Important Note
Read This Carefully

This is not just a report; it is an educational and implementation package. There are two parts to the package. Both parts are required to truly improve profitability:

- **The Report**—This guide reviews how the current planning process should be modified to improve performance.

- **The Excel© Template**—This tool allows firms to implement the ideas and concepts that the report discusses.

To obtain the template, go to: distperf.com

Navigate to the Programs tab. Once there select **Hands-on Tools**, then **Profit-First Planning**. Then download the template.

The template requires a password to open. Users will need to send an email to the Distribution Performance Project to obtain a password. Users will not receive any emails other than the one containing the password.

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Executive Summary

- Far too many distribution organizations produce adequate, but unexciting profit levels. Profits grow with sales, but don’t increase to desired levels. They are in a comfortable profit rut.

- One of the factors behind the profit rut is the use of traditional planning approaches that place more emphasis on sales than on profit.

- Profit-First Planning (PFP) has a proven track record in helping distributors increase their profits significantly.

- Using PFP requires abandoning the idea that “we have never done it this way” in favor of exploring a new approach to planning.

- The sequence for planning with PFP is 1) setting a profit goal, 2) forecasting sales growth, 3) enhancing the gross margin slightly, 4) calculating expenses, and 5) targeting investment levels.
The Profitability Challenge

Distributors as a group have always generated adequate profits. At the same time, distributors as a group have never produced spectacular profits. Individual firms have done very well, of course. At the other extreme, individual firms have struggled with miniscule profits; a few have even liquidated.

Between these outlying results, the typical firm’s profit performance is in a something of a rut. It is a somewhat comfortable rut as profits are acceptable. Despite being comfortable, it is still a rut.

The nature of the profitability challenge is shown in Exhibit 1 which tracks median Return on Assets (ROA) in distribution in five-year increments from 1995 to 2015. ROA is considered by most analysts to be the most valuable ratio for measuring profitability performance in distribution. It is profit before income taxes (but after all expenses) divided by total assets.

It is important to note that there are numerous variations on the basic ROA formula. Venture capitalists prefer to look at profit before depreciation and interest. Operating managers often prefer to look at profit only in relationship to non-fixed assets. The formula used here has proven to be the most accurate way to measure performance under various economic conditions and varying interest rates.

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1 The financial information is from the various financial benchmarking studies conducted in distribution.
As can be seen, the ratio generally fluctuated in the six to eight percent range. The single-largest driver of ROA was economic conditions. In point of fact, any five-year period during the last twenty years would have resulted in a graph very similar to Exhibit 1. Profit rises and falls with economic conditions. Over time, profit is adequate, but unexciting.

Exhibit 1
ROA in Distribution By Year

The lack of improvement is not for want of trying. Distributors have embraced new technology eagerly, explored untraditional sales opportunities, restructured their service profiles and engaged in a wide range of other activities to help enhance profitability. The impact has been modest at best.
There a number of reasons for the lack of profit improvement. For starters, distribution is incredibly competitive. In this competitive environment, too many firms are not able to differentiate themselves from other firms. In addition, virtually all distributors are beset with too many commodities. A number of other factors could be added.

One factor that does not get the attention it deserves is that an overwhelming proportion of firms do not develop a financial plan in a way that really improves results. They continue to use planning concepts that have no real track record of improving profitability. They do so largely because “we have always done it that way.”

This is not to say that traditional financial planning cannot be beneficial. Anything that helps managers think about the key factors in the business—sales, gross margin, expenses and investment—ultimately leads to somewhat improved results. It is just that the improvements from traditional planning are usually much smaller than required to escape the profit rut.

Managers also tend to view financial planning as something to get out of the way so that they can go back to real work. Planning is an interruption from their normal activities. That interruption is not particularly welcomed. The way planning is usually done, such thinking is understandable, even inevitable.

This report suggests that if managers can change the nature of the planning process slightly they can increase profitability a lot. They can also make the planning process an integral activity, not an episodic interruption. The challenge for management is to be willing to approach planning in a radically different light.

**The Problem With Traditional Planning**

The fundamental problem with traditional financial planning is that it ignores profit until the very end of the planning process. Traditional planning starts with sales, then moves to planning the various components of the income statement and ends up with profit.
Why not start with sales? After all, there is a wonderful management homily: “Nothing happens until somebody sells something.” The fact that some of the things that happen after somebody sells something creates losses rather than profit is never mentioned.

The real reason that planning always starts with sales is that the sales line is at the top of the income statement. Starting at the top and working down is the very essence of almost everything in life—“to do” lists, baseball batting orders, mindless PowerPoint® presentations and so on.

Unfortunately starting at the top leads to “profit by subtraction.” The firm plans sales first and then goes to the next item on the income statement, which is cost of goods. Once those two are planned, the firm then subtracts to get gross margin. After that, the firm plans expenses. Then expenses are subtracted from gross margin to get profit. With this approach profit is a residual factor when it should be a primary one.

