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. 1

2008

Profit Improvement Report

“The Sales to Payroll Delta: A Critical Planning Tool”

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

Profit Improvement Report

Prepared for DHI
Vol. 17, No. 1
March, 2008

The Sales to Payroll Delta: A Critical Planning Tool

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

Payroll control is a critical issue for all DHI members. According to the latest PROFIT report, payroll and associated fringe benefits account for 69.0% of total expenses. In slightly different terms, payroll costs are 2.2 times as large as all other expenses combined.

One important challenge in controlling payroll is finding a practical procedure for planning what payroll costs should be. It is not enough to simply suggest that payroll should be a lower percentage of sales, as that does not suggest how much lower payroll costs should be or how fast a reduction can be made.

Firms also face the very real issue that reducing payroll too much may diminish the firm's ability to service its customer set effectively. Indeed, payroll costs can be too low as well as too high.

This report examines an approach for planning payroll called the **Sales to Payroll Delta**. In doing so, the report will address two specific issues:

- **Targeting the Sales to Payroll Delta**—An explanation of the concept of a Sales to Payroll Delta plus a suggestion of some specific goals for planning payroll in the future.

- **Making Specific Improvements—**A review of the opportunities for improving payroll performance.

Targeting the Sales to Payroll Delta

The sales to payroll delta is the difference in the growth rates of sales and total payroll costs, including fringe benefits. As an example, if sales grew by 5.0% and payroll costs grew by 3.0%, then the sales to payroll delta would be 2.0 percentage points. Similarly, with 15.0% sales growth and 13.0% payroll growth, there would still be a 2.0% delta.

The most important point regarding the sales to payroll delta is that it focuses management on the fact that sales do not have to grow rapidly to generate substantially higher profits. In each of the examples above, the firm produced a 2.0% sales to payroll delta. The two plans are almost equally valuable.

This idea that actual sales growth may not be all that important is alien to traditional thinking, so it is useful to review Exhibit 1 which presents the latest financial results for the typical DHI member. As can be seen in the first column of numbers, this firm generates $8,000,000 in sales volume, operates on a gross margin of 31.0% and produces a bottom-line profit of 2.0%. In addition, payroll and fringe benefits are 20.0% of sales, the largest expense category.

Income Statement	Current Results	5% Sales Increase	10% Sales Increase
Dollars			
Net Sales	$8,000,000	$8,400,000	$8,800,000
Cost of Goods Sold	5,520,000	5,796,000	6,072,000
Gross Margin	2,480,000	2,604,000	2,728,000
Expenses			
Payroll and Fringe Benefits	1,600,000	1,648,000	1,728,000
All Other Expenses	720,000	756,000	792,000
Total Expenses	2,320,000	2,404,000	2,520,000
Profit Before Taxes	$160,000	$200,000	$208,000
Percent of Sales			
Net Sales	100.0 %	100.0 %	100.0 %
Cost of Goods Sold	69.0	69.0	69.0
Gross Margin	31.0	31.0	31.0
Expenses			
Payroll and Fringe Benefits	20.0	19.6	19.6
All Other Expenses	9.0	9.0	9.0
Total Expenses	29.0	28.6	28.6
Profit Before Taxes	2.0 %	2.4 %	2.4 %

Exhibit 1. The Impact of a 2% Sales to Payroll Delta At Different Levels of Sales Growth

In the final two columns of numbers, sales have been increased. In the middle column the sales increase is only 5.0%, while in the final column it is 10.0%. The key issue is that in both examples, there is a 2.0% sales to payroll delta. That means that when sales increased by 5.0%, payroll only increased by 3.0%. By the same logic, the 10.0% sales increase has been supported by an 8.0% payroll increase.

It is important to note that in both examples profit before taxes increased significantly. Of equal consequence, the 10.0% sales increase produced a profit improvement that was only modestly larger than the one generated by the 5.0% sales increase. This suggests that sales alone is not the driver of profitability. It is the ability of the firm to control payroll in relationship to sales that is key.

