales volume or if sales volume declines, the decline is more than offset by the increase in price so that the total revenue is still increased. |
| | Decrease | Sales volume increases sufficiently to compensate for the decline in price and/or new customers are won who will be retained in the future as and when price is increased to normal. |
| Variable costs | Increase | No change in product or service quality could affect sales. Improvement in product or service quality allows a higher price to be charged which is both accepted by the market and sufficient to offset the higher variable cost. |
| | Decrease | Indicates fewer goods sold. If variable costs decrease, while maintaining product or service quality and volume sold, profitability increases. |
| Sales volume | Increase | Price remains constant so the increase in volume translates into higher gross profit. |
| | Decrease | A saving in fixed costs is achieved by reducing the size of the business and the saving is greater than the reduction in gross profit. |
| Fixed costs | Increase | Sales may increase through better service delivery by an amount which is sufficient to compensate for the increase in fixed costs. |
| | Decrease | Sales may remain unchanged or if they decline the fall in gross profit is less than the decline in fixed costs. |

## Profit improvement strategy

When you look at the four profit determining factors, the first thing to notice is that no single factor can be considered in isolation without considering its impact on the others.

The second thing to remember is that a profit improvement strategy may involve either an increase or a decrease in each of the four factors. There is no standard success formula. it depends entirely on specific circumstances and the relative strengths and weaknesses or your business.

The third thing to notice is that a favourable change in price and/or your variable costs will improve your gross margin per dollar of sales. Whereas a favourable change in your sales volume and/or your fixed costs will indicate greater productivity. That is, the overheads you incur in running your business are lower per dollar of sales.

In other words, any profit improvement strategy must focus on either (or both) of two things:

1. Achieving a higher gross margin per dollar of sales by increasing price and/or reducing variable costs and/or
2. Achieving greater sales per dollar of fixed costs by increasing the productivity of those things which have a fixed cost.

## For example

Let's consider the profit improvement potential that would arise from a modest improvement in each of the four factors. We'll assume a 5% improvement in each of the four factors.

| **Factor** | | **Base** | **Change ↓** | **Change ↑** | **Result** |
|---|---|---|---|---|---|
| Price | | 100 | | 5% increase | $105 |
| Sales Volume | | 100 | | 5% increase | 105 |
| Total Revenue | | 10,000 | | | $11,025 |
| Variable Cost | (100 × $60) | 6,000 | 5% decrease | (105 @ $57) | $5,985 |
| Gross Margin | | 4,000 | | | $5,040 |
| Fixed Costs | | 3,000 | 5% decrease | | $2,850 |
| Net Profit | | $1,000 | | | $2,190 |

A 5% favourable change in each of the four factors without a consequential unfavourable impact on each of the other three would more than double your profit from $1000 to $2,190. This is a 119% improvement.

## Get the little things right

You may question the assumption that there are no consequential impacts. However, small improvements made to each of the four factors that determine your profit will combine to give a greater overall impact.

And, of course, the reverse is also true. If you discount your price, allow your sales volume to fall, fail to control your overhead costs and let your variable costs get away from you then you can destroy a potentially profitable business. This can happen very quickly.

It's all to do with leverage and this is what brings so many people unstuck. If you get all the little things right, the big picture looks after itself (with this example anyway). But if you get all the little things wrong, you're going to be in real trouble and it's likely you'll never know why.

## Developing a profit improvement strategy

To improve your profitability, you can either make a larger gross margin on each dollar of sales or sell more without increasing your fixed costs. The biggest improvement will occur if you can achieve both simultaneously.