Sales Versus Expenses: The On-Going Civil War

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One of the never-ending challenges in improving profitability is that there is a great deal of uncertainty within many firms as to what sorts of actions should receive the most attention. This uncertainty is seen most clearly in trying to determine the relative importance of sales growth versus expense management.

The sales versus expense issue is exacerbated by the fact that sales growth has great public relations while expense control has the world's worst PR. For most managers sales growth is what is right and good, while expense control is considered inherently evil, at least until sales start to fall.

This report attempts to provide a non-emotional perspective regarding the degree to which sales growth and expense control should be emphasized in the firm. It will do so by considering two different aspects of the "what to work on" issue:

- **The Profit Impact of Sales and Expenses—**An examination of the relative impact of changes in sales and expenses.
- **Integrating Sales and Expenses—**Suggestions for establishing a unified approach to profit improvement for the firm.

The Profit Impact of Sales and Expenses

The first step in reconciling sales and expenses is to look dispassionately at the impact of each of these factors on bottom-line results. Exhibit 1 does this for the typical distribution firm. It is important to note from the outset that the exhibit examines how profit might have been different this year under alternative scenarios.

As can be seen in the first column of numbers, the typical firm generates \$20,000,000 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.

Since the analysis is being conducted for this year, it is important to break expenses out into their fixed and variable components. Fixed expenses are overhead expenses that will not change during this year unless the firm takes a specific action to change them. For example, hiring an additional office employee would increase the firm's fixed expenses.

Variable expenses are those that will change automatically along with sales during the year. Items such as sales commissions and bad debts fall into this category. They tend to be a relatively consistent percentage of sales.

Fixed expenses for this representative firm are assumed to be $3,500,000 while variable expenses are 5.0% of sales. These are, of course, estimates. They represent a serviceable approximation for many distributors. None of the conclusions of the analysis will be changed if the estimates are off a little.

The last two columns of numbers look at the profit implications of either increasing sales or decreasing total expenses. In both instances the improvement factor is 5.0%. That is, sales are increased by 5.0% or expenses are decreased by the same exact 5.0%.

With a 5.0% sales increase, the first three lines on the income statement—sales, cost of goods sold and gross margin—all increase by 5.0%. Since the analysis focuses on this year, the fixed expenses remain the same. Variable expenses increase along with sales and continue to be 5.0% of the sales volume. The impact is a profit improvement of 40.0%, from $500,000 to $700,000.

In the last column of numbers net sales, cost of goods sold and gross margin remain constant. Instead of a sales increase, total expenses are reduced by 5.0%. Note that <u>total</u> expenses are reduced, including both fixed and variable. This means that no lines items are sacrosanct, including commission rates paid.

As can be seen, an expense reduction of 5.0% drives profit up slightly more than a sales increase of the same magnitude. Specifically, profit increases from the $500,000 figure to $725,000, an increase of 45.0%.

This set of economics represents a truism for managers in all situations. Expense cuts will <u>always</u> produce greater increases in profits than sales increases of the same magnitude. Always is a fairly strong word. The hard cold profit analysis says nothing about the ease of making the changes or management's enthusiasm for doing so. Still, more is more.

Integrating Sales and Expenses

To reiterate, expense control will always have a bigger "bang for the buck" than will increasing sales. At the same time, sales growth will always warm the cockles of a manager's heart much more than expense control. The challenge is to find approaches that balance both sides of the impact versus enthusiasm argument. Four such approaches are important.

Positioning Productivity Properly—For a lot of managers, productivity is the silver bullet for controlling costs. The idea is to maintain sales growth and allow new technology to deal with the costs issues. This is a dangerous perspective.

Indeed, every firm also must stay on top of new technology to enhance productivity. However, every firm also must be aware that in the long term such enhancements will not solve the expense challenges ad may not even diminish them significantly.

To use professorial language, technology is a necessary—but not sufficient—vehicle for controlling costs. Each and every firm that fails to stay on top of technology will be at an expense disadvantage vis-à-vis its competition. However, such an investment will only allow the firm to maintain cost parity versus the competition. The motto should be invest steadily, but continue to look beyond new technology.

Order Economics—Distributors in every line of trade continue to do too much work. Of greatest significance they process too many small orders which are inherently uneconomical. Every possible effort has to be made to put more lines on every order and increase the order line value.

Even a small change to the average order value has significant cost implications for the firm. If done properly—more aggressive add-on selling and increasing the firm's in-stock position—sales will increase on the same overall workload. In other terms, sales are up a lot while expenses are up a little.

Service Profile—There has been something of a rush in recent years to pile on additional services to strengthen customer support. Some of those services are extremely beneficial. Others are blatantly redundant.

The key for management is to line up the firm's service profile with the factors that customers truly think are important. Eliminating redundant services is actually going forward, not backward.

Re-thinking the Customer Set—All customers are not created equally. Some are wonderful to work with, some are terrible. From an economic perspective, only a small sub-set of customers are truly profitable for the distributor. It is essential to focus on customer profitability as a management responsibility.

Moving Forward

Distributors must balance sales and expenses. The traditional either/or thinking must be modified to reflect the opportunities to increase sales and control expenses simultaneously. The profit implications of such actions are substantial. Alas, achieving the profit potential requires new thinking by management.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. The company recently released ***Profit is Everybody's Business***, a DVD-based training program to ensure that all employees understand what drives profit. For information about obtaining a tailored video for your firm, please contact Al Bates at bigal6212@gmail.com.

Exhibit 1
The Impact of 5.0% Sales and Expense Improvements
for the Typical Distribution Firm

		-------5.0% Improvement-------	
Income Statement ($)	**Current Results**	**Net Sales**	**Total Expenses**
Net Sales	$20,000,000	$21,000,000	$20,000,000
Cost of Goods Sold	15,000,000	15,750,000	15,000,000
Gross Margin	5,000,000	5,250,000	5,000,000
Expenses			
Fixed Expenses	3,500,000	3,500,000	3,325,000
Variable Expenses	1,000,000	1,050,000	950,000
Total Expenses	4,500,000	4,550,000	4,275,000
Profit Before Taxes	$500,000	$700,000	$725,000
Income Statement (%)			
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
Expenses			
Fixed Expenses	17.5	16.7	16.6
Variable Expenses	5.0	5.0	4.8
Total Expenses	22.5	21.7	21.4
Profit Before Taxes	2.5	3.3	3.6