This procedure is the very heart of the problem: In this sequence profit really isn’t planned at all. Instead, profit ends up being whatever is left over after the firm stops subtracting. It is classic profit by subtraction. It is a process that should be scrapped.

**Profit-First Planning**

This report lays out a completely different planning process. To add yet another term to the already over-burdened management vocabulary, it is Profit-First Planning or PFP. In its simples terms, PFP starts the planning process with profit rather than sales. The rest of the plan is then structured to ensure that the firm generates that profit.

Despite the inherent wisdom of striving to plan to produce a desired profit, the idea of Profit-First Planning is routinely rewarded with the complaint that “it can’t be done.” The complaint is that it is impossible to know how much profit the firm can generate until after sales, gross margin and expenses are known. In reality the complaint is more of an admission that “we have never done it that way.”
PFP involves a precise five-step process. The Excel template that accompanies this report follows the same exact steps:

1. **Profit**—Setting a profit goal based upon the concept of increasing Return on Assets slowly but systematically.

2. **Sales Growth**—Ensuring that sales growth falls within the range that encourages the firm to move forward, but does not strain its financial resources.

3. **Gross Margin**—Identifying opportunities to enhance margin without being less price competitive.

4. **Expenses**—Calculating (not estimating) what expenses will be.

5. **Investment Levels**—Fine-tuning the growth in inventory and accounts receivable over time.

**Planning For an Illustrative Firm**

The remaining two sections of this report will walk through the five steps using a sample distributor. The first section will discuss the concept of PFP. The second will provide guidance for using the Excel template that is part of this educational package. In essence the final two sections are “what to do” and “how to do it.”

The starting point for any planning activity is last year’s results. **Exhibit 2** presents the key financial statements for an illustrative distributor as a basis for planning.

At the top, Exhibit 2 provides an income statement for this distributor. The bottom contains a balance sheet and a calculation of Return on Assets, which is the basis for profit improvement.

Readers should not be bothered if the results in Exhibit 2 “don’t look like our firm.” The concepts and ideas presented for this firm will hold true for all distributors, regardless of their size, operating structure or financial results.
Income Statement—There are five key elements of the income statement:

- **Net Sales**—The total revenue the firm generates, which for the sample firm is $20.0 million. It includes the sale of all products and services, less any discounts or allowances given to customers.

### Exhibit 2
Financial Reports for An Illustrative Distributor

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Dollars</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>$20,000,000</td>
<td>100.0</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>15,000,000</td>
<td>75.0</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>5,000,000</td>
<td>25.0</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td>2,500,000</td>
<td>12.5</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>300,000</td>
<td>1.5</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>200,000</td>
<td>1.0</td>
</tr>
<tr>
<td>All Other Expenses</td>
<td>1,500,000</td>
<td>7.5</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>4,500,000</td>
<td>22.5</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>500,000</td>
<td>2.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Partial Balance Sheet</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$250,000</td>
<td>5.0</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>2,000,000</td>
<td>40.0</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,500,000</td>
<td>50.0</td>
</tr>
<tr>
<td>All Other Assets</td>
<td>250,000</td>
<td>5.0</td>
</tr>
<tr>
<td>Total Assets</td>
<td>5,000,000</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Return on Assets 10.0%

- **Cost of Goods Sold**—How much the firm paid for the products and services that it sold. Cost of goods includes both the cost of merchandise and the cost of labor for firms that sell services. For the sample firm, every $1.00 in sales was associated with 75 cents of cost.
• **Gross Margin (Often Call Gross Profit)**—This is simply the difference between what the firm sold things for and what it bought them for. In this case, every $1.00 of sales revenue produced 25 cents of gross margin to cover expenses and generate a profit.

• **Expenses**—What it cost to run the business. This includes all expenses, but excludes income taxes. In Exhibit 2 expenses are broken into three payroll categories and then All Other Expenses (the aggregate of all non-payroll expenses).

Payroll is always the name of the game from an expense perspective in distribution. In fact, payroll is a lot larger than all of the other expenses combined. For the illustrative firm, total expenses eat up 22.5% of all sales revenue generated.

• **Profit Before Taxes**—This is what the firm gets to keep after paying all of the expenses. Profit before taxes is used as tax rates vary widely based upon the firm’s legal structure (C-Corp, S-Corp, etc) and their geographic location. Pre-tax profit allows firms to compare their results to industry standards accurately.

Like many businesses the sample firm produces a modest 2.5% bottom line. Every $1.00 in sales results in only 2.5¢ in profit. Since $20.0 million is a substantial sales number, the profit is $500,000 even with the small 2.5% profit margin.

