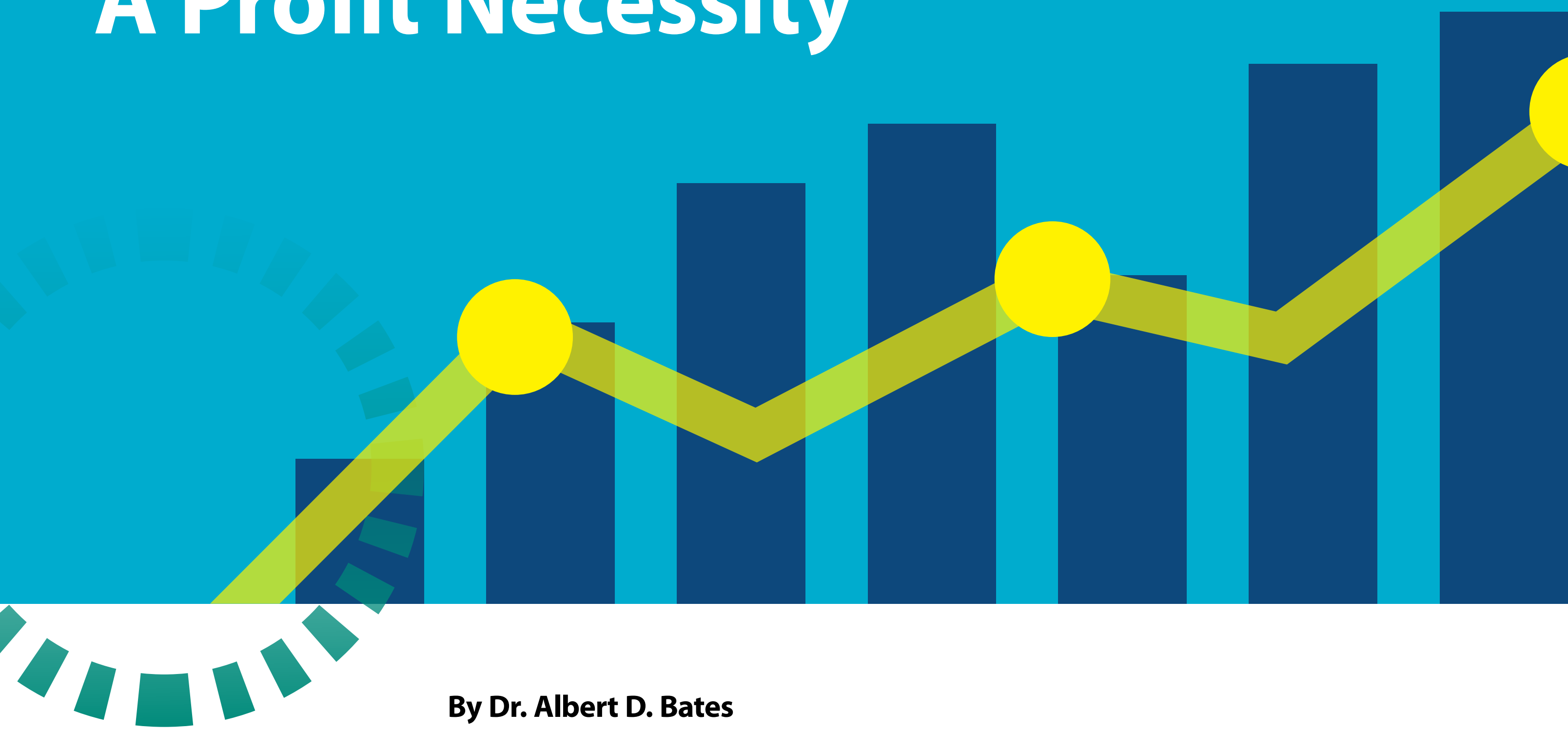
The Sales-to-Payroll Wedge: A Profit Necessity



By Dr. Albert D. Bates

At present most distributors are experiencing strong sales gains. The serious concerns about generating adequate sales are largely a thing of the past. Unfortunately, the strong increases in sales are not translating into strong increases in profit. The problem is that expenses, especially payroll expenses, are absorbing an excessive amount of the increase in sales.

The key to overcoming this problem—and generating substantially higher profits—is to produce what is commonly called a sales-to-payroll wedge. Simply put, sales must grow faster than payroll expense. It is an incredibly simple concept to understand but a maddeningly difficult one to implement.

This report examines the nature of the sales-to-payroll wedge from two perspectives:

- **THE ECONOMICS OF A SALES-TO-PAYROLL WEDGE:** An examination of how sales growth and payroll control combine to produce higher profits
- **IMPLEMENTING THE WEDGE:** A discussion of the specific management actions that are required to generate a sales-to-payroll wedge

The Economics of a Sales-to-Payroll Wedge

One of the oldest management bromides in distribution is "Sales are vanity; profits are sanity." Bromide or not, the statement continues to be true. Sales growth almost always helps, but what is needed is sales growth that does not require a commensurate increase in payroll expenses.

The economics of sales and payroll growth can be seen in Exhibit 1. It reflects the results for a typical DHI member based upon the latest PROFIT Report. The Current Results column indicates that the typical firm generates $12,500,000 in sales and operates on a gross margin percentage of 30.0 percent of sales. It produces a pre-tax profit of 1.5 percent of sales, or $187,500. Of particular note, total expenses are heavily weighted toward payroll, which represents 20.0 percent of sales, or 70.2 percent of total expenses. This is why payroll control is so critical.

The last two columns examine the impact of a sales-to-payroll wedge. Again, this means that sales growth outpaces payroll growth. Two sales growth scenarios are used to examine the sales-to-payroll wedge: 5.0 percent and 15.0 percent.

