Controlling the Uncontrollable Payroll Costs

In today's full-employment economy, payroll costs are close to being out of control. Stories abound about bonuses paid to new operating employees, extended time-off for family leave and the like.

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The implications for profitability are ominous. Payroll accounts for close to two-thirds of total operating expenses for firms in every line of trade. If payroll costs rise even modestly as a percent of sales, profit will plummet.

This article examines the nature of the payroll challenge and offers some solutions. It will do so from two important perspectives:

- The economics of the payroll challenge – a discussion of how even modest changes in payroll costs can cause profit to rise or fall.
- Managing payroll cost growth – some specific suggestions for improving payroll performance, even in a tight labor market.

ECONOMICS OF THE PAYROLL

Over time, payroll has remained an almost constant percent of sales for DHI members. Adjusting for economic conditions, payroll costs are virtually unchanged from 20 years ago. That is, in a moderate-growth period 20 years ago, payroll was about the same percent of revenue as it is in a moderate-growth period today. Both sales and payroll have grown at about the same rate.

The fundamental issue going forward is whether this parity of sales growth and payroll growth will continue or whether payroll will move ahead faster than sales. On a more positive note, it is possible that sales could grow faster than the payroll expenses required to generate those sales.

The relationship between sales growth and payroll growth is what is commonly called the sales to payroll wedge. This wedge can be either positive, with sales growing faster than payroll, or negative if payroll growth outpaces sales. The size of the sales to payroll wedge is critical

The chart on the next page demonstrates the impact of the sales to payroll wedge for the typical DHI member based upon the latest IFBR Report. As can be seen in the first column, the firm generates $20,000,000 in sales, operates on a gross margin of 31.5 percent of sales and has a bottom line profit of $800,000 or 4 percent of sales.

Payroll is 17 percent of sales. In this specific instance payroll accounts for 61.8 percent of total operating expenses. It is important to note that payroll expense is a fully-loaded number. It includes all salaries, wages, commission and bonuses. It also includes the social costs associated with payroll, including FICA, Medicare, worker's compensation, health insurance and all retirement programs. Payroll is, quite simply, the name of the game.

The last two columns examine the impact of a positive or negative sales to payroll wedge. Once again, this means that sales are growing faster than payroll (positive) or growing slower than payroll (negative). To demonstrate the impact of the wedge, a modest 5 percent sales growth figure has been used. Any sales growth rate would produce the same sort of results.

In the middle column, payroll grows by 3 percent (2 percent slower than sales) for a positive sales to payroll wedge. In the final column payroll increases by 7 percent (2 percent faster than sales), producing a negative sales to payroll wedge.

The impact of such a modest wedge is rather startling. A 2 percent positive wedge generates an increase in profit of $108,000 or a 13.5 percent change. With a negative wedge, profit actually declines despite the same 5 percent rate of sales growth. Even modest differences in payroll control have a huge impact on the bottom line.

MANAGING PAYROLL GROWTH

In trying to generate a positive sales to payroll wedge, most firms turn to two specific approaches. The first is simply cutting payroll, ideally in areas deemed to be unimportant in servicing customers. The second is to rely increasingly on new technology to drive higher productivity, especially in key operations areas such as the distribution center and accounting.

Payroll Reduction – The challenge with payroll reduction programs is that payroll is not just an expense item like utilities. Payroll costs represent the employees who provide services that generate adequate sales. It may be possible to identify a very few areas in the firm that do not contribute to sales generation. However, those opportunities are seldom large enough to reduce payroll costs

Productivity Enhancements – Nobody can realistically argue against the ongoing process of improving the rate of order picking, order processing and the like. Even though they are important, their payoff tends to be generated slowly over time. Given the perceived challenge of increasing compensation rates, something with a quicker payoff is required.

The challenge, as stated before, is to drive sales growth faster than payroll growth. This requires actions that focus on both the sales and payroll expense side of the issue simultaneously. One important approach is to monitor the firm's transaction economics.

Assessing transactions economics involves reviewing the amount of work associated with each individual transaction. It addresses the reality that the same level of sales volume can produce very different profit levels, depending upon the workload required. The challenge is to be able to control that workload.

Two key factors have always been important in transaction analysis. The first is the number of line items sold per transaction. The second is the average line value. A system that measures these factors and then uses them in planning can go a long way towards actually producing a positive sales to payroll wedge.

The number of line items rests heavily on the degree to which add-on selling is continually reinforced throughout the firm. Over time, there is a tendency to grow tired of asking the "do you want fries with that" question. The need to keep asking must be emphasized continually.

The average line item extension is by far the more important of the two factors in terms of creating a positive sales-to-payroll wedge. Increasing this number has almost no impact on payroll other than commissions. Like everything in life, if it is the most important, it is also the most difficult.

The line extension improvement involves two very different issues. The first is to work with customers to modify, at least slightly, their buying pattern. Ideally, they would purchase the same amount of merchandise, but do so with fewer, larger orders. The second approach is to raise prices judicially where possible.

Both approaches have the potential to alienate customers, so care must be taken. They are, however, key to generating a positive sales-to-payroll wedge.

Sales growth must be maintained at a level that allows the firm to produce a positive sales to payroll wedge of something in the 2 percent range. However, sales growth can be rapid or modest as long as the relationship between sales growth and payroll growth is controlled. With such a delta, the long-term challenge with payroll control can finally be overcome. +

THE IMPACT OF A TWO PERCENT CHANGE IN PAYROLL COSTS FOR THE TYPICAL DHI MEMBER

Income Statement–$	Current Results	2.0% Positive Payroll Wedge	2.0% Negative Payroll Wedge
Net Sales	$20,000,000	$21,000,000	$21,000,000
Cost of Goods Sold	13,700,000	14,385,000	14,385,000
Gross Margin	6,300,000	6,615,000	6,615,000
Payroll and Fringe Benefits	3,400,000	3,502,000	3,638,000
All Other Expenses	2,100,000	2,205,000	2,205,000
Total Expenses	5,500,000	5,707,000	5,843,000
Profit Before Taxes	$800,000	$908,000	$772,000
Change in Profit		$108,000	-$28,000
Income Statement-%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	68.5	68.5	68.5
Gross Margin	31.5	31.5	31.5
Payroll and Fringe Benefits	17.0	16.7	17.3
All Other Expenses	10.5	10.5	10.5
Total Expenses	27.5	27.2	27.8
Profit Before Taxes	4.0	4.3	3.7