The top five profit drains and how to plug them
House, Deborah
The Journal of Business Strategy; Mar/Apr 2003; 24, 2; ProQuest Central
pg. 32

MANAGEMENT

THE TOP FIVE PROFIT DRAINS AND HOW TO PLUG THEM

Profit drains always exist, but they're often very hard to spot.

Deborah House

PROFITS CAN SEEP OUT OF A P&L JUST AS FAST AND AS easily as a small water leak drips down the sink and through the pipes. Fortunately, a leaky faucet is easy to spot and repair before the pipe bursts. Not so fortunately, profit drains are tough to find, difficult to plug, and can destroy a company so fast and so insidiously that it's hard to understand what happened. The most dangerous can wreak devastating financial catastrophes upon a company.

Like water, profit drains always seek the path of least resistance and can find the smallest crack. Although they may start out quite small and insignificant, before long they evolve into crises. The more subtle the profit drain, the more dangerous it becomes—spiraling out of control before anyone even knows it exists. Fortunately, companies that spot them always have an opportunity to fix them and avoid catastrophes.

Profit drains damage corporate performance by creating multiple crises that take all the attention away from the core business. Yet, frequently the warning signs are ignored, sometimes resulting in the decimation of stable, century-old companies. It's critical to fix profit drains, while there are still options, before the business is flooded with red ink. Fixing all of them ensures a business model will be profitable in any economy.

Profit drains are camouflaged in the midst of routine, everyday business occurrences. In some cases, companies eventually accept them as a normal cost of doing business. Employees become complacent because "that's just the way things have always been." But

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

just like the leaky pipe that commands no attention until it bursts, a profit drain can become a crisis overnight. Especially with the lack of stability in today's economy, no business can afford to allow profit leaks to continue.

Of all the profit drains that will "burst" if ignored, these are the most critical:

- Customer complaints
- Lack of innovation
- Annuity compensation programs
- Efficiency through standardization
- Looking inside out

Profit Drain #1: Customer Complaints

Fixing problems is what defines customer service. Some great companies are organized to handle a high volume of re-work. In fact they expect it, and, for them, customer complaints are an acceptable cost of doing business. companies must eliminate this dangerous profit drain from their culture. Obviously, the cost of fixing a problem is always greater than if the work had just been done right the first time. Providing the right product with the right features that works at the right time is obviously more profitable than delivering the wrong product that doesn't work and requires fixing later.

The most important and costly side effect of this profit drain is customer ill will. Moreover, the costs of staffing a complaint department and either returning, replacing, or fixing the product are very high. There will likely be customers who won't be willing to pay for the product because it can't be relied upon to solve their critical problem. Consider the cellular telephone industry. Customers know that sending photos via a cell phone doesn't fix the problem of static and dropped calls. Cell phone companies aren't fooling customers with these new gadgets, nor are they building loyalty. The first cellular organization to eliminate customer complaints by providing reliable, stable service will get their loyalty.

The quickest way to determine if a company suffers from Profit Drain #1 is to look at the P&L and study the customer service costs rather than business processes. If a profit drain

المنارة للاستشارات
Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

doesn't show up on the bottom line, there's no need to mess with any business process.

It's important to remember that losing a customer is only a symptom of a larger issue—that is, problems with quality. Profit Drain #1 is only fixed by improving quality to the point at which there's no need for a customer service group.

Profit Drain #2: Lack of Innovation

What red flags identify Profit Drain #2? Ask these two questions: Who brought the last innovation to market? If it was someone else, was it a direct competitor or a company that doesn't regularly play in the same market space? Either way, there's a profit leak lurking in the shadows.

Consider the problem IBM faced in the 1980s. Initially, Big Blue didn't believe that every household would ever own a PC. Missing this innovation caused IBM's profit leak to reach a critical level. It's not that playing catch-up is impossible, as IBM proved. It's just really expensive. It's much more cost-effective to be on the front-end of innovation. At the very least, this avoids the communication costs and embarrassment associated with having to explain how such an opportunity could have been missed.

