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The Story of a Businessperson Who Lost His Way by Looking at the Wrong Measure of Performance

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It is unfortunate, but true, that financial reports prepared for tax or compliance purposes do not provide information needed to successfully manage a business.

All successful businesses have management information systems (MIS) in place that provide the manager with information that is both relevant and timely. To be effective, your MIS should tell you exactly what is happening in your business and do so quickly enough so that you can respond as needed, when needed.

A couple of years ago, a new client came to us with a problem. During the previous 3 years, his profit had fallen by almost £96,000. This is what his annual financial statements looked like:

	2000	**2001**	**2002**
Sales	£ 800,000	£ 740,000	£ 735,000
Gross Profit (%)	£ 280,000 (35%)	£ 259,000 (35%)	£ 220,000 (30%)
Expenses	£ 160,000	£ 175,000	£ 196,000
Net Profit	£ 120,000	£ 84,000	£ 24,000

Our client saw his "problem" as being a decline in sales. And he couldn't understand this because, in his own words, "we've never been busier."

In 2000, a couple of new competitors emerged and captured some of his market share. He held his gross margin in 2001, but he lost £60,000 in sales revenue compared to the previous year. At the same time, his overhead expenses increased by £15,000. The net result was a £36,000 fall in profit.

His immediate reaction was to cut prices and to aggressively seek new customers. He doubled his advertising expenditure with an emphasis on "*we won't be beaten on price*." His strategy was intended to attack his competitors.

During 2002, he was pleased with the results. He had stopped the drop in sales. Each week he got his sales figures and compared them with the same time in the previous year. He knew he was winning the battle…or so he thought. In 2002, he was going full-speed ahead, his team was busy, the phone never stopped, his advertising was getting tons of enquiries, but his cash flow was deteriorating.

When his year-end accounting was done, he was astounded that he'd only made £24,000. His accountants must be wrong. That's why he came to us: He wanted a second opinion.

His accountants weren't wrong. He'd fallen for the classic 3-card trick. He'd had his eye on the wrong thing. He was focusing on sales revenue. But on the whole, sales revenue has little, if anything, to do with profitability.

He was desperate. He couldn't reduce his prices any more. Inflation would push his expenses higher in 2003, which meant that even the small profit he'd made in 2002 would be wiped out in 2003.

Then he turned his attention to his competitors. After spending 20 minutes criticising them, he acknowledged that there wasn't a thing he could do about them. If he was going to turn his fortune around, he'd have to do it by working on ***his*** business, not theirs.

We asked him for 2 things: the number of invoices he'd issued in each of the past 3 years and the number of active customers on his books. He really didn't see the relevance of this, but he got back to us the next day.

We did a couple of quick calculations:

	Invoices	Active Customers	Sales/ Invoice	GP/ Invoice	Sales/ Customer	Invoices/ Customer
2000	2,286	181	£350	£122	£4,420	13
2001	2,651	205	£279	£98	£3,608	13
2002	3,587	318	£204	£61	£2,301	11

When he saw the figures, he realised exactly what had happened. He had an additional 137 customers to look after and an extra 1,301 transactions to negotiate and process. No wonder he was busy!

When we see this type of thing, accompanied by a fall in revenue per sale and gross profit per sale, it generally means only one thing—service has fallen, prices have been cut, and fixed costs have risen to handle the additional volume of business transactions.

He'd been so busy looking for new customers to sell to that he'd failed to properly look after the ones he already had.

When he dug deeper into his records, he found that his top 20% of customers had been spending over £10,000 a year with him in 2000, but this had dropped to about £6,400 by 2002. In 2002, 80% of his active customers were actually only spending £1,290 with him.

If he'd been monitoring the number of sales and the average value of each sale on a weekly basis in 2001, he would have had an insight into what was happening well before the shock at year-end. The new competitors had given his customers a choice, so they took it and found better service and a better price. They still bought from him, but not as much as they had before.

