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Profitability Recipes for Food and Beverage Companies: Know Where Your Profits Are Coming From

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I often meet with food and beverage executives who can't wait to tell me about their new customers or new products and how each might be the next nirvana. This inevitably leads to a discussion about the bottom line and how they monitor and evaluate customer or product profitability. The nuances of this complex and very important topic are worthy of further examination.

Gross-to-Net

The first area is what I refer to as "gross-to-net". Companies often report net sales in their external financial statements but internally, it's critical evaluate how the top line gets diluted by promotional spend, returns and allowances, rebates and discounts. Recent accounting regulations on revenue recognition address some of these issues and companies must be aware of how the new regulations could change their reporting for many of these spends and could materially impact their financial statements.

The most interesting aspect of gross-to-net is tracking performance both prospectively and retroactively: prospectively to determine if the spend is truly effective in increasing sales and retroactively to determine how much the company must set up in reserves for any given timeframe, which will affect the company's financial reporting.

Deduction Management Systems

It also depends on which side of the fence the company resides. If you're a retailer receiving slotting fees, how do you account for that revenue? If you're a manufacturer, how are you amortizing that cost? The underlying contracts will dictate the appropriate treatment. These questions must be answered in order to obtain solid financial data. If a company's spend has averaged 22 percent of sales (which is quite common) and in the most recent period the spend has dropped to 10 percent of sales, what signal does that send? Is the company spending less? Is it amortizing costs differently? Has sales growth been affected? Do reserves for unrecorded spend need to be established?

There are deduction management systems which monitor and approve spend. Imagine the headaches for a typical manufacturer selling to multiple chains, which submit thousands of coupons for redemption. Technology and strong systems are critical components in navigating this area, which can easily get out of hand.

SKUs: 80/20 Rule

After analyzing gross-to-net, the next area to attack is the number of SKU's F&B companies have. Stocking a large catalog of products is typically a response to customer demand; as you add customers, you add new products. That's easy if you're making one delivery. Adding additional products increases sales and endears you further to your customer. But I challenge all companies to closely examine how much profit is generated by each product. Extra products will generate extra sales, but at what cost? What about product research and design? What about packaging, testing, marketing, labeling, regulatory compliance, warehousing, handling and inventory requirements? These costs can completely obliterate profitability.

Any analysis to address this problem begins with sorting all sales by product in descending order. You will immediately notice that 80 percent of your sales are generated by 20 percent of your products. So, in a situation where a company has 1000 SKU's, 200 products will generate 80 percent of all sales while the other 800 generate only 20 percent. Stripping down the products to eliminate unprofitable SKUs will generate immense and immediate rewards.

Contribution Margin

While much about these concepts may be clear, the optimal methodology to analyze profitability is not commonly understood or used by many companies. Most companies focus on gross profit, synonymous with "margin", which is the classic way accountants track sales less the cost of goods sold. Some companies even erroneously equate margin with mark-up, when a mark-up will not generate the same percentage gross profit. For example, a 20-percent mark-up will only yield a 17-percent gross profit.

The problem with gross profit is that cost of goods sold often includes fixed expenses such as rent, which don't change incrementally with sales. Because of the distortion caused by fixed expenses, companies often make poor profitability decisions when relying on a gross profit percentage. Therefore, using *contribution margin* is the preferable method in analyzing the profitability of a customer, product or distribution channel.

Contribution margin is defined as sales less all *variable* expenses. You won't see contribution margin in a published financial statement, as gross profit still rules, but it should be a part of every internal financial statement when management has to make financial decisions.

Contribution margin reflects the profit generated from sales of products after all variable costs are deducted. So if a company's contribution margin percentage is 30 percent, it would mean that for every net sales dollar, 30 cents covers fixed expenses. And fixed expenses, by their very nature,

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remain constant regardless of sales volume or whether you're open for business that day.

Break-Even

The exercise of calculating contribution margin is quite simple. Extract from cost of goods sold all fixed expenses and then add to your analysis all variable expenses, such as sales commissions, broker fees, and distribution costs. You would apply this formula to overall sales and determine the percentage contribution margin. By taking this contribution margin percentage and dividing it into fixed expenses, you will have calculated your break-even sales.

"Break-even" is used to define the amount of sales necessary to cover all fixed expenses with no profit. For example, if all fixed expenses amount to $2 million annually and your contribution margin is 30 percent, your annual breakeven sales would be $6.66 million ($2 million divided by 30 percent).

Why is this so important? Applying the formula to determine your break-even sales won't help with customer or product profitability. That's where the analysis starts to get interesting. You'll notice as you drill into customer data that promotional costs, slotting fees or rebates affect the profitability of that customer. You'll also notice that certain costs might vary more with some customers than others, such as demo costs, commissions, broker fees or distribution costs. You don't have to analyze what impact fixed expenses have because they aren't relevant to that one customer.

Conclusion

Many companies are lured into customer relationships because they generate more sales but they don't take the next step of looking at profits generated by that customer. Analyzing the contribution margin of each customer or product is essential to overall profitability. Beware if you calculate a negative contribution margin, which would mean that, for every dollar of sales from that customer, you are losing the negative contribution margin amount. Don't be that company that's lured into products or customers that are unprofitable, because the bottom line for all businesses is a profitable bottom line.

Louis Biscotti *is national leader of Marcum LLP's Food and Beverage Services Group. He's been an entrepreneurial accounting leader, focused on the F&B industry, for more than 40 years. He is a frequent lecturer and founded a series of best practice forums for senior food and beverage executives across the country. He publishes a monthly column for the F&B industry on Forbes.com.*

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