Learning to Love Expense Control

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Distributors in all lines of trade, including DHI members, operate in a sales-focused environment. Interestingly, that focus is both positive and negative. On the one hand, the economy continues to provide a strong tailwind which allows firms to enjoy steady, albeit moderate, growth. On the other hand, there is near-hysterical concern about how Amazon might cause the sales party to end badly.

Such a sales focus inevitably leads to a challenge with regard to expense control. In a strong growth environment, expense control is largely neglected. Further, if Amazon is a competitive concern, customer services—and the associated expenses—need to be increased.

This report attempts to balance with the sales versus expense conundrum. It does so by examining two specific issues:

- **Goal Setting for Expense Control–** Specific targets that firms can use to control expenses over time.
- **Expense Control Procedures–** Examination of the specific actions required to make the expense goals a reality.

GOAL SETTING FOR EXPENSE CONTROL

Expense control has a terrible reputation. This is because it is generally confused with expense cutting. The mere thought of expense cuts puts fear into the heart of almost every manager.

Expense *control* is the polar opposite of expense *cutting*, except in a very few instances where expense levels may be outrageous. Expense control involves matching up expenses with sales in a more meaningful way. It starts with the assumption that in most firms, expenses are likely to rise from year to year. The key is to control the rate of growth relative to the anticipated increase in sales.

This is demonstrated in Exhibit 1, which presents current results for the typical DHI member. The first column provides information at the present time, with dollar figures in the top and percent of sales figures at the bottom.

At present, the typical firm generates $15 million in sales, operates on a gross margin percentage of 30 percent and generates $525,000 in pre-tax profits. This represents a bottom-line profit of 3.5 percent of sales.

The final three columns of numbers track the performance of this typical DHI member as it generates sales growth of 5 percent. This is a fairly typical figure in mature industries. The three columns combine the same 5 percent sales growth rate with three different levels of expense growth.

The first of the three scenarios demonstrates the impact of 5 percent sales growth with an expenses increase of only 3 percent. This produces what is typically called a 2 percent sales-to-expense wedge. It is a figure that is widely discussed in distribution as a reasonable goal for expense control.

As can be seen, profits explode from the current $525,000 to $630,750. This $105,750 improvement is an increase of 20.1 percent as shown at the bottom of the first "what if" column. It represents a modest improvement in expense control, but a significant improvement in the bottom line.

The second scenario reflects sales and expenses increasing by the same exact 5 percent rate. It is a sales-to-expense wedge of zero. The result is that profit follows along with a modest 5 percent increase. This represents what has tended to happen in distribution over the last two decades—glacial change.

The final scenario highlights what happens if the sales-to-expense wedge is negative. In this case, expenses have increased 2 percent faster than sales. Sales still reach the same $15,750,000 level as in the first two scenarios, but profit is decimated. The resulting profit margin is just 3 percent and profit falls by $53,250

In all three projected columns sales have increased at the same 5 percent rate. However, the level of expense growth causes profit to increase by very different amounts. Over time the change is massive.

Ideally, firms should be looking for ways to achieve a positive sales-to-expense wedge on the magnitude of 2 percent. This should be an integral part of the planning process. However, it can't be generated without some precise planning.

EXPENSE CONTROL PROCEDURES

Historically, there has been an assumption in distribution that a greater use of technology will result in expense control. The historical pattern discussed earlier indicates that sales and expenses have grown at about the same rate over time. This does not mean that technology is not important. Instead, it suggests that something must be added to the technology mix. Four additional ingredients are required to help achieve true expense control.

Analytics–It is hard to know if expenses are under control or out of control without some specific points of comparison. It is essential to benchmark against other firms in the same industry on an expense line by expense line basis.

Transaction Economics–The two most important metrics that influence costs throughout the business are the number of lines on each order and the average line value. Transactions with few line items or a low value per line extension are inherently unprofitable.

Customers buy the quantity they want, of course. However, the opportunities to change both the line extension and number of lines per order are huge. The simple idea of one more item on every order (want fries with that?) can dramatically change the entire sales to expense equation.

Customer Analysis–Results continually show that some customers are highly profitable and others are quite unprofitable for the firm. While eliminating customers is almost never justified, working with customers to equate the support and services they receive to the profit levels they generate is entirely reasonable.

Proper Planning–The role of planning in generating higher profit levels cannot be overstated. Unfortunately, too many firms continue to plan sales and expenses separately. They must be planned simultaneously in order to ensure that the desired sales to expense wedge is achieved.

MOVING FORWARD

Expense control continues to be the Achilles' heel of most distribution organizations. Cost levels have not been decreased despite major technological improvements. It seems time to think in some new ways. +

EXHIBIT 1 THE IMPACT OF ALTERNATIVE EXPENSE INCREASES COMBINED WITH A FIVE PERCENT SALES INCREASE FOR MEMBERS

		The Expense Increase Associated with a 5.0% Sales Increase		
Typical Firm Income Statement–$	**Current Results**	**3.0% Expense Increase**	**5.0% Expense Increase**	**7.0% Expense Increase**
Net Sales	$15,000,000	$15,750,000	$15,750,000	$15,750,000
Cost of Goods Sold	10,500,000	11,025,000	11,025,000	11,025,000
Gross Margin	4,500,000	4,725,000	4,725,000	4,725,000
Total Expenses	3,975,000	4,094,250	4,173,750	4,253,250
Profit Before Taxes	$525,000	$630,750	$551,250	$471,750
Typical Firm Income Statement–%	**Current Results**	**3.0% Expense Increase**	**5.0% Expense Increase**	**7.0% Expense Increase**
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	70.0	70.0	70.0	70.0
Gross Margin	30.0	30.0	30.0	30.0
Total Expenses	26.5	26.0	26.5	27.0
Profit Before Taxes	3.5	4.0	3.5	3.0
Change in Dollar Profit		105,750	26,250	-53,250
Percentage Change in Profit		20.1%	5.0%	-10.1%