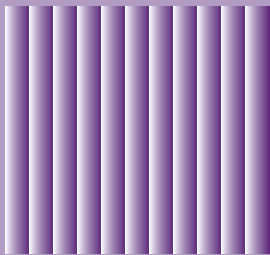


ROI | INCOME STATEMENT | EXPENSES IN RELATIONSHIP TO GROSS MARGIN | BALANCE SHEET  
| FINANCIAL RATIOS | ASSET PRODUCTIVITY RATIOS | MERCHANDISING PROFILE | EMPLOYEE  
PRODUCTIVITY RATIOS | SALES VOLUME ANALYSIS | REGIONAL ANALYSIS | TREND ANALYSIS

Vol. 17, No. 3



2009

# Profit Improvement Report

**“Focusing on the Big Two”**

Sponsored By the Door and Hardware Institute  
and the Foundation for the Advancement of Life Safety and Security

**Exhibit 1**  
**The Financial Impact of a Combination of**  
**Gross Margin and Expense Leveraging**

<b>Income Statement--\$</b>	<b>Current Results</b>	<b>Systematic Changes</b>	<b>Percent Change</b>
Net Sales	8,000,000	8,400,000	5.0
Cost of Goods Sold	<u>5,520,000</u>	<u>5,743,920</u>	4.1
Gross Margin	2,480,000	2,656,080	7.1
Payroll and Fringe Benefits	1,600,000	1,648,000	3.0
All Other Expenses	<u>720,000</u>	<u>734,400</u>	2.0
Total Expenses	<u>2,320,000</u>	<u>2,382,400</u>	2.7
Profit Before Taxes	160,000	273,680	71.1
<b>Income Statement--%</b>			
Net Sales	100.0	100.0	
Cost of Goods Sold	<u>69.0</u>	<u>68.4</u>	
Gross Margin	31.0	31.6	
Payroll and Fringe Benefits	20.0	19.6	
All Other Expenses	<u>9.0</u>	<u>8.7</u>	
Total Expenses	<u>29.0</u>	<u>28.4</u>	
Profit Before Taxes	2.0	3.3	

# Profit Improvement Report

Prepared for DHI  
Vol. 17, No. 3  
September, 2008

## Focusing on the Big Two

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

One of the more interesting aspects of management is the degree to which extremely small changes in key areas of the business result in large changes in overall profitability. In point of fact the differences between the very top firms in DHI's annual PROFIT Report 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 that there are lots of 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. These issues are 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.

## Improvement Goals and Their Profit Impact

The link between small changes and large improvement is outlined in **Exhibit 1**. The first column in the exhibit presents results for the typical DHI member based upon the latest PROFIT Report. As can be seen in the exhibit, the typical firm generates sales of \$8,000,000, operates on a gross margin of 31.0% of sales and produces a pre-tax profit of 2.0% of sales, or \$160,000.

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 DHI 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 5.0%. However, any level of growth could have been used, either positive or negative. The 5.0% 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 2.0% 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 5.0%) times the existing gross margin of 31.0%, then adding an additional 2.0% more margin dollars. The result is that the gross margin increases from 31.0% of sales to 31.6%.
- **Expenses**—The basic concept of expense leveraging is to manage the expenses so that they grow at a slower rate than sales. In the exhibit, two different leveraging rates have been used. While sales have grown by 5.0%, payroll has grown by 3.0% and other expenses by 2.0%. 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 \$160,000 to \$273,680, an increase of 71.1%. 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 2.0% more gross margin, are not necessarily recommended as goals for all DHI members. Every firm has its own unique set of economics which requires company-specific goals.

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

It is important to note that inventory and accounts receivable are conspicuous by their absence in the analysis. This does not mean that these are not important elements of the business. 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 that if gross margin is increased by 2.0%, profit will increase by the same 2.0% figure.

The second implementation challenge is that the 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 it contributes to realizing the overall company goals and objectives.

For example, if sales must be increased by 5.0%, then that needs to be translated into the number of additional order lines that the sales force has to produce each week, or the increase in the 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 towards the improved performance goals.

## **Moving Forward**

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

---

### **About the Author:**

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

©2008 Profit Planning Group. DHI has unlimited duplication rights for this manuscript. Further, members may duplicate this report for their internal use in any way desired. Duplication by any other organization in any manner is strictly prohibited.

## A Managerial Sidebar: What About One Out of Two?

Sometimes the issue with regard to the “big two” become 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.

<b>Income Statement--\$</b>	<b>Current Results</b>	<b>Expense Leveraging</b>	<b>Gross Margin</b>
Net Sales	\$8,000,000	\$8,400,000	\$8,000,000
Cost of Goods Sold	<u>5,520,000</u>	<u>5,796,000</u>	<u>5,470,400</u>
Gross Margin	2,480,000	2,604,000	2,529,600
Payroll and Fringe Benefits	1,600,000	1,648,000	1,600,000
All Other Expenses	<u>720,000</u>	<u>734,400</u>	<u>720,000</u>
Total Expenses	<u>2,320,000</u>	<u>2,382,400</u>	<u>2,320,000</u>
Profit Before Taxes	\$160,000	\$221,600	\$209,600
Increase in Profit		61,600	49,600
Total of the Two Increases			111,200
The Combination Impact (Exhibit 1)			113,680
Synergistic Impact			2,480
Distribution of the Impact			
Expense Leveraging			54.2
Gross Margin Improvement			43.6
Synergy			<u>2.2</u>
Total			100.0



Sponsored by:

## FOUNDATION

for the Advancement of *Life Safety and Security*

As the direction of the Foundation has changed, now so has its name. The DHI Education Foundation is now the "Foundation for the Advancement of Life Safety and Security." This name change reflects the work that the Foundation has undertaken on behalf of our industry. The name reflects an area of growth opportunity—security. There is much to be done to provide enhanced security within the buildings we touch.

Along with providing security, we also have an opportunity to play a very important leadership role in life safety - through the fire-door inspection process. If we can achieve increased financial support, the Foundation can begin to implement a program that will raise the awareness level of this important new code change. The fire-door inspection concept is a huge opportunity for the architectural openings community - an opportunity to provide valuable insight into the safety and security of each and every fire-rated door.

The Foundation's core purpose is to raise funds to provide education and research for the advancement of the architectural openings industry and the safety and security of the built environment.



**Safely Securing the Built Environment**

Door and Hardware Institute  
14150 Newbrook Drive  
Suite 200  
Chantilly, VA 20151-2232

phone: 703.222.2010  
fax: 703.222.2410

[www.dhi.org](http://www.dhi.org)

The Door and Hardware Institute is a professional organization that serves the North American marketplace as the advocate and primary information resource for professional development and certification for the architectural openings industry with a focus on the channels of distribution.

USA \$75.00