SLOW GROWTH: The 5.0 percent growth column reflects operations in a mature market. This growth rate was achieved with no change in the gross margin percentage. As a result, both cost of goods sold and gross margin also increase by 5.0 percent.

The real key to this column is that payroll expense only increases by 3.0 percent. This provides a 2.0 percent sales-to-payroll wedge (5.0 percent sales growth minus 3.0 percent payroll growth). For most firms, 2.0 percent is a realistic goal that should be part of planning.

The other expenses (all of the non-payroll items, such as rent, utilities, interest and the like) are assumed to increase at the same rate as sales. Realistically, such expenses would *not* grow as fast as sales. However, this assumption allows the exhibit to focus exclusively on the power of the sales-to-payroll wedge.

As can be seen, the modest 5.0 percent sales growth does wonders for the bottom line if the 2.0 percent sales-to-payroll wedge can be generated. Profit increases from $187,500 to $246,875, an increase of 31.7 percent. Profit is now 1.9 percent of sales.

FAST GROWTH: The last column examines the impact of more rapid growth, defined here as a 15.0 percent increase in sales. The same sorts of effects that were observed in the 5.0 percent column also are seen here. The gross margin percentage stays at 30.0 percent, so sales, cost of goods and gross margin all increase by 15.0 percent.

A 2.0 percent sales-to-payroll wedge is still the goal, so payroll only increases by 13.0 percent. The other expenses follow the same growth path as sales and increase by 15.0 percent. The end result is that profit grows by 41.7 percent to $265,625.

EXHIBIT 1

The Impact of a 2% Sales-to-Payroll Wedge for a Typical DHI Member

		2.0% Sales-to-Payroll Wedge	
Income Statement ($)	**Current Results**	**5.0% Sales Growth**	**15.0% Sales Growth**
Net Sales	$12,500,000	$13,125,000	$14,375,000
Cost of Goods Sold	8,750,000	9,187,500	10,062,500
Gross Margin	3,750,000	3,937,500	4,312,500
Expenses			
Payroll and Fringe Benefits	2,500,000	2,575,000	2,825,000
All Other Expenses	1,062,500	1,115,625	1,221,875
Total Expenses	3,562,500	3,690,625	4,046,875
Profit Before Taxes	$187,500	$246,875	$265,625
Income Statement (%)			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	70.0	70.0	70.0
Gross Margin	30.0	30.0	30.0
Expenses			
Payroll and Fringe Benefits	20.0	19.6	19.7
All Other Expenses	8.5	8.5	8.5
Total Expenses	28.5	28.1	28.2
Profit Before Taxes	1.5	1.9	1.8

It is obvious that a more rapid rate of sales growth produces a somewhat larger bottom line. However, to get to $265,625 in profit versus $246,875, the firm had to generate another $1,250,000 in sales. To do so, it probably had to hire more employees as payroll increased to $2,825,000. It was a lot more work.

The reality is that rapid sales growth makes the sales-to-payroll wedge a little easier to produce. However, sales growth is not the real factor behind higher profits. What matters is how much sales can be increased in relationship to how much payroll has to increase to support that sales growth.

Implementing the Wedge

Producing a sales-to-payroll wedge should seem like a great idea. Although readers can quibble with the 2.0 percent figure if they desire, a wedge of some size seems essential. The issue now is to identify how such a wedge can be generated.

In trying to produce the sales-to-payroll wedge, it is important to note that improved productivity systems are probably not the answer. Distributors have become much more sophisticated in using technology tools over the last decade, yet payroll remains about the same percent of sales as it did 10 years ago. There has been no sales-to-payroll wedge.

Something else is required. That “something else” necessitates attention to the three areas where the sales versus payroll expense trade-off should be positive.

LINES PER ORDER: Putting more lines on every order allows for a sales increase with only a modest payroll cost increase. Increasing the lines per order revolves around two actions. The first is to have the sales force do more add-on selling. It is an age-old issue of monitoring, evaluating and compensating.

The second action in driving more lines per order is to ensure that customers are aware of everything in the firm's assortment. There is nothing wrong with telling them over and over about one-stop shopping.

FILL RATE: If you don't have it, you can’t sell it, and if you don't have it often enough, all of your customers go away. However, improving the fill rate inevitably leads to the requirement to carry more inventory.

Adding inventory to increase sales is *always* a good idea. Of course, adding inventory without increasing sales is a terrible idea. The truth is that way too many firms have cut inventory to the point that sales are impacted negatively.

AVERAGE LINE VALUE: Increasing the average line value (or line extension, to use different terminology) is largely a pricing issue. No customer wants to pay too much. However, every distributor has a large array of slower-selling items for which availability is much more critical than price. It is an opportunity that needs to be exploited to produce more sales dollars from the same unit sales.

With the effort to increase the fill rate mentioned previously, the opportunity to be the “always in stock at a fair price” distributor increases substantially. However, the increased fill rate must be supported by fair-value pricing. Firms must get paid for the services they provide.

Moving Forward

Payroll as a percent of sales is stuck in a rut that goes back at least 10 years. If firms are going to lower their payroll expense percentage and increase their bottom line, they must plan with the concept of a sales-to-payroll wedge in mind. Generating that wedge will require emphasizing three concepts: more lines per order, a higher fill rate, and an increase in the average order line value. ■

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Want More Profit Improvement Help?

In addition to the upcoming annual Profit Survey for distributor corporate members, all DHI members now have access to an archived webinar on **www.dhi.org**, The Real Profit Drivers, presented by Dr. Albert Bates, Chairman, President and Founder of Profit Planning Group. This webinar reviews the results of the annual survey of distributor profitability and discusses what factors drive profitability across a wide range of distribution company sizes. For more information on these member benefits contact Member Services at **memberservices@dhi.org**.