**A Side Note For Small Businesses**

Most small businesses are S Corporations, partnerships, LLCs or individual proprietorships. This means that the salary and fringe benefits inevitably are mixed up with profit.

Sometimes there is no salary for the owner at all. Everything is in profit. In other instances payroll for the owner represents a draw against profit. It is based upon how much the owner needs to cover the mortgage and other personal expenses. Neither approach is helpful in planning profit. Actually, both approaches are harmful.
The reason this is critical is that the firm has to determine a true salary and fringe benefits number in order to figure out what its profit really is. The payroll category must include a line item for the salary, health insurance and retirement benefits that the firm would have to pay an outsider to come in and run the business if the owner weren’t there. No more, no less.

This is absolutely not the salary, health insurance and retirement benefits the owner actually receives. The actual number is immaterial for calculating true profit. The adjusted number should be used based upon the local labor market. This requires a separate income statement for planning purposes.

This profit versus salary problem is seldom the case with larger firms unless they are S Corporations. There are exceptions, though. Even in some sizeable family-owned businesses there is a founder living in Florida who is still drawing a “salary.” Such situations also require adjusting just as per the owner’s compensation.

**Balance Sheet**—Most managers find the income statement extremely interesting. Unfortunately, they view the balance sheet as the dullest financial statement in the history of the free world. However, it is important, so forgive a few paragraphs.

Exhibit 2 presents a partial balance sheet for the sample firm. It ignores the liabilities side of the balance sheet which is not essential for basic profitability planning. The balance sheet as shown provides two important bits of information: 1) how much money is invested in the business, and 2) where it is invested.

1) **How Much Is Invested.** The Total Assets line is the one that indicates (translated from accounting) the total amount of money invested in the business. In the case of there is $5.0 million invested.

2) **Where It Is Invested.** In every distribution business, accounts receivable and inventory are the two big items in terms of investment. Accounts receivable shows how much customers owe for the things they bought but haven’t yet paid for. Inventory is the cost value of all the merchandise in stock.
There is one major item and two minor items that need to be addressed. All three of these are in the All Other Assets account.

The one important item is fixed assets, including equipment, vehicles, leasehold improvements and the like. These cannot be ignored, but typically only change when management takes an action, such as purchasing a new delivery vehicle. To simplify the planning process, such additional investments are ignored. However, the depreciation of these items is a specific component of expenses on the Income Statement.

The first of the minor items in the All Other Assets line which is the accumulation of a number of different small categories. These include factors such as Prepaid Expenses or Supplies. For most businesses these can be lumped into All Other Assets.

The second minor item is Cash. Referring to Cash as a minor item is something of a heresy. However, almost no distribution business has as much cash as it would like. With proper planning this can be overcome. Any plan that increases profit will ultimately increase cash as well.

Finally, the bottom of the exhibit indicates the Return on Assets for the firm which is currently 10.0%. It is a fairly strong ROA, but it can be even better.

With the basic financial statements in hand, it is time for the firm to actually begin to plan. The next section will examine the concept of Profit-First Planning. The final section will outline how to use the Excel template to implement the concept.
Developing a Profit-First Plan

As noted earlier, Profit-First Planning involves five steps that must be conducted in order: 1) Setting a Profit Goal, 2) Forecasting Sales, 3) Enhancing the Gross Margin Percentage, 4) Calculating Expenses and 5) Determining Investment Levels. The following paragraphs will walk through these steps using information from the sample firm introduced in the last section.

Setting a Profit Goal

To nobody’s surprise the first step in Profit-First Planning is to set a profit goal. The challenge is to make sure that the profit goal is not arbitrary. In that regard the profit goal must satisfy two conflicting objectives—it must require the firm to stretch to improve results while at the same time being attainable.

Most managers, by their very nature, tend to move towards stretch performance automatically. Once again, homilies abound: “Why not the best?” or “There is lots of low-hanging fruit.” Stretch performance typically doesn’t have to be encouraged, it has to be tempered.

Focusing on results that are actually attainable suggests taking a slower, more cautious approach to profit improvement. It involves some homilies that too many managers find to be anathema: “Rome wasn’t built in a day” or “Slow but steady wins the race.”

The reality is that profit improvement goals that are too high or too low are both detrimental to the firm. A goal that is too low will cause the firm to waste time and energy and not meet its full potential. A goal that is too high will almost never be met. Then, the following year another high goal will be set and also not met. Eventually this causes everybody in the firm to ignore the goal.

The search is for a happy medium. In looking for that medium, there are some useful guidelines that are distributor-specific in nature. These guidelines need to be understood, even if the firm chooses to ignore them.
REALISTIC PROFIT GOAL: Most distribution firms can improve Return on Assets by 2.0 to 3.0 percentage points in a single year. Anything less than 2.0 points is not challenging the firm to stretch. Anything more than 3.0 points is moving towards not being realistic.