In 2002, weekly monitoring of these key factors would have confirmed the problem. His average gross profit per transaction had halved and yet it was costing him as much, if not more, per transaction as in 2000. But, more importantly, he was so busy trying to look after his additional 137 customers that his service had reached an all-time low.

By concentrating on total sales revenue, he had lost his way. Yes, he'd gained a lot of new business, but most of it was worthless.

Most of his new customers were small, bad payers (which exaggerated his cash flow problem) and extremely price-sensitive (which he'd encouraged by his advertising). They had influenced his thinking about the relative value of price versus service. Because his new customers had a preoccupation with price, he started to think that all of his customers were only concerned about price. In 2003, he discovered that this wasn't the case.

He did a complete turnaround in 2003. He set his prices to achieve an average 38% gross margin. He met with each of the top 30% of his customers and discussed what was important to them. He developed a customer service plan with his team members.

He ruthlessly applied a strict credit control policy. He identified customers whom he didn't care to service and politely referred them to his competitors. He spoke to his competitors about the folly of competing only on price—they agreed. He invested money he'd previously allocated to advertising on more focused customer communication.

The results were staggering. In 2003, his active customer count fell to 232. His average sales per customer rose to £3,420, and his gross profit per customer averaged £1,322. His net operating profit for 2003 was just over £97,000 and, during the year ended June 30, 2004, his profit was £132,000.

There is nothing magical about this type of turnaround. By frequently monitoring the things that are important, namely a measure of the volume of activity (in this case, the number of sales) and a measure

of the pound significance of this activity (in this case, sales value and average gross profit per transaction), you, too, can fine-tune your business and direct it precisely where you want it to go.

All you need to know is what to monitor, how frequently to monitor, and what to do when things start to go awry.

This particular client is in the wholesale business. But we've seen the same problems and the same results achieved in a variety of retail establishments, mechanical workshops, an estate agency, insurance brokers, restaurants, a light engineering firm, a cabinetmaker, and an aluminium fabrication business.

In fact, in one £2m turnover print and stationary business, by using activity based costing, we discovered that 450 out of their 950 business customers were essentially unprofitable given the processing costs of each order! Can you imagine how powerful this insight was in forming a strategy to improve the health of their business?

Remember: What can be measured can be managed, but you have to measure the right activities.

However…prescription without diagnosis is malpractice

The story above is just one example of why any business can operate at a sub-optimal level. Whilst we should not assume that a similar exercise would yield similar results for your business, identifying the critical activities that need measuring is a very useful exercise for most businesses.

As every business comprises a large variety of activities and processes, pin-pointing the real reasons for sub-optimal performance is sometimes not quite so easy. Even if you are able to identify a weak functional area, such as sales & marketing or finance, being objective, and knowing how to set about improving the systems and processes, can be problematical. This is particularly so if the business is in fire-fighting mode or even just trying to cope with the everyday pressures.

To help our clients self-diagnose their own strengths and weaknesses, we have a developed a time-efficient *Business Diagnostic* programme. The core element relies strongly on self analysis by the existing management team, and is structured so that, if necessary, every part of the business can be examined. This comprehensive programme can also be modularised to 'shine the spotlight' on any suspected problem area.

Optionally, we also have a *Customer Diagnostic* programme, to gather the input and perception of the customer base and a *Team Diagnostic* to gather the input of the employees, as considered appropriate by the business. Some of the most valuable business improvement ideas have been uncovered during these sessions.

The benefits offered by such analysis are extremely valuable in helping any business to reshape their business strategy and the subsequent return on investment can sometimes be enormous, depending on the size and circumstances of the business.

Total consultants time for the core diagnostic programme is usually 1.5 days and 1 day for each of the Customer and Team diagnostics. For businesses in the governments' objective area 2, a large portion of this cost may be funded by grant monies.

Compared to the potential benefits, the investment of time and money should be a relatively insignificant consideration for most businesses (particularly given our unique money back guarantee, should you not be delighted with the results.)

If you would like more details about the diagnostic process, or a one hour free initial consultation, then contact Mark Salmon at Strategic Alliance on 07903 047438 or mark.salmon@strategic-alliance.ltd.uk.