The Sales to Payroll Wedge:
A Profit Necessity

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At present most distributors are experiencing strong sales gains. The serious concerns about generating adequate sales are largely a thing of the past. Unfortunately, the strong increases in sales are not translating into strong increases in profit. The problem is that expenses, especially payroll expenses, are absorbing an excessive amount of the increase in sales.

The key to overcoming this problem, and generating substantially higher profits, is to produce what is commonly called a sales to payroll wedge. Simply put, sales must grow faster than payroll expense. It is an incredibly simple concept to understand, but a maddeningly difficult one to implement.

This report will examine the nature of the sales to payroll wedge from two perspectives:

- **The Economics of a Sales to Payroll Wedge**—An examination of how sales growth and payroll control combine to produce higher profits.
- **Implementing the Wedge**—A discussion of the specific management actions that are required to generate a sales to payroll wedge.

The Economics of a Sales to Payroll Wedge

One of the oldest management bromides in distribution is “Sales are vanity, profits are sanity.” Bromide or not, the statement continues to be true. Sales growth almost always helps, but what is needed is sales growth that does not require a commensurate increase in payroll expenses.

The economics of sales and payroll growth can be seen in **Exhibit 1.** It reflects the results for a typical distribution firm. The Current Results column indicates that the typical firm generates $20,000,000 in sales and operates on a gross margin percentage of 25.0% of sales. It produces a pre-tax profit of 2.5% of sales, or $500,000. Of particular note, total expenses are heavily weighted towards payroll which represents 15.0% of sales, or 66.7% of total expenses. This is why payroll control is so critical.

The last two columns examine the impact of a sales to payroll wedge. Again, this means that sales growth outpaces payroll growth. Two sales growth scenarios are used to examine the sales to payroll wedge—5.0% and 15.0.

Slow Growth—The 5.0% growth column reflects operations in a mature market. This growth rate was achieved with no change in the gross margin percentage. As a result, both cost of goods sold and gross margin also increase by 5.0%.

The real key to this column is that payroll expense only increases by 3.0%. This provides a 2.0% sales to payroll wedge (5.0% sales growth minus 3.0% payroll growth). For most firms 2.0% is a realistic goal that should be part of planning.

The other expenses (all of the non-payroll items, such as rent, utilities, interest and the like) are assumed to increase at the same rate as sales. Realistically, such expenses would not grow as fast as sales. However, this assumption allows the exhibit to focus exclusively on the power of the sales to payroll wedge.

As can be seen, the very modest 5.0% sales growth does wonders for the bottom line if the 2.0% sales to payroll wedge can be generated. Profit increases from $500,000 to $585,000, an increase of 17.0%. Profit is now 2.8% of sales.

Fast Growth—The last column examines the impact of more rapid growth, defined here as a 15.0% increase in sales. The same sorts of effects that were observed in the 5.0% column also are seen here. The gross margin percentage stays at 25.0%, so sales, cost of goods and gross margin all increase by 15.0%.

A 2.0% sales to payroll wedge is still the goal, so payroll only increases by 13.0%. The other expenses follow the same growth path as sales and increase by 15.0%. The end result is that profit grows by 27.0% to $635,000.

It is obvious that a more rapid rate of sales growth produces a somewhat larger bottom line. However, to get to $635,000 in profit versus the $585,000, the firm had to generate another $2,000,000 in sales. To do so, it probably had to hire more employees as payroll increased to $3,390,000. It was a lot more work.

The reality is that rapid sales growth makes the sales to payroll wedge a little easier to produce. However, sales growth is not the real factor behind higher profits. What matters is how much sales can be increased in relationship to how much payroll has to increase to support that sales growth.

Implementing the Wedge

At this point producing a sales to payroll wedge should seem like a great idea. Although readers can quibble with the 2.0% figure if they desire, a wedge of some size seems essential. The issue now is to identify how such a wedge can be generated.

In trying to produce the sales to payroll wedge, it is important to note than improved productivity systems are probably not the answer. Distributors have become much more sophisticated in using technology tools over the last decade, yet payroll remains about the same percent of sales as ten years ago. There has been no sales to payroll wedge.

Something else is required. The “something else” necessitates attention to the three areas where the sales versus payroll expense trade-off should be positive.

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, and 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.

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 different 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

Payroll as a percent of sales is stuck in a rut that goes back at least ten years. If firms are going to lower their payroll expense percentage, and increase their bottom line, they must plan with the concept of a sales to payroll wedge in mind. Generating that wedge will require emphasizing three concepts—more lines per order, a higher fill rate and an increase in the average order line value.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group and a Principal at the Distribution Performance Project. He is the author of the newly-released ***Breaking Down the Profit Barriers in Distribution***. It is a book every manager should read and is available from Amazon and Barnes & Noble.

Exhibit 1
The Impact of a 2% Sales to Payroll Wedge
For a Typical Distribution Firm

		2.0% Sales to Payroll Wedge	
Income Statement ($)	**Current Results**	**5.0% Sales Growth**	**15.0% Sales Growth**
Net Sales	$20,000,000	$21,000,000	$23,000,000
Cost of Goods Sold	15,000,000	15,750,000	17,250,000
Gross Margin	5,000,000	5,250,000	5,750,000
Expenses			
Payroll and Fringe Benefits	3,000,000	3,090,000	3,390,000
All Other Expenses	1,500,000	1,575,000	1,725,000
Total Expenses	4,500,000	4,665,000	5,115,000
Profit Before Taxes	$500,000	$585,000	$635,000
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			
Payroll and Fringe Benefits	15.0	14.7	14.7
All Other Expenses	7.5	7.5	7.5
Total Expenses	22.5	22.2	22.2
Profit Before Taxes	2.5	2.8	2.8