It should be obvious immediately that 2.0% to 3.0% is a very narrow range. Empirical evidence from the financial benchmarking reports conducted by the Profit Planning Group indicates that many firms fall outside of this improvement range each year. Of much greater significance the empirical evidence also suggests that for many firms ROA falls in some years.

If firms can fall outside of the 2.0% to 3.0% range with regularity, it seems somewhat futile to plan around those numbers. In fact, the goal is far from futile. The numbers are extremely helpful in improving results consistently over time.

For way too many firms, ROA goes up for one or two years, then falls back down for one or two years. It is the classic profit rut that was identified in the first section. The fundamental objective of PFP is to escape that rut.

Underlying the 2.0% to 3.0% goal is an attempt to build a sustainable improvement position. That is, the firm should endeavor to increase ROA by 2.0 to 3.0 percentage points to establish a new base profitability level. That base will then be enhanced by an additional 2.0 to 3.0 points the following year until the firm reaches its full potential.

There are always extenuating circumstances that would cause the firm to set a higher or lower goal for a specific year. However, over time a 2.0 to 3.0 percentage point improvement is doable, realistic and attainable. The firm stretches, but sets a goal it can actually reach.

Yet another homily: “If something can’t go on forever, it won’t.” When applied to ROA this simply means that when a firm becomes a top ROA producer in its industry, the improvement goals change. Emphasis moves from improving to maintaining.
Forecasting Sales

At long last, the firm can go to the top of the income statement and start to work down. Since the sales goal will have a clear impact on almost everything else in the plan, a reasonable target is essential. It is necessary to have clear idea of how much of a sales increase is required for success.

Once again, there is a search for the happy medium. This time the trade-off is between slow growth causing expenses to eat away at the business versus fast growth creating chaos for the firm.

The impact of slow growth is obvious. If sales grows by 2.0% and expenses increase by 3.0%, then all of the increased sales goes to expenses rather than to profit. It is an unsustainable situation.

Excessive sales growth is not as well understood by management. The final homily in this report argues that there is no such thing as excessive sales growth: “Sales solves all problems.” Realistically, sales solves a lot of problems, but creates a few more.

Excessive sales growth puts pressures on existing employees and eventually causes the firm to have to find and train new employees as well. It also necessitates increases in plant and equipment, inventory and accounts receivable. Ultimately, it may require unpleasant discussions with bankers on how to finance the future.

REALISTIC SALES GROWTH GOAL: For most (but again not all) distributors, the sweet spot for sales growth in today’s economy is somewhere between 5.0% and 10.0% per year. This overcomes inflation while avoiding explosive growth.

The sad reality is that most distributors are in mature industries. Sales growth of 5.0% is not an automatic occurrence. The challenge in mature industries is to systematically secure additional market share. Simply put, the firm may need to grow by 5.0% while the market only grows by 2.0% or 3.0%.
The idea of market share enhancement in distribution is a long and complex one, so it cannot be discussed in any detail here. However, an overview of the concepts can be found in a free report on the Distribution Performance Project web site.\(^2\)

There are always extenuating circumstances that would cause the firm to set a higher or lower sales growth goal for a specific year. In particular, economic conditions will weigh heavily on the goal that is chosen. Longer term, though, the firm should strive for consistent sales growth.

**Enhancing the Gross Margin Percentage**

The two largest drivers of profitability in distribution are the firm’s gross margin percentage and its operating expense percentage. While they are important individually, they are crucial in terms of their interaction.

Simply put, actions that increase the gross margin percentage but also increase the operating expense percentage do the firm no real good. Gross margin and expenses need to be planned in conjunction with each other.

In the Profit-First Planning approach, profit before taxes was the very first item set in the plan. After that, a sales goal was put in place. If both the top and bottom lines of the income statement are planned, then planning either gross margin or expenses will finalize the plan for the entire Income Statement.

If, for example, gross margin were to be planned right after sales, then expenses would automatically be Gross Margin minus Profit Before Taxes. By definition that must equal Expenses. Conversely, if expenses were planned right after sales, then gross margin would automatically be Expenses plus Profit Before Taxes.

Theoretically, it makes no difference if gross margin or expenses are planned first. However, in actuality gross margin should be the

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\(^2\) Visit distperf.com. Go to the Articles tab and select *An Order is Not an Order is Not an Order* (September 2016). The pdf download is free.
variable that is planned directly after profit and sales. This will cause expenses to be calculated as a residual. This is not an arbitrary decision.

For most firms, there is a significant and largely untapped opportunity to improve the gross margin percentage. It involves identifying items where prices can be increased without impacting the firm’s competitive position. Once again, this topic is beyond the limits of this discussion. However, a brief, free discussion of the opportunity is available on the Distribution Performance Project website.³

REALISTIC GROSS MARGIN ENHANCEMENT GOAL: For most (but again not all) distributors, the potential to improve the gross margin percentage is somewhere around 2.0%.

