

Finding Opportunity in the Current Economy

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Although CFOs generally prefer to pursue top line growth over any other form of profit enhancement, recent economic conditions have, least temporarily, curtailed that option in many industries.

But a pause after an extended period of revenue growth can be profitably used to tighten operations and position the company to capture even greater gains in future economic expansion cycles.

Astute practitioners can offer services that help the CFO achieve profit objectives while strengthening their relations with the client by adding value in a field that they are uniquely qualified to offer—that of applied managerial accounting.

Organizational profit derives from two sources—margin and leverage. Margin is defined as the difference between the selling price and the cost of the sale. Increased margins provide current benefits along with opportunities for even higher profit levels if sales volumes increase. Increased margins also help organizations survive volume downturns.

Leverage is the extent to which operating expenses remain fixed in relationship to changes in sales volume. Leverage comes between margin and profit, and determines how much of the firm's margin will actually end up on the bottom line.

A firm with a low rate of leverage will find that profit tracks closely with its total sales volume. Correspondingly, a firm with high leverage will find that profit increases almost exponentially with increases in sales volume. The reverse is also true—firms with high leverage will experience proportionately larger decreases in profits should sales volumes decrease, which is why firms with high amounts of leverage are considered to have greater risk of failure.

For any current level of sales volume plus management's anticipated near term change in volume, there exists an optimal rate of leverage. At a practical level, leverage is often directly associated with the incurrence of fixed costs. Variable costs are associated with margin.

Practitioners can assist CFO's during this economic pause by reviewing their clients fixed and variable costs at a detailed level with an eye to adjusting the delicate balance between margin and leverage to optimize profits in the current climate situation and position the company for greater success in the future.

While this general principle applies to all areas of a company's expense, it is particularly true with labor costs, which often comprise 30-70% of a company's operating expense.

At a strategic level, the company should evaluate whether its current hire or outsource strategy is still the best one, within each of the skill categories that it requires. Changes in both the employment and outsource markets will need to be evaluated. As demand falls, many outsource markets, such as residential real estate construction, will respond by lowering prices to levels below the cost of hiring employees. In that case management may find that the benefit derived from giving up the leverage of some in house employed positions exceeds the reduced margins

due to outsourcing. Given the weaker U.S. dollar, companies that incur costs of overseas sourcing may now find it cheaper to repatriate with a U.S. based firm. In some cases, the costs of overseas sourcing may be buried deep in the costs of a supplier or subcontractor, and some sleuthing work may be necessary to uncover all the opportunity here.

Part of the hire versus outsource decision will be affected by the cost of benefits which are now approaching 30-40% of wages in some companies. Benefit plans whose costs have been subject to year after year of increases are particularly vulnerable to becoming overpriced in the current market. Reducing benefit plans costs may simply involve rebidding the contract in the context of the current market. Additionally, right sizing benefits may require changes to benefit levels, or plan design. Practitioners can coordinate this review and bring in insurance industry expertise as needed in order to ‘right size’ the benefits cost within the current and future revenue stream of the client.

The final element of labor cost analysis requires internal process reviews. CPA’s already have experience in identifying and documenting internal controls, and in evaluating the interaction of internal controls. Much of this skill can be applied to the identification and documentation of the operational processes in a company. The organization of the reviews can follow the familiar lines of internal control reviews as well—the revenue cycle, the cash cycle, the purchasing cycle, planning and reporting cycles, etc. The purpose of these reviews is to identify those activities within the company that do not add value. Value being defined either as a reason why the customer purchased this particular product, or a reason why the customer would willingly pay more for the product, if this element was incorporated into the product. In most companies, there are usually a few core processes that add significant value, surrounded by a large number of other processes that do not add value much value. These are the processes that must be identified and brought to the attention of management.

During periods of growth, companies may have evolved separate but parallel processes. Information may be collected and disseminated from duplicated data bases. Information that is available in the company computer may still be manually collected by an isolated department. In larger organizations with extensive computer systems, practitioners may identify data collected on internal forms that no longer aligns with required data elements on computer screens. Now is the time to clean up the forms or update the computer system to better align with the inputs. Users may not be using the computer as it was originally intended, and therefore not realizing its inherent benefits. This could be due to inadequate security access, employee turnover, skill degradation caused by infrequency of use, or changes in organizational requirements. Computer system “work arounds” should be identified and resolved. In fact, it is a best practice to re-audit every installed computer application every 3-5 years and validate that the system still is being used as intended. Otherwise, management has no assurance that the expected benefits are being realized, and that the application is not costing more money than it is saving. In those areas where the use of the system is not meeting the objectives, the system should be re-implemented through process redesign, application reconfiguration, or additional training for users.