Why It Is So Difficult To Predict The Profitability of Privately Owned Companies and Easier to Project Revenues©

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Sales of products to customer are the revenues of the seller. The seller knows immediately the initial reaction of the customer being offered the products. Either the product offers a sufficient value and benefit to the customer, on the terms offered, or it doesn't. If it does a sale is made and revenue generated.

The seller then has the task of identifying additional prospective customers, who should also find the product desirable and therefore make a purchase.

Sales projections reflect a prediction of reorders and the mechanics and cost of marketing the product to new prospective customers.

Continuing customer product satisfaction and the market remaining free of competitive products, offered on more attractive terms, are necessary factors for sales projections to be achieved.

Therefore, the seller is dependent on both making sales to new customers and the growth of the businesses of the customers.

This is all pretty elemental and demonstrates that customer satisfaction, something easily ascertainable, is key to the seller's revenue growth.

The other side of the business assessment exercise is understanding the cost of producing the product, including cost of materials and labor. Simply put, profit is the difference between the all inclusive cost and net revenues.

What can go wrong, making it difficult to predict profit, and even more so of profit per share of outstanding stock of the company?

First of all the true customer appreciation of the product can be overrated and overstated by those making the sales. From personal experience, I know that relying on sales personnel estimates in the planning and financing of production and marketing can be fatal.

The cost of raw materials is beyond the control of business managers. The cost of labor can also be difficult to predict as frequently the demands of labor increase as the revenues of the business grows. Labor disruptions are a part of the difficulty in predicting cost.

Necessary raw material can be delayed in delivery causing significant production problems and great loss as the overhead continues with or without production being possible.

Even satisfied customers will naturally want to improve their own profitability and negotiating more favorable terms with suppliers is a routine exercise.

The cost and availability of financing, which is dependent on external domestic and international forces beyond the control of business managers as impacting interest rates and lender attitudes can be a problem in forecasting profitability.

There can be changes in regulations and laws, which impact the cost of production and the pricing of products offered for sale.

There are many factors, which are ever challenging in the management of a business, which can play an unexpected role in the profit making of any business.

Finally, after all these complex issues has been resolved, there is more to consider before we know a company's actual declared profits.

One factor is the discretion of management, consulting with its legal, financial and accounting advisors, as to how much profit to actually declare for tax purposes; some items may be advanced or deferred basic on standard accounting practices. The controlling owners of privately owned companies may not wish to declare maximum profits and have a range of legal and appropriate decisions to make which may reduce the profit level which must be declared. The cheapest capital a company can have is that not paid in taxes.

**There are also interest, depreciation, foreign currency, various price hedging strategies and allocations. There are legal means of both advancing or delaying recognition of quarterly revenues, expenses and receivables.
In the end, it is just easier to project revenues than to predict profits.**

Therefore, investors are better served to invest in a company by buying a percentage of revenues than ownership, as the value of the royalty will increase with sales success irrespective of management's ability to achieve ever-increasing profits.

Royalties are the better way.

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