This is not an increase in the gross margin percentage of 2.0 percentage points. A firm with a 25.0% gross margin percentage should not think in terms of increasing it to 27.0%.

Instead, the firm should be able to increase the 25.0% figure to somewhere around 25.5%. That figure is the original 25.0% times 1.02. Again, this is a somewhat arbitrary improvement. However, empirical evidence repeatedly indicates it is an attainable goal across almost all of distribution from low-margin lines of trade to high-margin ones.

Different firms may deviate from the guideline. However, no firm should conclude that its gross margin percentage cannot be improved. Virtually every firm can make some improvement.

It is entirely possible for firms to plan on a lower gross margin percentage. Severe competitive conditions may require this. Planning for a lower gross margin percentage, however, inevitably leads to some dramatic and unpleasant reductions in expenses. It is not an impossible situation to deal with; merely extremely difficult.

³ Visit distperf.com. Go to the Articles tab and select Pricing the Forgettable Last Five Percent (Sep 2015). The pdf download is free.
Calculating Expenses

As was discussed previously, once profit and gross margin are planned, expenses then become the residual factor in the plan. They are calculated, not really planned. The heart of the planning process will be in how the calculated goal will be met.

For the typical distribution organization in the United States payroll and fringe benefits typically account for about two-thirds of total expenses. For most firms the payroll expenses are not only the largest category, but also the most volatile. Non-payroll expenses tend to trudge along, increasing each year by somewhere around the overall inflation rate. Payroll expenses go up and down (usually up) in a much more frenetic manner.

For these reasons, it is useful to break payroll down into three categories to be planned separately. The first is simply direct payroll costs—the total of all W-2s (T4s in Canada). Payroll taxes represents a separate item and includes, FICA, Medicare, Unemployment Insurance and Worker’s Compensation. Finally, Fringe Benefits covers all other payments, most notably 401(k) payments and health insurance.

One final, and very important technical note. Since profit is being planned after all expenses, the expense entry includes both operating expenses and non-operating expenses. This expense definition specifically includes interest.

Determining Investment Levels

The firm now has a complete income statement plan which is the heart of the overall planning process. However, it is still necessary to plan two key investment items—inventory and accounts receivable. In both instances, care needs to be taken to avoid lowering these investment levels to the detriment of sales.

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4 For Canadian firms the figure is around 60.0% as health insurance is paid through a tax mechanism.
Over the course of the last decade, there has been a very strong push in distribution to reduce both inventory and accounts receivable. This reflects a move among distributors to take a more “financial view” of their businesses.

The move to reduce inventory continues even as research project after research project indicates that the two main complaints that customers have regarding their distributors is an inadequate service level (fill rate) and an assortment that is too narrow. Customers are stating in rather emphatic terms that inventory levels are too low.

The same challenges are also associated with accounts receivable. Reducing the investment here requires shortening credit terms. It is an instantaneously apparent action that customers tend to resist.

REALISTIC INVESTMENT GOAL: An ideal starting point in planning is to have inventory increase at the same rate as cost of goods sold and accounts receivable to increase at the same rate as sales. The result of such actions would be no change in the Inventory Turnover Rate and no change in the Average Collection Period (Days Sales Outstanding).

Like every other aspect of the planning process, individual firms may vary from the suggested targets because of market situations. Such deviations should be planned carefully.

A Complete Financial Plan

At this point the firm finally has a complete financial plan covering all of the factors that influence overall profitability. That plan is shown in Exhibit 3. The plan uses the specific guidelines developed throughout this section of the report as a starting point:

- Increasing ROA (on the existing assets) by 3.0 percentage points. This is at the upper end of the 2.0% to 3.0% range. The result is a target ROA of 13.0% and a dollar profit goal of $650,000 ($5,000,000 in total assets times 13.0%).
- Increasing sales by 6.0%. This is towards the bottom end of the 5.0% to 10.0% range.
• Increasing the gross margin percentage by 2.0%. This produces a planned gross margin percentage of 25.5% (25.0% times 1.02)
• Increasing accounts receivable by 6.0%, the same rate as growth sales. This means the firm is neither tightening nor loosening collections.
• Increasing inventory by 5.0% while Cost of Goods Sold is increasing by 5.3%. This suggests a slight improvement in inventory turnover.

All of these actions require an effort to make the improvements a reality. The approaches necessary can be found in *Breaking Down the Profit Barriers in Distribution*.  