The results from Exhibit 1 may seem self-evident. Of course, profit is increased when sales grow faster than payroll. The reality, though, is that while the results are self-evident, a measurable sales to payroll delta has proven to be an elusive goal for most DHI members.

Over the long term, sales and payroll tend to rise together. In tough economic times, firms tend to get aggressive on payroll. In good times, they tend to grow lax. The net result is that over a five-year period, sales and payroll tend to rise at the exact same rate. It is this pattern of equal increases that needs to be broken.

Setting a specific goal for the sales to payroll delta must be done at the individual firm level. For firms that have always had strong control of payroll expenses, a delta of only 1.0% or so per year may be all that is possible. For firms where payroll is somewhat out of control, a 3.0% improvement should be attainable. For the typical DHI firm, somewhere around a 2.0% goal is realistic for each of the next three to five years.

The goals may also need to vary depending upon economic conditions. As was shown in Exhibit 1, with a 10.0% sales increase it is relatively “easy” to produce a 2.0% sales to payroll delta. Payroll can increase by 8.0% which allows for adequate increases in compensation for the existing work force and possibly even additional staffing.

In contrast, with only a 5.0% sales increase, the 3.0% increase in payroll requires a much more austere approach to payroll planning. Certainly for some employees there is no latitude to increase compensation at all.

In a period of no sales growth, the 2.0% delta would require a reduction in payroll of 2.0%. At the most extreme, in a recession where sales fall by say 5.0%, then achieving the goal of 2.0% would require a 7.0% reduction in payroll. Clearly, the slower the sales growth, the more difficult the 2.0% goal is to achieve. Even so, firms should target the 2.0% as a realistic goal over time. For the next five years, a cumulative goal of 10.0% is desirable.

Making Specific Improvements

It is a lot easier to talk about making payroll improvements than it is to actually make them. All the sales to payroll delta can do is suggest the magnitude of the improvements that are needed to reach higher levels of profitability. The goals need to be translated into specific actions.

As was noted earlier, generating a sales to payroll delta is much easier when sales are increasing. This means that the focus should be on creating an environment in which the firm generates modest sales growth continually. In essence, the firm must stop being captive to either market growth or prevailing economic conditions.

This conclusion leads back to a recurring theme in profit planning. DHI members must gain control over operating economics. This involves making significant improvements in three areas:

- **Sales per Order Line—**If the average line value on an invoice can be increased, then for the same level of expense, the firm generates more profit.

- **Lines per Order—**Working with customers to add one more line on every order creates more sales, but only a little more expense.

- **Fill Rate—**When the firm is out of stock a lot of effort is expended for no sales. A higher fill rate is always beneficial from a sales viewpoint.

Payroll is likely to be an issue for DHI members in perpetuity. Employees will always desire improved wages, and health insurance seems destined to increase at a significant rate. Firms must gain control over the payroll side, even in periods of modest sales growth. The sales to payroll delta is the most beneficial concept in planning for payroll control.

A Managerial Sidebar:
Percent of Sales or Percent of Gross Margin?

Payroll costs can be evaluated either as a percent of sales or as a percent of gross margin. The second approach is known as the Personnel Productivity Ratio or PPR. The PPR for the typical DHI member is:

$$\frac{\text{Payroll and Fringe Benefits}}{\text{Gross Margin}} = \frac{\$1{,}600{,}000}{\$2{,}480{,}000} = 64.5\%$$

Most managers are more comfortable thinking of payroll as a percent of sales, simply because the approach has been used for so long. It also links payroll directly to sales generation.

The PPR is more encompassing in that it is impacted by changes not only in sales and payroll costs, but also gross margin. While ultimately a useful ratio, it can be difficult to pinpoint exactly why improvements are taking place.

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

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.

dhi

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

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 $25.00