



ADVISORY

FOCUSING ON THE BIG TWO

Profit Improvement

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One of the more interesting aspects of management is the degree to which extremely small changes in key areas of business result in large changes in overall profitability. In fact, the difference between the top firms in STAFDA's annual *Performance Analysis Report (PAR)* and the lower-profit firms is a matter of doing just a little better on a few critical factors.

The difficulty in driving the "philosophy of small changes" throughout the business is there are several different areas where such changes are possible. In reality, though, there are only two fundamental issues that management needs to address from a financial perspective: expense leveraging and gross margin management.

The need for control over these two fundamental concepts will be examined from two different perspectives:

- **Improvement Goals and Their Profit Impact**—Most firms are not fully aware of the extent to which very modest changes in performance will result in huge improvements in profitability. This section will examine just how large the opportunity is.
- **The Implementation Challenge**—Even though the improvement need is modest, it is still an improvement. There must be some specific programs in place to help achieve this result.

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Improvement Goals and Their Profit Impact

The link between small changes and large improvement is outlined in **Exhibit 1**.

Exhibit 1

The Financial Impact of a Combination of Gross Margin and Expense Leveraging

| Income Statement—\$ | Current Results | Systematic Changes | Percent Change |
|-----------------------------|------------------|--------------------|----------------|
| Net Sales | 6,000,000 | 6,300,000 | 5.0 |
| Cost of Goods Sold | <u>3,900,000</u> | <u>4,050,900</u> | 3.9 |
| Gross Margin | 2,100,000 | 2,249,100 | 7.1 |
| Payroll and Fringe Benefits | 1,250,000 | 1,287,500 | 3.0 |
| All Other Expenses | <u>670,000</u> | <u>683,400</u> | 2.0 |
| Total Expenses | <u>1,920,000</u> | <u>1,970,900</u> | 2.7 |
| Profit Before Taxes | 180,000 | 278,200 | 54.6 |

| Income Statement—% | | | |
|-----------------------------|-------------|-------------|--|
| Net Sales | 100.0 | 100.0 | |
| Cost of Goods Sold | <u>65.0</u> | <u>64.3</u> | |
| Gross Margin | 35.0 | 35.7 | |
| Payroll and Fringe Benefits | 20.8 | 20.4 | |
| All Other Expenses | <u>11.2</u> | <u>10.8</u> | |
| Total Expenses | <u>32.0</u> | <u>31.3</u> | |
| Profit Before Taxes | 3.0 | 4.4 | |

The first column in the exhibit presents results for the typical STAFDA member based upon the latest *PAR*. As shown, the typical firm generates sales of \$6,000,000, operates on a gross margin of 35% of sales and produces a pre-tax profit of 3% of sales, or \$180,000.

The final column of numbers in the exhibit identifies the profit impact of focusing on expense leveraging and gross margin management. The exhibit incorporates some highly specific goals for STAFDA members which need to be well understood. There are three areas in which changes have been made:

- **Sales**—The sales growth factor used in the exhibit is 5%. However, any level of growth could have been used, either positive or negative. The 5% figure represents the modest performance demonstrated in many mature industries during periods of normal economic activity. The point is that rapid growth is not required for profit improvement.

- **Gross Margin**—This is the impact of 2% more margin dollars on whatever level of sales volume is generated. This is not the same as increasing the gross margin percentage by two percentage points. Instead, the new gross margin figure is the new sales volume (which has increased by 5%) times the existing gross margin of 35%, then adding an additional 2% more margin dollars. The result is that the gross margin increases from 35% of sales to 35.7%.

- **Expenses**—The basic concept of expense leveraging is to manage expenses so they grow at a slower rate than sales. In the exhibit, two different leveraging rates have been used. While sales have grown by 5%, payroll has grown by 3% and other expenses by 2%. This reflects the reality that payroll expenses (including all of the fringe benefits) are more difficult to control than non-payroll expenses.

