# Making Incremental Volume
# Profitable Volume

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Distribution managers have long been enamored of the idea of generating incremental sales volume. Theoretically, incremental volume represents additional sales that can be generated without any increase in expenses. In distribution vernacular, “it all goes to the bottom line.”

The problem with the incremental volume concept is that there are both good and bad ways of generating such volume. In the overwhelming majority of cases the costs associated with servicing the sale tend to be underestimated. Further, the idea of a “cost-free” sale too often leads to serious margin erosions. The combination of higher-than-planned expenses and a low gross margin is almost always disastrous.

This report examines how the concept of incremental volume can be employed successfully in distribution organizations. It does so by examining two specific issues:

- **The Financial Impact of Incremental Volume**—A review of the impact that efforts to generate incremental volume can have on distribution firms, under alternative cost and margin scenarios.
- **Controlling Incremental Sales**—A discussion of the various ways that firms can ensure that incremental sales volume actually produces incremental profits.

## The Financial Impact of Incremental Volume

**Exhibit 1** looks at the economic impact of incremental volume, under present conditions and three different scenarios. The first column presents the financial position of a representative distributor. As can be seen, the firm has $20,000,000 in sales, operates on a gross margin of 25.0% of sales and produces a bottom line profit of $500,000 or 2.5% of sales.

The firm’s expenses have been broken into two distinct categories:  1)Payroll and Fringe Benefits and 2) All Other Expenses. Payroll, which includes all social costs (payroll taxes, retirement programs and health insurance), is by far the larger of the two categories. This has some serious implications in the quest to drive truly incremental sales volume.

The last three columns of numbers represents the impact of a 10.0% increase in sales under three different scenarios. The top half of the exhibit provides dollars figures while the bottom half demonstrates the results as a percent of sales.

**Theoretical Scenario—**This represents the idealized situation that too many managers dream about. Sales are up by 10.0% with the same gross margin percentage as before. Of greatest consequence, none of the expenses increase at all. The profit impact is spectacular. Profit rises to $1,000,000 or 4.5% of sales.

The only problem is that this set of results almost never materializes. For very small amounts of incremental sales, this scenario can become a reality in the very short run. However, when there is any significant amount of incremental volume—and 10% qualifies as significant—the expenses inevitably increase.

**Best Case Scenario—**This is what could result if the firm managed incremental volume effectively. It combines the 10% sales increase with a parallel 10.0% increase in payroll and an 8.0% increase in the all other category of expenses.

The idea that payroll will rise right along with sales is based upon the historical reality in distribution. Namely, payroll always has risen directly with sales. More activity requires more people to support that activity. A thirty-year trend of sales and payroll rising together is unlikely to suddenly change.

However, the firm can leverage sales against the non-payroll expenses. With this expense leveraging, profit increases to $580,000. It is a much more modest, but still attractive, increase that can be achieved with effort.

**Sad Reality Scenario—**This reflects what too often happens when incremental volume comes entirely from new customers. In this scenario, the price charged to new customers has been reduced by 5.0% since “there are no extra costs in servicing them” or more colloquially, “the truck is going right by there anyway.”

This means that the original $2,000,000 of incremental volume (10% of current sales) falls by 5.0% and ends up at only $1,900,000. This means that profit ends up at only $480,000 even though the firm has increased its sales activity.

The firm has gained some market share, of course. However, it has done so without reaping additional profits. It has also alienated its existing customer base by charging new customers less. It is a clear example of the race to the bottom.

## Controlling Incremental Sales

Exhibit 1 reflects the reality that the profit impact of incremental volume depends upon two factors. The first is the extent to which incremental volume necessitates incremental expense. The second is the degree to which incremental volume results in gross margin degradation.

To a real extent these two factors are associated with whether the incremental volume comes from external sources or internal sources. In simpler terms, does the volume depend upon new customers or existing ones.

The lure of new customers is irresistible to every distribution organization. However, research going back seventy-five years consistently indicates that servicing new customers is the lowest-profit approach to profitability. Firms must strive to add customers of course. It should not drive their profit model, though.

The most profitable approach to generate truly incremental volume is to engage in the rather unexciting idea of selling more to existing customers. The classic strategy in this regard is to add an additional line to every order. It involves no more delivery stops, no more orders picked (simply more lines) and virtually no increase in payroll expense.

This approach involves monitoring the sales force to ensure they are engaged in add-on selling. It also requires educating customers as to the breadth of the product line. Finally, in a number of instances it is a matter of being in stock on what customers want to buy. All have major profit implications.

If managed properly, such an internal focus can increase sales by 5.0% to 10.0%. Profit results can actually be a little better than the Best-Case Scenario

## Moving Forward

If managed properly, incremental sales volume can be an important profit driver. The problem is that proper management is extremely difficult to maintain in the face of the pressures for new customers. The real need is to look internally to the existing customer base.

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**About the Author:**
Dr. Albert D. Bates is Director of Research at the Profit Planning Group, and a Principal at the Distribution Performance Project. That organization’s web site: distperf.com has numerous free tools that distributors can use to improve profitability. His recent book *Breaking Down the Profit Barriers in Distribution* is the basis for this report. It is a book that every manager should read. It is available in trade-paper format from Amazon and Barnes & Noble.

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**Exhibit 1**
**The Impact of Incremental Volume Under Different Assumptions**
**For an Illustrative Distributor**

| | | 10% Increase in Sales Volume | | |
|---|---|---|---|---|
| **Income Statement** | **Current Results** | **Theoretical Scenario** | **Best Case Scenario** | **Sad Reality Scenario** |
| Net Sales | $20,000,000 | $22,000,000 | $22,000,000 | 21,900,000 |
| Cost of Goods Sold | 15,000,000 | 16,500,000 | 16,500,000 | 16,500,000 |
| Gross Margin | 5,000,000 | 5,500,000 | 5,500,000 | 5,400,000 |
| Expenses | | | | |
| Payroll and Fringe Benefits | 3,000,000 | 3,000,000 | 3,300,000 | 3,300,000 |
| All Other Expenses | 1,500,000 | 1,500,000 | 1,620,000 | 1,620,000 |
| Total Expenses | 4,500,000 | 4,500,000 | 4,920,000 | 4,920,000 |
| Profit Before Taxes | $500,000 | $1,000,000 | $580,000 | $480,000 |
| Net Sales | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of Goods Sold | 75.0 | 75.0 | 75.0 | 75.0 |
| Gross Margin | 25.0 | 25.0 | 25.0 | 25.0 |
| Expenses | | | | |
| Payroll and Fringe Benefits | 15.0 | 13.6 | 15.0 | 15.0 |
| All Other Expenses | 7.5 | 6.8 | 7.4 | 7.4 |
| Total Expenses | 22.5 | 20.5 | 22.4 | 22.4 |
| Profit Before Taxes | 2.5 | 4.5 | 2.6 | 2.2 |