The usual argument against innovation is that taking a new product to market is expensive and risky. Even worse, timely payback is uncertain. That is certainly the case for blue-sky research. But a disciplined new product development process with milestones and concrete decision-making criteria is essential for insulating companies against economic cycles. Conventional wisdom says that R&D expenditures indicate a profit leak. Not so. No matter how stable an industry is, today it's changing at least 10 times faster than 25 years ago. New up-start companies that develop products in their garages have proven that creative innovation is no longer a luxury but a requirement for a company's long-term survival. The true cost of the innovation profit drain isn't the cost of R&D, it's the revenue and market share gained by competitors.

Many theories abound why some companies are more innovative than others are. Most involve spending money on "out-of-the-box" thinking and creativity classes trying to find a "big" idea. But it's much simpler than all that. Ask customers what they lose sleep over. Then, invest to fix their problem, and do it fast enough so the problem doesn't change before the new product or service goes to market. To avoid being a victim of Profit Drain #2, keep this in mind: It's *much* more expensive to play catch-up after being leap-frogged by a competitor's new innovation.

Profit Drain #3: Annuity Compensation Plans

By far one of the most lethal drains comes from salary and those alleged variable bonus plans. They zap the passion to maximize the company's profits. The media provided many examples this year illustrating that salary and bonus plans have failed to motivate profit production. The only event that salaries motivate is showing up. Salary plans are similar to long-term annuities because regardless of an employee's accomplishments, a direct deposit is received on the 15th and 30th of every month. It doesn't matter whether the employees increased profits or just kept busy doing stuff. Another effect of this profit drain is the talent drain. Risk-takers and creative executives often get frustrated when they are rewarded the at the same levels as mediocre performers.

Add bonuses on to salaries and a profit flood ensues. When unemployment was really low, it became popular to link compensation plans to profits. The idea was that employees could become "intrapreneurs" and receive similar rewards and supposedly assume similar risks. That is, no profits—no bonuses. But, that's not necessarily so. Unfortunately, bonus systems have now become part of the annuity package. Even with significantly lower profits and severe cost-cutting efforts,

Companies that forget the money comes from "out there" usually receive less of it.

bonuses, although reduced, are still being paid. For most companies, this profit drain is now a flood.

To fix this drain, salary plans have to go. Even the CEO needs to be paid based upon *real* profits earned. A suggestion is implementing an across-the-board hourly pay system. That is, employees get paid when they produce profits. If they don't produce, they don't get paid. If they have to pay overtime, bosses tend to make better decisions about the work they request since they have to pay for it. Such a pay for services system allows companies to know exactly how much everything costs. To maximize a company's profitability, it's imperative that everyone in the firm is accountable for producing profits.

Profit Drain #4: Efficiency through Standardization

This is a tough profit drain to identify, let alone fix. An example of it was when companies were rushing to install enterprise resource planning (ERP) systems to solve their Y2K issues. The value of ERP systems is that every transaction is treated the same—no exceptions. However, if a company's value hinges on being extremely flexible and adaptable to customer requirements, standardization is more costly, not less. If employees do manual work-arounds to avoid the restrictions of the new $25 million system, for instance, the company suffers from Profit Drain #4.

The key to identifying this profit drain lies in knowing whether the company is in a commodity or niche market. Those in niche markets have few operating processes that can be replicated into boilerplate templates. Customization doesn't mean, "Would you like it in yellow or blue?" It means the solution is hand-tailored to meet the customer's unique needs. Companies that implement standardized processes to save costs actually destroy the customization value that first attracted customers and keeps them paying a premium price.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

The best way to fix this profit leak is to avoid the temptation. It is so tempting to standardize that custom-made suit, assuming the buyer will never know. Well, be careful! The first customer won't notice, but when customers start comparing their customized solutions and find those solutions all look alike, watch out. The consulting industry has suffered for several years from trying to increase profits through standardizing a custom product, as evidenced by the generic strategic plans being produced. Due to several factors, such as not being able to articulate the value of a strategic plan, wanting to quickly increase profit margins the easy way, and using consultants without much business experience, strategic plans have become 90% boilerplate. The result is that any company's name could be on the title page.

