

# Profit Engineering for Small Businesses

By Jerry P. Sims

Now that many businesses have ended their calendar year and are preparing for tax reporting, it is an excellent time to evaluate last year's performance and define areas needing improvement. As the economy tends to drift along at a sluggish pace, most businesses need to sharpen planning skills and develop a strategy that will deliver desired results at the end of this year.

To begin, let's look at the Income Statement for this past year and focus on Income from Operations (may be referred to as Net Profit or Earnings before Taxes). Do the earnings represent what the business should be doing? What should earnings for this past year amount to? What should earnings be for this current year? Write it down to the right of last year's Income from Operations (Net Profit or Earnings before Taxes are all terms for the same thing, i.e., what we made or lost before taxes).

Next, let's look at Operating Expenses. As we look over Operating Expenses for last year, what expenses can we reduce or eliminate? What expenses must increase? Write this year's expenses down to the right and total.

Now focus in on Gross Profit for last year. Add your Income from Operations figure you wrote down for this year with this year's Total Operating Expense figure you calculated. Write the sum to the right of last year's Gross Profit. This total is Gross Profit Dollars you must plan to bring in this year to meet your Income from Operations objective. What percent of Net Sales did last year's Gross Profit represent? (Divide last year's Gross Profit by Net Sales.) Is this reasonable and consistent with your market and competition? What should this percentage figure be and how does it compare to last year? If last year's percent is lower than what it should be, what can you do this year to improve it? There may be no simple answer to this; however, simply put, to improve Gross Margin percentage, we must increase Sales (while keeping Cost of Goods Sold the same) or reduce Cost of Goods or Services Sold, or some combination of both. Take the Gross Profit percent that should be applicable and reasonable for your business and write it down to the right of the Gross Profit dollars figure for this year that you calculated previously.

Now divide your Gross Profit dollars by your Gross Profit percentage (remember to convert your percentage to a decimal to do the calculation). Your answer is the Sales objective you must achieve this year, and your Cost of Goods is the difference between Sales and Gross Profit dollars. Look over your Cost of Goods; does this seem reasonable and obtainable? If not, lower your Gross Profit percent and recalculate. Notice as we lower Gross Profit percent, sales increase. Also notice the Gross Profit dollars remain the same. We must have this to cover our operating expenses and realize our Income from Operations objective. Fine tune until you are comfortable with the numbers and settle on a reasonable and obtainable Sales objective for the year.

With the Sales objective set, we must now develop the marketing plan that will bring in the Sales numbers we need to realize our profit objective. As we go through the year, we must track our performance to make sure we are on target and take corrective action where needed. The best way to approach this is to spread the sales forecast into months along with budgeted cost of goods and operating

expenses. As each month comes to a close, measure the forecast budget with what was actually achieved. Major variances in the comparison will point to areas needing management attention.

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## *Business Sense*

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For assistance in developing and perfecting this process at no charge, call The University of Georgia Small Business Development Center nearest you. You can find a listing of offices on the Internet at [www.sbdc.uga.edu](http://www.sbdc.uga.edu).

*Jerry Sims is a business consultant in the Dalton office of the Georgia SBDC Network. To find your local SBDC, call the state office at 706-542-2762 or locate it on the web at [www.sbdc.uga.edu](http://www.sbdc.uga.edu).*