

# Close-up on profit

Companies are being squashed by suppliers, crushed by rising fixed costs and squeezed by customers looking to keep their own expenditure down. Many are seeing their profit margins reduced to a fraction of pre-crunch levels – but there are ways to increase profit, **Sarah Coles** writes.

**T**he first step for businesses looking to restore their profit margins is to put in place proper management reporting to identify the most and least profitable areas of the business. “Business owners often don’t know the products and services which are making the most profit,” says Mark Perrin, a Partner at Menzies. “You need this information to make good quality business decisions.” Hidden costs such as labour input, packaging, management time and distribution costs can cause businesses to overestimate the profitability of key products and services.

Tim Dunn, also a Partner at Menzies, says the process can yield some surprises: “The largest clients can actually prove the least profitable as they can negotiate discounts and absorb the time of senior management, which can make a major difference to profitability.”

Paul Hickson, another Menzies Partner, cites a company that had seen turnover increase in recent years. However, with the right reports, he showed the company had made more profit on a lower turnover three years earlier because it had been selling higher margin services. “It helped focus their attention on the mix of products and services being sold rather than just chasing turnover,” he says.

## Golden ratio

The second step is an understanding that profitability can be improved by selling more products and services to existing customers. “We always look for the 80:20 ratio, where 80% of business comes from 20% of customers,” Perrin says. “We want to focus on that segment, because

it’s usually the 80% of customers generating 20% of the business that create the most problems.”

Hickson adds: “Businesses need to take a step back, look at the top 20% of customers and ask how often they are starting a discussion with them about their biggest business issues and how they can help solve them.”

Third, companies can sell existing products and services to new, more suitable customers. Bringing in dedicated sales and marketing expertise may be a steep change, Hickson says, but it can make a dramatic difference to the business. Perrin says that assessing the characteristics of an ideal customer can also help.

A fourth option is to put prices up. Perrin says prices should be as close as possible to the “glass ceiling” where they are deemed too high. “We had one client that started to put day rates up. They got to the point where they had doubled day rates and nobody complained.”

Fifth, businesses can look at the other side of the profit equation and rationalise costs. “It’s not an opportunity to beat people down on fees because the easy savings have been made; it means challenging the fundamentals of the process to make it more efficient,” Hickson says.

Richard Godmon, a Tax Partner at Menzies, says tax incentives are another aspect. “A business should make

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Examination of a  
business's books  
can boost profits

sure they maximise their research and development tax credits and capital allowances: they need to be tested at all times." One client, Gordon Murray Design, has received a substantial payout through R&D credits (see box, page 6).

### Extract profits efficiently

Profit, once made, should be extracted in the most efficient manner possible. "I am always asked whether salary or dividends are the best approach, but the answer depends on the circumstances," Godmon says. "It starts with understanding objectives for the next year, three years, five years or ten years. It leads on to how the business should be structured and owned. That flows through into how you extract profit." There are five common considerations.

The first is salary. In many instances it may be appropriate for salary to be kept low, as income tax and national insurance burdens are so hefty. However, where there is a contract in place, salary must not be lower than the national

minimum wage. Godmon advises that it may be appropriate to pay a higher level of salary, for example, for mortgage or pension purposes.

Dividends are a popular alternative because they are not liable to any form of national insurance contributions and are tax-free where they fall within the basic rate band of the shareholder. However, rules must be followed regarding the level of dividends in comparison to the level of profits made, and dividends are subject to tax where they come above the basic rate upper threshold.

Third, pensions provide more options since the introduction of the Self-Invested Personal Pension (SIPP), which allows a personal pension to invest in commercial property. Godmon says buying premises or a warehouse opens up new possibilities. "They can contribute to a SIPP tax-efficiently then use the SIPP to buy the property. The business will then rent the property from the pension scheme. It's an incredibly tax-efficient way to extract cash." >

> A share ownership plan is the fourth option. This can be highly effective but shares must be used in a way that suits all shareholders. Perrin says: "When you have three or four director/shareholders you need to understand everyone's personal position and find the line of best fit." For example, shares held by directors can be given to family members to enable dividends to be paid to a spouse or an adult child.

The Enterprise Management Incentive (EMI) is a popular share option scheme. Although this is highly tax efficient, Godmon warns that it must be properly explained to staff. "The worst type of EMI is when the paperwork is just presented to staff and they think the company is about to be sold and that they are about to lose their jobs."

The fifth consideration is some kind of more advanced planning, using employer financed retirement benefit schemes or employee benefit trusts, for example. However, Godmon cautions that more aggressive schemes are not for the fainthearted. "They don't come with any guarantees. HMRC is continually changing the rules and they can

apply retrospectively, so you may receive no benefit."

### Leaving the cash

Alternatively, business owners can choose not to extract the cash from the business at all. "Leaving the cash in the business is a perfectly valid remuneration plan," Hickson says.

Dunn notes that this option can also mean less taxation. "You would

need advice if you planned to sell the business and bring it into the capital gains tax regime, but even that is a lower rate of tax. Quite often we will ask how much money the owners actually need from the business because there's no point in taking more than you need and then paying tax on it. The client may feel that they have earned this money, but in some cases it's about thinking as a shareholder rather than as an employee."

In such a difficult economic environment, where HMRC is challenging every attempt to pay less tax, owners should be open-minded to change. "A lot of business owners make decisions on a gut feel of how the business is performing," Perrin says. "You have to respect that because it is their business and no one knows it better than them, but when you go through the detail of the whole picture it can enable them to be more objective and it can often lead them to better decision making."

*Sarah Coles is a past winner of the Watson Wyatt media award for excellence in journalism.*

## CASE STUDY

### Gordon Murray Design

Gordon Murray Design Limited obtained payments of just under £1 million from the Government for the first two years of its project – a new car manufacturing process to cut production and running costs, lighten vehicles, improve space utilisation and boost fuel economy.

Gordon Murray designed Formula 1 racing cars for Brabham and McLaren, before going on to design the McLaren F1 sports car. His latest project is a new small car that seats three people, weighs only 575 kilograms, delivers around 96 miles per gallon and is built using a unique, holistic manufacturing process known as iStream.



Cashflow is crucial for the design stage – there are no sales revenues and usually the only source of cash is from investments in equity or loans. Menzies proposed an R&D tax credit claim, designed to maximise the cash recovered from HMRC at this critical time, culminating in a six-figure payment.

## CASE STUDY

### FTI profits from New Horizons

Andrew Parker, Managing Director of FTI, a supplier and manufacturer of instrumentation products, has been working with Menzies on a 'New Horizons' project. The process – breaking the business down into 12 areas then challenging what is done and how – has made a massive difference. "This year we have grown turnover by 50% and doubled the number of staff. The business is unrecognisable."

The first step was to put in place a new management accounting system, which enabled scrutiny of individual product lines and customers to see what each customer buys and what profit has been derived.

Parker says: "It meant we could spend more time marketing to more profitable areas and reduce our exposure to large suppliers. The following year we increased our margins by 4-5% and decreased our exposure to our largest supplier from 45% to 35%."

The company has also set up new methods of profit extraction, including an EMI scheme. "The scheme has allowed us to establish a tax-efficient reward mechanism for a newly employed director," Parker explains. "We are also contributing into a SIPP which in the longer term we will use to fund purchasing a commercial property, an extremely tax-efficient strategy for us."

### More information

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