Exhibit 3  
Planned Financial Results

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Current Results</th>
<th>Planned Results</th>
<th>Dollar Change</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>$20,000,000</td>
<td>$21,200,000</td>
<td>$1,200,000</td>
<td>6.0 %</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>15,000,000</td>
<td>15,794,000</td>
<td>794,000</td>
<td>5.3</td>
</tr>
<tr>
<td>Gross Margin</td>
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<td>5,406,000</td>
<td>406,000</td>
<td>8.1</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td>2,500,000</td>
<td>2,625,000</td>
<td>125,000</td>
<td>5.0</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>300,000</td>
<td>325,000</td>
<td>25,000</td>
<td>8.3</td>
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<tr>
<td>Fringe Benefits</td>
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<tr>
<td>All Other Expenses</td>
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<td>1,581,000</td>
<td>81,000</td>
<td>5.4</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>4,500,000</td>
<td>4,756,000</td>
<td>256,000</td>
<td>5.7</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>$500,000</td>
<td>$650,000</td>
<td>$150,000</td>
<td>30.0 %</td>
</tr>
</tbody>
</table>

| Balance Sheet                          |                 |                 |               |                |
| Cash                                  | $250,000        | $460,000        | $210,000      | 84.0 %         |
| Accounts Receivable                   | 2,000,000       | 2,120,000       | 120,000       | 6.0            |
| Inventory                             | 2,500,000       | 2,625,000       | 125,000       | 5.0            |
| All Other Assets                      | 250,000         | 250,000         | 0             | 0.0            |
| Total Assets (assumes the investment of estimated after-tax profits) | $5,000,000 | $5,455,000 | $455,000 | 9.1 % |

5 The author feels bad, but not terrible, about suggesting a book that he has written. However, it is the only book that discusses the issues raised in this report. It is a book that every manager should read. Albert D. Bates, *Breaking Down the Profit Barriers in Distribution*, D. M. Kreg Publishing, 2014. Available from both Amazon and Barnes & Noble, trade paper format.
Exhibit 3 (Continued)
The Changes Behind the Plan

1. Profit increase: $150,000 This drives the entire plan

2. Sales increase: 6.0%

3. Gross margin increase: 0.5 percentage points
   Original margin percentage 25.0%
   New gross margin percentage 25.5%

4. The sales and gross margin changes result in gross margin dollars increasing by $406,000

5. Total expenses are simply the gross margin minus the new profit or total expenses of $4,756,000

6. Total assets are the old total assets plus the new profit AFTER taxes. Total assets become $5,455,000 because of:
   New Profit Before Taxes $650,000
   Assumed Tax Rate 30.0%
   Reinvestment Rate 70.0% (100% minus tax rate)
   Amount Reinvested $455,000

7. Accounts receivable increases by 6.0% and becomes $2,120,000

8. Inventory increases by 5.0% and becomes $2,625,000

9. All other assets do not increase

10. Cash is equal to total assets minus all of the other asset categories

Planning is an essential activity. Too often, though, plans are developed and then immediately forgotten. It is essential to use the plan to stay on target.

Quarterly Control

A plan has only limited value if it is not used as the basis for control during the year. Every firm must develop a calendar for ensuring the firm stays on plan—or knowing why it did not.
There is a fairly large amount of disagreement as to how often, and in what form, that review should take place. The gamut of review frequencies runs from every week all the way to once at the end of the year only. Once again the task at hand is to develop a happy medium.

It is suggested here that firms review sales levels as frequently as desired and hold a full-fledged profitability review once per quarter. This allows monthly variations to work themselves out before the firm responds. It also provides a quick enough time frame to respond when major variations from plan arise.
Using the Excel Template

The Excel template component of this package contains instructions for its use. This section serves as a supplement to the template in instances where there may be some confusion.

The template has three major sections after the welcome screen:

- **Current Results**—Entering information for the latest full year as a basis for future planning.
- **Planning**—Developing the actual financial plan.
- **Quarterly Control**—Ensuring that the firm stays on plan via a periodic review.

The text and exhibits below describe each section in some detail. The template as shown here has numbers for the illustrative firm already entered as a guide as to the magnitude of the numbers required.

**NOTE:** All of the exhibits in this section are direct pulls from the Profit-First Planning Excel Template available at distperf.com.

**Current Results**

Setting up results for last year requires entering ten numbers for last year as shown in Exhibit 4.

**Exhibit 4**

**Entering Current Results**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Payroll (Total of all W-2 Forms for the Year)</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Payroll Taxes (FICA, Medicare, Worker’s Comp)</td>
<td>300,000</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>200,000</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>500,000</td>
</tr>
<tr>
<td>Cash--End of Year</td>
<td>250,000</td>
</tr>
<tr>
<td>Inventory--End of Year</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Accounts Receivable--End of Year</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total Assets--End of Year</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>
Two factors are important in the exhibit. First, only a few numbers from the income statement and balance sheet must be entered. All other numbers will calculate automatically. Second, each of the cells where numbers can be entered have a Comment associated with them. The comments will appear when the mouse is moved across the cell. Comments must be turned on in Excel to activate this.

