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Profit Improvement Report

"Surviving the Recovery"

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Surviving the Recovery

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The American economy continues to grow at a rate that is somewhere between modest and anemic. Good economic news is almost always followed by bad news. The hope that a rising tide would lift all boats seems ephemeral.

In a slow-growing market, the challenge is to somehow maintain sales momentum at a rate that exceeds the growth of the market as a whole. It is a difficult, but not insurmountable, task.

This report looks at sales growth in a somewhat unconventional manner. It will do so by exploring two aspects of the sales equation:

- **The Sales Mandate**–An examination of the relationship between sales growth and profitability.
- **Cost of Goods Not Sold**–Some specific suggestions for ensuring that the firm gets every dollar of potential sales.

The Sales Mandate

One of the central tenets of profit improvement is that sales must grow faster than the expenses required to generate those sales. In particular, sales must increase faster than payroll expenses–including all salaries, commissions, bonuses, social costs (Medicare and FICA) as well as health insurance and retirement, usually a 401(k) program.

The real requirement with regard to sales growth is for that increase in sales to be larger than the increase in payroll expense. This is what is commonly call a *sales-to-payroll differential*. A realistic target for the differential is two percent.

If sales increases by 10.0%, then payroll could be allowed to increase by 8.0% to support the sales increase. As long as sales volume is growing at a reasonable rate, such as 10.0%, then the objective seems "easy" to achieve. When only a 5.0% increase in sales is possible, payroll must be controlled more aggressively, so that only a 3.0% increase is allowed.

It is extremely important to note that in terms of profitability the 10.0% sales growth/8.0% payroll growth model is really not that much better than the 5.0% sales growth/3.0% payroll growth model. Any time sales growth outpaces payroll growth (holding other factors constant) profit will increase appreciably. The challenge occurs when sales growth is very slow or even non-existent.

Theoretically, a 2.0% sales-to-payroll differential can be generated even if sales are flat. With no sales growth, payroll would have to be reduced by 2.0%. There is the obvious potential for a death spiral in such a situation. Lower sales leads to lower payroll which leads to poor customer service. Eventually, this leads to even lower sales.

In the real world (where analysts fear to venture) life without sales growth is unthinkable. With a flat economy, growth must be taken out of a competitor's share. Ultimately, the key to generating a continually higher level of sales growth is enhanced performance by the sales force.

Cost of Goods Not Sold

As long as the economy is growing briskly, an ineffective salesperson is a minor problem. A poor salesperson here, a poor one there; the good ones generate enough volume to cover up the problems. However, as the economy becomes less supportive of automatic growth, this scenario is no longer viable.

Exhibit 1 looks at the profit impact of an ineffective salesperson for the typical member of DHI. The first column of numbers demonstrates total company performance. As indicated in the PROFIT Report, it is a $10,000,000 firm with a bottom line profit of $150,000 or 1.5% of sales.

The only detail that might not be clear is that the sales force is being paid a commission equal to 10.0% of the gross margin dollars. In addition, there are other variable expenses equal to 5.0% of sales volume.

The second column simply assumes that there are five salespeople and that every territory is exactly equal in potential. Mathematically, all of the numbers in the first column have been divided by five.

The last column examines the profit impact of a salesperson that only produces 80% of what a typical salesperson would produce in the same territory. This is not 80% of the top salesperson, but the average one. As can be seen, the territory that should generate $30,000 in profit actually has lost $54,400. The difference between the profit the territory could have generated and what it actually generated is what the author has termed Cost of Goods Not Sold.

This is a loss that is never seen on the income statement because the performance of the poor salesperson is offset by the performance of the good ones. All the firm tends to focus on is the aggregate results in column one.

In the short run, in every territory some sales volume is better than non. In addition, the costs of replacing a salesperson are extremely visible. There are recruitment costs plus the fact that the salesperson will undoubtedly need time to ramp up to a desired level. Even then, the replacement may be no better than the original. These factors make firms extremely hesitant to make staffing changes with regard to sales.

It is not the intent of this report to decimate the sales force. It is simply to state that generating higher profit is indelibly linked to generating a sufficient rate of sales growth. That growth can only be achieved in a sluggish economy if every salesperson is performing adequately. Not spectacularly. Only a few can reach that level. Adequacy should be expected from all.

For outside salespeople, measuring performance accurately requires knowing the potential in each territory. Firms must spend at least some time evaluating account potential. Without this indicator firms can still intuitively distinguish great salespeople from typical, but will have real problems determining whether the low-end performer is inadequate or is saddle with a less-desirable territory.

For inside salespeople, life is much easier. It is only necessary to know the total number of customer contacts. Sales per contact is a simple, but effective ratio.

Ensuring that sales performance is adequate also requires incorporating a specific set of metrics into the company's management information system. In particular, it is essential to understand the extent to which the salesperson is maximizing the potential of every transaction.

Two key factors have always been important in transaction analysis. The first is the number of line items sold per transaction. This measures performance with regard to add-on selling. The second is the average line value. This reflects the capacity for up-selling. Without a system that can pinpoint these issues per-salesperson basis, improvement is simply not possible.

Moving Forward

Sales growth must be maintained at a level that allows the firm to produce a sales-to-payroll differential of something in the 2.0% range. When (not if) the economy starts growing again, this will be easier to accomplish. In the meantime, firms need to use every tool available to ensure that the productivity targets of the sales force are being met.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book, ***Triple Your Profit!***, is available at: www.tripleyourprofitbook.com, as well as Amazon and Barnes & Noble.

A Managerial Sidebar:
Isn't a Higher Growth Rate Better?

Intuitively it would seem that faster sales growth would always produce a dramatically higher level of profit than slower growth. In truth, the real key is the ability to generate the sales-to-payroll differential.

For the typical DHI member, 5.0% sales growth combined with 3.0% payroll growth drives profit from the current $150,000 to $197,500. With 10.0% sales growth and 8.0% payroll growth profit increases to $205,000.

Admittedly, $205,000 is higher than $197,500. However, the difference is not dramatic. Both scenarios reflect a significant improvement in profitability.

The Impact of a 2% Sales to Payroll Differential

Income Statement--$	**Current Results**	**5% Sales Growth**	**10% Sales Growth**
Net Sales	$10,000,000	$10,500,000	$11,000,000
Cost of Goods Sold	7,100,000	7,455,000	7,810,000
Gross Margin	2,900,000	3,045,000	3,190,000
Expenses			
Payroll	2,000,000	2,060,000	2,160,000
All Other Expenses	750,000	787,500	825,000
Total Expenses	2,750,000	2,847,500	2,985,000
Profit Before Taxes	$150,000	$197,500	$205,000
Income Statement--%			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	71.0	71.0	71.0
Gross Margin	29.0	29.0	29.0
Expenses			
Payroll	20.0	19.6	19.6
All Other Expenses	7.5	7.5	7.5
Total Expenses	27.5	27.1	27.1
Profit Before Taxes	1.5	1.9	1.9

Exhibit 1
The Challenge of Under-performing Salespeople
For the Typical DHI Member

Income Statement--$	**Current Results**	**Per Salesperson**	**80% Salesperson**
Net Sales	$10,000,000	$2,000,000	$1,600,000
Cost of Goods Sold	7,100,000	1,420,000	1,136,000
Gross Margin	2,900,000	580,000	464,000
Expenses			
Sales Commissions	290,000	58,000	46,400
Variable Expenses	500,000	100,000	80,000
Fixed Expenses	1,960,000	392,000	392,000
Total Expenses	2,750,000	550,000	518,400
Profit Before Taxes	$150,000	$30,000	-$54,400

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