The impact of these changes is dramatic. Profit before taxes increases from \$180,000 to \$278,200, an increase of 54.6%. In short, a concerted effort on making small changes in the big two can provide a significant improvement in overall profitability.

The specific figures used in the exhibit, such as 2% more gross margin, are not necessarily recommended as goals for all STAFDA members. Every firm has its own unique set of economics which require company-specific goals.

However, they are suggested as starting points in each firm's planning process. In most cases, realistic targets for STAFDA members should be relatively close to the illustrative figures used in the exhibit.

It's important to note inventory and accounts receivable are conspicuous by their absence in the analysis. This does not mean they are not important business elements. However, it does suggest that improvements in inventory and accounts receivable control are not required.

If performance in these two areas can be maintained at existing levels, the focus on margin and expense leveraging will be sufficient for profit improvement. Conversely, if improvements in either gross margin or expense leveraging are possible, profit enhancement will be extremely difficult.

The Implementation Challenge

Plans are wonderful. They're a roadmap that helps firms see how to get where they need to go. A detailed, easy-to-understand plan is particularly valuable as it readily translates into understandable terms for employees. Understandable plans are more likely to be achieved.

However, even the best plan does not ensure success. From an implementation perspective, firms need to do two specific things. First, they need to educate employees on the reason for these changes. Second, they need to translate the overall goals into action items for all employees.

Financial education of employees is essential, but frequently ignored. The problem is that without a basic understanding of what happens in a business from a financial perspective, change is misunderstood. For example, most employees believe if gross margin is increased by 2%, profit will increase by 2%.

The second implementation challenge is that overall goals—in terms of both margin and expense planning—must be translated into a plan for each individual in the firm. In essence, every employee needs to know specifically what to do and how to contribute to the overall company goals and objectives.

If sales must be increased by 5%, that translates into the number of additional order lines the sales force has to produce each week, the increased service level that must be achieved, or the number of potential new accounts that must be contacted. Then it is necessary to demonstrate the potential cumulative impact on profits. Only when employees have precise marching orders and an appreciation for their impact can the company move toward improved performance goals.

Moving Forward

If STAFDA members are going to reach higher levels of profitability, it's essential they develop improvement plans in two areas—gross margin and expense leveraging. In addition, they must ensure every employee understands how individual actions will help make the improvements a reality.

A Managerial Sidebar: What About One Out of Two?

Sometimes the issue with regard to the “big two” becomes which one to do first. The following example shows the impact of improvements in expense leveraging and gross margin improvement in isolation. At the bottom of the example, the small synergistic impact from taking both actions simultaneously is calculated as well.

| Income Statement--\$ | Current Results | Expense Leveraging | Gross Margin |
|------------------------------------|--------------------|-----------------------|------------------|
| Net Sales | \$6,000,000 | \$6,300,000 | \$6,000,000 |
| Cost of Goods Sold | <u>3,900,000</u> | <u>4,095,000</u> | <u>3,858,000</u> |
| Gross Margin | 2,100,000 | 2,205,000 | 2,142,000 |
| Payroll and Fringe Benefits | 1,250,000 | 1,287,500 | 1,250,000 |
| All Other Expenses | <u>670,000</u> | <u>683,400</u> | <u>670,000</u> |
| Total Expenses | <u>1,920,000</u> | <u>1,970,900</u> | <u>1,920,000</u> |
| Profit Before Taxes | \$180,000 | \$234,100 | \$222,000 |
| | | | |
| Increase in Profit | | 54,100 | 42,000 |
| Total of the Two Increases | | | 96,100 |
| The Combination Impact (Exhibit 1) | | | 98,200 |
| Synergistic Impact | | | 2,100 |
| | | | |
| Distribution of the Impact | | | |
| Expense Leveraging | | | 55.1 |
| Gross Margin Improvement | | | 42.8 |
| Synergy | | | <u>2.1</u> |
| Total | | | 100.0 |