**Planning**

Planned entries are required for each of the critical factors in a financial plan—profit, sales, gross margin, expenses, accounts receivable and inventory. In addition, an entry for an effective tax rate is required to forecast the firm’s future cash position.

**Profit**—Exhibit 5 demonstrates how the typical firm could plan to improve using the Profit-First Planning Template. As can be seen, all the template requires is a target profit number.

| Current Profit Before Taxes | 500,000 |
| Current ROA% | 10.0% |

**Profit—Exhibit 5** Planning Profit For Next Year

| Target Profit Before Taxes | 650,000 |
| Percentage Change | 30.0% |
| Resulting ROA% if Assets Don't Increase | 13.0% |

**Profit Guru Comment**

This is a reasonable change in the ROA%.
A typical one-year change is between 2.0 and 3.0% points.

However, in the blue boxes at the bottom of the exhibit, the template provides a word of caution. Below the heading entitled Profit Guru Comment, the template indicates whether the goal is reasonable. It also repeats the goals discussed in this report.

**Sales**—Exhibit 6 demonstrates how the typical firm could plan its sales goal using the Profit-First Planning Template. As with setting a
profit goal, all the template requires is a percentage increase number for sales.

**Exhibit 6**
**Forecasting Sales for Next Year**

<table>
<thead>
<tr>
<th>Current Sales</th>
<th>20,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planned Percentage Change</td>
<td>6.0 %</td>
</tr>
<tr>
<td>Planned Sales</td>
<td>21,200,000</td>
</tr>
</tbody>
</table>

**Profit Guru Comment**

- This is a reasonable sales increase.
- An ideal goal is 5.0 to 10.0%.

Once again, though, in the blue boxes at the bottom of the exhibit, the template provides a word of caution. Below the heading entitled Profit Guru Comment, the template indicates whether the sales growth goal is reasonable. It also repeats the goals discussed in this section.

**Gross Margin and Expenses**—As was mentioned in the previous section, when one of the two factors (gross margin and operating expenses) is planned, the other will be known automatically. The template mandates that gross margin be planned first.

**Exhibit 7** demonstrates how the typical firm could plan its gross margin goal using the Profit-First Planning Template. To be redundant, all the template requires is a new gross margin percentage.

Once again, though, in the blue boxes at the bottom of the exhibit, the template provides a word of caution. Below the heading entitled Profit Guru Comment, the template indicates whether the gross margin goal is reasonable. It also identifies a realistic goal. That goal is based upon a 2.0% improvement in the firm’s current gross margin percentage. Every firm will see a different statement by the Profit Guru as it will have a unique starting gross margin percentage.
Exhibit 7
Planning the Gross Margin Percentage for Next Year

<table>
<thead>
<tr>
<th>Current Gross Margin--$</th>
<th>15,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Gross Margin--%</td>
<td>25.0 %</td>
</tr>
<tr>
<td>Planned Gross Margin--%</td>
<td>25.5 %</td>
</tr>
<tr>
<td>Planned Gross Margin--$</td>
<td>5,406,000</td>
</tr>
</tbody>
</table>

Profit Guru Comment
This is a reasonable increase in gross margin percentage.
A manageable one-year change is around 0.5%.

Exhibit 8 demonstrates how the typical firm could plan its expenses using the Profit-First Planning Template. In this instance, all the template requires are dollar entries for the three payroll categories. Non-payroll expenses will calculate automatically.

Exhibit 8
Planning Expenses for Next Year

<table>
<thead>
<tr>
<th>Expense Category</th>
<th>Current Results $</th>
<th>Planned Results $</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll</td>
<td>2,500,000</td>
<td>2,625,000</td>
<td>5.0%</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>300,000</td>
<td>325,000</td>
<td>8.3%</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>200,000</td>
<td>225,000</td>
<td>12.5%</td>
</tr>
<tr>
<td>All Other Expenses</td>
<td>1,500,000</td>
<td>1,581,000</td>
<td>5.4%</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>4,500,000</td>
<td>4,756,000</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

For once, there is not blue box Profit Guru Comment. All of the payroll items, as noted earlier, have the potential for large changes. The Profit Guru has chosen to remain silent on this issue.

Investment—Exhibit 9 demonstrates how the typical firm could plan its key investment factors using the Profit-First Planning Template. In this instance, all the template requires are percentage increase figures for inventory and accounts receivable.

