



## Where do you make the money ?

By David J. Abbott

Do you feel that you are working extremely hard and yet it does not seem to be hitting the bottom line ? Are you very busy and almost could not take on any new work, yet the firm's profitability seems to be stagnant ? You might be surprised how common a problem this is.

First step in all of this is to segment your business in terms of the products or services that you offer. A segment is a separate distinct product or service that you sell, or it may be that you are selling the same product to a different group of customers. Another way to segment in a business would be in terms of geography, breaking it down by customers in Nairobi, or Kisumu or Mombasa. Or, you might chose to segment by the competitors you face?

In any case, move into action, and do a rough customer segmentation, you can always improve on it as you go along.

Once you have created your business segments, what you really need to know is which product or service lines are the most profitable, those that are just breaking even, and there might be some that are even losing money.

Ideally, your accounting system can provide this information, or can be modified a little to come up with the figures. However, it would not be uncommon to find that the system is not set up in a way to show profitability by segment. What usually happens at this stage, is if you go to the accountant or book-keeper and ask them to provide the information they will say it is going to take some time to restate the accounts in this way. What now, do you wait and give up? Give it a go. Once you look into segment profitability you are going to come up with some valuable insights and you hopefully will be on the way to generating profits for the firm. Figures in your accounting system can [hopefully] give you like sales per segment and possibly the gross margin [sales less the cost of goods]. Plus, you will know the total costs for all the segments. By total costs is meant all the variable and fixed costs of the business.

Now the trick is to be able to allocate all the costs that go into producing the product or service to be able to get a true idea of their profitability. One way of doing this is by allocating costs on a percentage of turn-over basis. So for instance if hot sauce represents 30% of the revenues you would allocate 30% of the costs. That is a good start, but after thinking about it, one realise some products or services are more difficult, more expensive to deliver than others. Say extra hot red sauce is 2 times more difficult to make in the production process, then you would allocate a greater proportion of costs. Go through the same process for all the products and you will get a rough estimate of an allocation of the fixed and variable costs.

Soon you will have an estimate of return on sales which is profitability divided by sales. Yes, this process may be crude in the beginning, but once you have the rough model go back with your accountant and polish it up. Great majority of time when you compile the profit figures by segment it turns conventional wisdom on its head. It would not be uncommon to find, products you thought are profitable are not, and those you though were doing poorly actually may be small in number but are quite profitable.

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## About aCatalyst

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