If a company isn't maximizing its profits from a customized product or service, standardizing delivery is not the answer. To fix this profit drain, a company must first determine if its product still solves critical customer problems. If it doesn't, it's time to build a better mousetrap. If the product remains a necessity for customers, increasing profitability requires reducing waste, not standardization. Standardization reduces a product's uniqueness and, therefore, its ability to support a premium price. Reducing waste, on the other hand, preserves the product's uniqueness while driving out unnecessary or redundant processes, obtaining more precise customer requirements up-front, or eliminating production errors.

Profit Drain #5: An Inside-Out Focus

Another subtle profit drain that exists in 90% of organizations comes from leaders who have an internal rather than external focus. How do the company's leaders spend their time? Look at their calendars. Do they spend the majority of their time on internal problems or with customers, suppliers, and peers? The old cliche that "executives need to work on the business, not in the business" is more right than wrong. CEOs who spend more than 20% of their time solving internal issues probably need to evaluate the effectiveness of their senior team. Companies that forget the money comes from "out there" usually receive less of it.

Keeping an external focus can be scary. CEOs are going to hear things they probably won't like but need to hear. To avoid hearing unpleasant news, some companies go so far as to call internal projects, like implementing a new IT system, a strategic initiative and then base bonuses and raises on them. Since people do what they are rewarded for, everybody works on the IT project even if it means not collecting receivables or answering customer phone calls. Inevitably, customer complaints abound, and before long at least two profit leaks exist and the company is headed for disaster.

Having an external focus also means looking at nontraditional competitors because they might redefine the customer problem. One example is McDonald's. Traditionally, McDonald's looked at Burger King, Wendy's, KFC, and Taco Bell as competitors. But if the problem is redefined as a need for quick, low-cost food and drinks, a whole new set of competitors come into play, such as convenience stores, frozen meals at grocery stores, and gas stations, just to name a few.

Low-hanging fruit was picked years ago. All that's left are the tough issues.

To fix the inside-out profit drain, key executives must spend at least 75% of their time out there—with customers, suppliers, and peers. This will not only solve the company's group think problem but will also spur innovation as they learn about customers' critical problems.

Traps to Avoid, Steps to Take

There is no doubt that most CEOs take profit drains seriously, once they find them. The logical first step to finding them is to look out for the five profit drains discussed. Of course, fixing these drains involves change, and any change is risky. However, avoiding the traps companies typically fall into when they start to plug the leaks can minimize the risks. Among the most common pitfalls are:

- *Expecting a new IT system to plug the leak.* Technology is notorious for causing more leaks than it fixes.
- *Thinking that profit leaks are low-hanging fruit.* Low-hanging fruit was picked years ago. All that's left are the tough issues.
- *Expecting the people who do the work can fix the leak.* An objective eye is required to fix profit drains.
- *Seeking easy results overnight.* If this were true, everyone would have already plugged the leaks.

The Billion-Dollar Question

Keep in mind this important reality: Profit drains start out as sneaky leaks, and sneaky leaks are hard to spot. The billion-dollar question is how to design a business model that avoids profit drains. The answer comes in three parts. First, always assume profit drains exist. They just haven't been found yet. Second, don't confuse profit drains with overspending. Profit drains are much more serious. Third, tie everyone's compensation, including the CEOs, to detecting and fixing profit drains. Furthermore, remain aware that fixing the profit drains averts potential disasters, but there is no guarantee that others won't spring up.

Following these steps ensures a company will be profitable all the time—no matter what the economy is doing. Ignoring profit drains not only threatens a company's profitability but also its long-term survival. Plugging the profit leaks ensures a company won't become extinct. ◆

Deborah House is the CEO and founder of The Adare Group, a strategic profitability consulting firm headquartered in the Chicago area. For further information, contact DHouse@TheAdareGroup.com.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com