

Profit Improvement Report

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The Problem That Will Not Die

By Dr. Albert D. Bates
President, Profit Planning Group

Payroll expense is like a character in a cheap horror movie—it's frightening and just when it seems to have been vanquished, it turns up in a sequel. Well, just like in the movies, payroll expense is back. This time the sequel is due to sales challenges associated with the recession. Sales have disappeared a lot faster than reductions in payroll expense can be made.

This report will examine the impact that payroll expense is having on industry profit performance and how that performance can be brought back in line with desired payroll levels. It will do that by addressing two key issues:

- **Assessing the Payroll Challenge**—An explanation of the most effective way to evaluate payroll productivity.
- **The Economics of Payroll Control**—An examination of the alternative approaches available to management to lower payroll expenses.

Assessing the Payroll Challenge

There are numerous ways to evaluate payroll, including sales per employee, payroll as a percent of sales, or payroll per employee. However, none of these ratios provides as complete an examination of the firm's ability to control payroll as the Personnel Productivity Ratio (PPR).

The PPR, which is reported each year in the FDPFR Report sponsored by IFDA, expresses total payroll expense as a percentage of the gross margin dollars generated by the firm. Total payroll expenses include all employee compensation and all fringe benefits. The ratio is not intuitive, so it is useful to start with a look at some of the key financial results for the typical IFDA member:

- Net Sales: \$85,000,000.
- Gross Margin: \$14,025,000, or 16.5% of sales.
- Payroll: \$8,246,700, or 9.7% of sales.
- PPR: 58.8% (\$8,246,700 of payroll divided by \$14,025,000 of gross margin).

The PPR is one of the rare ratios where lower is better than higher. For IFDA members, the ratio means that every \$1.00 of gross margin generated requires a payroll expenditure of 58.8 cents. This means that after paying all payroll expenses, there is only 41.2 cents left to cover all of the firm's other expenses and generate a profit for the firm.

The strength of the PPR is that it reflects the overall impact of three different profit pressure points—sales, payroll itself and gross margin. However, this advantage is also something of a disadvantage. Sometimes it is difficult to determine which of the three different pressure points should be addressed:

- **Sales Volume**—If additional sales can be generated with the same gross margin percentage and the same dollar commitment to payroll, then the PPR will fall.
- **Payroll Costs**—Any cut in payroll that does not result in a reduction in sales will clearly lower the PPR.
- **Gross Margin**—If the firm increases its gross margin percentage on the same sales volume, the PPR will also fall.

In most instances, management uses a blend of actions to bring down the PPR. What is most important to remember is that any group of actions that lowers the PPR will simultaneously generate higher profits for the firm.

The Economics of Payroll Control

Exhibit 1 examines the financial impact of the three major options to improve the PPR identified above. Exhibit 1 presents information for the typical IFDA member—the firm producing mid-point performance on sales, gross margin, PPR and bottom-line profit. While every firm is somewhat unique, the figures in Exhibit 1 reflect how profit results will change as the PPR is lowered.

The first column of numbers simply reviews the typical firm's performance. The firm generates \$85,000,000 in sales which produces \$1,275,000 in profit before taxes, or 1.5% of sales.

The next three columns examine what would be required to reduce the PPR by exactly 2.0 percentage points if the three actions were taken individually—either increasing sales, lowering payroll or improving the gross margin percentage. The 2.0 figure is merely illustrative. Some firms can lower the PPR more in a single year while others have less potential for improvement. However, two points is a reasonable goal for most firms.

The second column of numbers indicates that if sales rise by 3.5% (actually 3.521% for the purist reader), then the PPR will be reduced by exactly 2.0 percentage points. The ultimate implication of a sales-based approach to lowering the PPR is that profit will increase to \$1,768,838, or 2.0% of sales.

The sales-based strategy is dependent upon two very crucial assumptions. First, the gross margin percentage must be maintained at 16.5% of sales. This means that price cutting cannot drive the sales increase. Second, payroll expense remains at the same dollar level, namely \$8,246,700. The implication of this is that as sales recover, the first 3.5% of sales increase must go to improving performance, not to providing compensation increases to employees, regardless of how deserving they may be.

The third column of numbers examines the reduction in payroll expense that would be necessary to lower the PPR in light of no increase in sales volume. The required reduction is 3.4%, just slightly smaller than the 3.5% increase in sales required to achieve the same reduction in the PPR. Despite producing the same reduction in the PPR, the increase in profit is smaller with expense reductions than with sales increases. The resulting profit is only \$1,555,500 or 1.83 of sales. It is still a significant increase.

Finally, if the gross margin percentage can be improved by 0.6 percentage points (increasing from 16.5% to 17.1%), then the PPR will also fall by the same 2.0 points during the year. This approach produces the same exact amount of gross margin dollars and the same amount of profit as the sales increase approach. For the sake of simplicity, the example assumes the margin is increased via improved buying. A price increase model would have produced almost virtually the same financial result.

Each of the three approaches has its own challenges. Regardless of which approach is selected, it is clear that a 2.0 percentage point reduction in the PPR increases profits significantly. It is a reasonable starting point for planning.

Moving Forward

Economic conditions have caused payroll expense to once again come to the fore as a significant issue. Given continued uncertainty in the economy, firms need to take a multi-faceted approach to controlling payroll. The PPR is the best tool available to evaluate the success of those actions.

About the Author:

Dr. Albert D. Bates is founder and president of Profit Planning Group, a distribution research firm headquartered in Boulder, Colorado.

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A Managerial Sidebar: Three Quickies for Lowering the PPR

For the most part lowering the PPR involves time-phased, long-term commitment to a number of initiatives. However, there are a few things that can be done quickly. The following represents but three examples:

- **Sales Volume**—Probably the fastest way to increase sales, especially in a down market, is to generate more lines on every order. Only a very small change is required to generate higher sales without any increase in payroll expense (other than commissions). The sales force is probably tired of hearing the plea to put more lines on every order, but it is a plea worth making again.
- **Payroll Expense**—Most firms provide a wide array of extremely valuable services that their customers relish. They also provide a few services that customers don't ever use or view as having almost no value. The quickest way to lower payroll expenses is to stop doing the things that have limited or no value to customers.
- **Gross Margin**—Virtually every firm routinely under-prices slow moving merchandise. Yet, there is an incredible value added for customers by having inventory of slow-selling items available when they are needed. That value added is worth a slightly higher price.

Exhibit 1 Alternative Scenarios for Improving the PPR For a Typical IFDA Member

	Current	3.5% Sales Growth	3.4% Payroll Reduction	0.6% Point Higher Gross Margin
Net Sales	\$85,000,000	\$87,992,958	\$85,000,000	\$85,000,000
Cost of Goods Sold	<u>70,975,000</u>	<u>73,474,120</u>	<u>70,975,000</u>	<u>70,481,162</u>
Gross Margin	14,025,000	14,518,838	14,025,000	14,518,838
Payroll and Fringe Benefits	8,246,700	8,246,700	7,966,200	8,246,700
All Other Expenses	<u>4,503,300</u>	<u>4,503,300</u>	<u>4,503,300</u>	<u>4,503,300</u>
Total Expenses	<u>12,750,000</u>	<u>12,750,000</u>	<u>12,469,500</u>	<u>12,750,000</u>
Profit Before Taxes	\$1,275,000	\$1,768,838	\$1,555,500	\$1,768,838
PPR	58.8%	56.8%	56.8%	56.8%
Profit Before Taxes--%	1.5%	2.0%	1.8%	2.1%