Surviving the Payroll Challenge

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The economy has grown at a rate that, at least temporarily, has outstripped the availability of employees needed to support that growth. As a result, payroll costs have demonstrated the potential to grow faster than sales. Virtually every firm has experienced this reality.

The payroll challenge has also impacted many firms in a second, more subtle, way. The inability to fill key positions has created challenges in generating the level of sales growth that might otherwise have been reached. In short, not enough employees to service customer needs.

In either case, payroll costs represent a real profit threat to firms in almost every industry. This report examines the payroll challenge from two perspectives:

- **Payroll Versus Sales—**An analysis of the relative impact of rising payroll costs versus the sales requirement to offset that increase.
- **Minimizing the Payroll Cost Impact—**An examination of specific actions that firms must take to moderate the profit impact of rising payroll costs.

Payroll Versus Sales

Exhibit 1 demonstrates the interrelationship between payroll cost and sales and their impact on profit for a representative distributor. As can be seen in the first column, the typical firm generates $20.0 million in sales, operates on a gross margin of 25.0% of sales and produces a bottom-line profit of 2.5% of sales or $500,000.

The important item worth noting at this point is that payroll (fully loaded to include all fringe benefits) is by far the most important expense component. Specifically, payroll represents 17.5% of sales which is 77.8% of total expenses. Any change in payroll expense will cause some dramatic changes in overall profitability.

Two different scenarios are presented in the exhibit. Both reflect a 5.0% increase in payroll costs. The first represents that 5.0% increase in payroll costs without any mitigating action on the part of the firm. The second demonstrates the increase in sales required to offset the payroll increase.

The two columns of numbers reflects the proverbial good news/bad news perspective. Doing nothing with regard to payroll cost is extremely damaging. At the same time, recovery to past profit levels should be within the realm of possibility.

The *Initial Profit Challenge* column demonstrates the impact of a 5.0% increase in payroll costs. At this point the assumption is that all other factors in the business—sales, gross margin and all other expenses—remain constant.

The result is that payroll costs increase by $175,000. With the increase, profit falls by the exact same amount. This is a material decrease in profit of 35.0%. Profit before taxes has fallen from 2.5% of sales to only 1.6%. Clearly, it is an untenable situation. The bad news portion of good news/bad news is clear.

The *Offsetting Sales Increase* column delivers the good news in the exhibit. Specifically, sales only have to increase to $20,700,000 to return profit to its original dollar level. This is only a 3.5% increase, which should be attainable for most firms. It should be noted that the profit margin falls slightly.

However, the good news needs to be tempered with at least three caveats. First, the gross margin must be maintained at 24.5% of sales. There is no price cutting to generate the sales increase. Second, all other expenses (everything except payroll) cannot increase as sales grow. Third, there is no real increase in payroll other than the original wage increases first shown in the middle column. The same employee base must drive higher sales.

Overcoming these challenges is difficult, but not impossible. It requires thinking through the ways that can most effectively drive sales without causing negative changes in other aspects of the business.

Minimizing the Payroll Cost Impact

There is a long list of actions that will increase sales volume. However, the most obvious of them involve increasing expenses, probably before sales increase. Such actions include adding new customers, expanding the product line and increasing the firm’s service profile. All of them are actions that might be taken at some point. However, the increase in workload associated with these actions severely negates their desirability for driving sales without increasing payroll.

The bag of tricks available for driving sales without increasing payroll costs appreciably is limited. Three specific actions are most important in this endeavor.

Lines per Order—Putting more lines on every order allows for a sales increase with only a modest payroll cost increase. Increasing the lines per order revolves around two actions. The first is to have the sales force do more add-on selling. It is an age-old issue of monitoring, evaluating and compensating.

The second action in driving more lines per order is to ensure that customers are aware of everything in the firm's assortment. Nothing wrong with telling them over and over about one-stop shopping.

Fill Rate—If you don't have it, you can’t sell it. If you don't have it often enough all of your customers go away. However, improving the fill rate inevitably leads to the requirement to carry more inventory.

From a profit trade-off perspective, adding inventory to increase sales is always a good idea. Of course, adding inventory without increasing sales is a terrible idea. The truth is that way too many firms have cut inventory to the point that sales are impacted negatively.

Average Line Value—Increasing the average line value (or line extension to use alternative terminology) is largely a pricing issue. No customer wants to pay too much. However, every distributor has a large array of slower-selling items for which availability is much more critical than price. It is an opportunity that needs to be exploited to produce more sales dollars from the same unit sales.

With the effort to increase the fill rate mentioned above, the opportunity to be the “always in stock at a fair price” distributor increases substantially. However, the increased fill rate must be supported by fair-value pricing. Firms must get paid for the services they provide.

Moving Forward

The payroll challenge is not likely to abate any time soon. Controlling payroll costs versus sales requires a concerted effort on the activities that can drive sales without increasing payroll costs. This should be a planning focus.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His two latest books, ***Breaking Down the Profit Barriers in Distribution and Profit Guide for the Small Distributor***, are available online at Amazon and Barnes & Noble.

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Exhibit 1
The Impact From Payroll Challenges
For a Representative Distributor

		5.0% Payroll Cost Increase	
Financial Profile--$	**Current Results**	**Initial Profit Challenge**	**Offseting Sales Increase**
Net Sales	$20,000,000	$20,000,000	$20,700,000
Cost of Goods Sold	15,000,000	15,000,000	15,525,000
Gross Margin	5,000,000	5,000,000	5,175,000
Payroll and Fringe Benefits	3,500,000	3,675,000	3,675,000
All Other Expenses	1,000,000	1,000,000	1,000,000
Total Expenses	4,500,000	4,675,000	4,675,000
Profit Before Taxes	$500,000	$325,000	$500,000
Financial Profile--% of Sales			
Net Sales	100.0	100.0	100.0
Cost of Goods Sold	75.0	75.0	75.0
Gross Margin	25.0	25.0	25.0
Payroll and Fringe Benefits	17.5	18.4	17.8
All Other Expenses	5.0	5.0	4.8
Total Expenses	22.5	23.4	22.6
Profit Before Taxes	2.5	1.6	2.4