The exhibit also adds an unpleasant reality—income taxes will reduce the amount of money available to reinvest in the business. The estimated income tax rate for the firm (federal, state and local) needs to be entered as a percentage.
Exhibit 9
Planning Investment Levels for Next Year

Planned Increase in Sales 6.0 %
Current Inventory--$ 2,500,000
Planned Increase in Inventory 5.0 %
Planned Inventory--$ 2,625,000

Current Accounts Receivable--$ 2,000,000
Planned Increase in Accounts Receivable 6.0 %
Planned Accounts Receivable--$ 2,120,000

Estimated Income Tax Rate--% of Profit 30.0 %

The results of the planning process are shown back on Exhibit 3.

Developing a realistic process may well involve iterating through the planning inputs several times. The template allows multiple iterations, of course. Ideally, those iterations would be supported by detailed plans on how to make the numbers a reality.

Quarterly Control

At the end of each quarter, nine items must be entered. All of the financial numbers must be Year-to-date numbers. The entry format is shown in Exhibit 10.

Exhibit 10
The Quarterly Control Process

End of Quarter Number: 3

Results Year-to-Date--$

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Net Profit</td>
<td>450,000</td>
</tr>
<tr>
<td>Payroll</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>250,000</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>200,000</td>
</tr>
<tr>
<td>Inventory--End of Quarter</td>
<td>2,525,000</td>
</tr>
<tr>
<td>Accounts Receivable--End of Quarter</td>
<td>2,250,000</td>
</tr>
</tbody>
</table>
The results of quarterly control are shown in Exhibit 11. This report should be the basis for getting back on plan.

**Exhibit 11**

**Analysis of Performance: Year-to-Date**

<table>
<thead>
<tr>
<th>Time Period Analyzed: End of the Third Quarter</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>YTD Plan</td>
<td>Variance</td>
<td>Percentage Variance</td>
</tr>
<tr>
<td>Net Sales</td>
<td>$16,000,000</td>
<td>$15,900,000</td>
<td>$100,000</td>
<td>0.6</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>12,000,000</td>
<td>11,845,500</td>
<td>154,500</td>
<td>1.3</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>4,000,000</td>
<td>4,054,500</td>
<td>-54,500</td>
<td>-1.3</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td>2,000,000</td>
<td>1,968,750</td>
<td>31,250</td>
<td>1.6</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>250,000</td>
<td>243,750</td>
<td>6,250</td>
<td>2.6</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>200,000</td>
<td>168,750</td>
<td>31,250</td>
<td>18.5</td>
</tr>
<tr>
<td>All Other Expenses</td>
<td>1,350,000</td>
<td>1,185,750</td>
<td>164,250</td>
<td>13.9</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>3,550,000</td>
<td>3,323,250</td>
<td>226,750</td>
<td>6.8</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>$450,000</td>
<td>$487,500</td>
<td>-$37,500</td>
<td>-7.7</td>
</tr>
<tr>
<td>Inventory</td>
<td>$2,525,000</td>
<td>$2,659,238</td>
<td>-$134,238</td>
<td>-5.0</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$2,250,000</td>
<td>$2,147,651</td>
<td>$102,349</td>
<td>4.8</td>
</tr>
</tbody>
</table>

**Notes to the Results**

1. Income statement items are not seasonally adjusted. All quarters are assumed to have equal sales, gross margin and the like.

2. Planned inventory and accounts receivable figures are dynamic components of the plan. For example, if sales are 10% above plan, then planned accounts receivable would be expected to increase by the same 10%. The same 10%. The happens automatically in the YTD Plan column. For inventory the factor is cost of goods sold.

Ideally, the Excel template will provide a basis for firms to plan and control their profit performance on a continual basis. If the template has not been downloaded, please go to distperf.com and toggle to
the Programs tab, then select Hands On Tools. Then select Profit-First Planning.

Moving Forward

Financial planning and controlling will probably never be the favorite activity of most managers. However, it can be made a profit-improving activity. That alone should increase the enthusiasm level associated with the planning process.

Firms are encouraged to try the Excel template one time in their firm. If necessary it can be utilized alongside traditional planning. If profit-first planning enhances the firm’s performance, it is a test well worth undertaking.
About the Author

Dr. Albert D. Bates is a Principal in the Distribution Performance Project, a research group devoted to distribution issues.

Al makes numerous presentations each year on topics such as Improving the Bottom Line, Getting Serious About Profit, Doing More with Less, and Pricing for Profit. He is also a featured speaker at the University of Innovative Distribution.

He has written extensively in both the professional and trade press, including the Harvard Business Review, the California Management Review and Business Horizons. In addition he writes the quarterly Profit Improvement Reports for various industry groups.

Al received his undergraduate degree from the University of Texas at Arlington and his MBA and doctorate from Indiana University. While at Indiana he was one of the first recipients of the Ford Foundation Fellowship in Business Education.

He is married and has three grown daughters. When he is not traveling giving seminars he enjoys tennis and skiing. He is not particularly good at either one.

Please visit the Distribution Performance Project web site (distperf.com) to read past articles, and chapters of books as well as to download free profitability improvement tools.