Avoiding the Mistakes Of the Past

By Dr. Albert D. Bates
Principal, Distribution Performance Project

Currently, economists keep predicting a recession and the economy keeps growing steadily. Eventually the economists will be right. There have always been good and bad economic periods. There always will be. It is prudent to have preparations in place for when sales grow slowly or maybe even decline.

An additional inevitability is that many firms will make the same mistakes in responding to the next downturn as they have during past recessions. As Yogi Berra so aptly said, “It’s déjà vu all over again.”

This report examines the nature of the typical reaction to declining sales and suggest some ways to avoid making the same mistakes again. It will do so from two important perspectives:

- **The Profit Impact of a Sales Decline**—An analysis of the relationship between a sales decline and the resulting profit level.
- **Actions for Continued Profit Success—**Specific suggestions as to what firms should do to ensure success under all economic conditions.

The Profit Impact of a Sales Decline

The relationship between declining sales and the resulting decline in profit can be measured with a ratio called the Sales Sensitivity Index (SSI). It measure how large of a sales decline is required to drive the firm to its break-even point. That is, how much of a sales decline will cause profit to fall to zero.

The size of the SSI depends in large part upon the expense structure of the firm. **Exhibit 1** examines this by looking at the income statement for a representative distributor. As can be seen in the first column, the firm currently generates $20,000,000 in sales and operates on a gross margin of 25.0% of sales. This results in a pre-tax profit of $500,000, which is equal to 2.5% of sales.

To understand how sales declines impact profit for this firm, it is necessary to break the expenses into two categories—fixed and variable. For too many firms this distinction is not clearly understood.

Fixed expenses are “overhead expenses.” The key factor is that once a budget is set for the year, these expenses will only change if management takes specific actions to change them, such as negotiating a lower rent. For most firms, fixed expenses represent somewhere around 80% of total expenses. For the illustrative distributor they are estimated to be $3,500,000 per year.

Variable expenses, in contrast, rise and fall automatically as sales rise and fall. They include sales commissions, interest on accounts receivable, and the like. For the typical firm variable expenses are estimated to be 5.0% of sales.

The second column of numbers examines the impact of a sales decline that causes the firm to move to its break-even point. That is, it generates no profit. As can be seen, for the typical firm a sales decline of just 12.5% is all that is required to wipe out the entire profit of the firm. That figure is the firm's SSI.

The 12.5% figure is based upon a typical expense structure where approximately 80% of expenses are fixed and the remaining 20% are variable. Deviations from this ratio will cause the firm to be more or less impacted by a sales decline.

Consider, for example, if the firm changed its expense structure from 80% fixed/20% variable form to 90% fixed/10% variable. It could do this by lowering the commission rate and compensating the sales force with a larger base salary. The result would be to cut variable expenses about in half and they would be only 2.3% of sales, not 5.0%.

This would mean as sales fell, the firm would shed variable expenses at a slower rate. The 2.3% firm would be impacted more by a given sales decline than would the 5.0% firm. For every $100,000 drop in sales, variable expenses would only fall by $2,250 rather than by $5,000.

This does not mean that one scenario of fixed to variable expenses is better than another. What it does mean is that the level of fixed and variable expenses depends upon the decisions the firm makes, such as how to compensate the sales force. The profit implications of those actions needs to be understood.

Actions for Continue Profit Success

Mitigating the impact of a sales downturn involves taking some specific steps and carefully avoiding others. Truly avoiding the mistakes of the past requires focusing on five actions. Some are "must do" actions, others are "don't do."

Target the SSI—Before the next downturn occurs firms should not simply calculate its SSI. It should develop a target for the SSI and develop plans to make that target a reality. Ideally, firms should try to enhance their financial position, so that their SSI is at least 20.0%. That means that almost no sales decline would be cause for panic. For the illustrative firm, increasing the SSI requires only a moderate increase in its current profit.

Avoid Price Cutting—An almost automatic response to a sales decline is to think in terms of reducing prices to "get that volume back." However, any reduction in pricing only increases the physical sales volume required to maintain profits. Price cutting is problematic in good times; it is a disaster in bad times.

Maintain Working Capital Investment Levels—Another reaction to declining sales declines is to horde cash. Inevitably this leads to converting inventory and accounts receivable into cash. Lowering inventory almost always involves a “stop buying” edict that causes the firm’s service level to deteriorate. Accounts receivable reductions have a similar impact on sales. Lowering either of these will simply drive sales down at a faster rate.

Don’t Sell Out the Future—The idea of “right sizing” expenses is tailor made for a period of declining sales. However, expense cuts must be limited to areas where the cuts will do no harm to sales. For example, too many firms reduce their marketing expenditures during a recession only to find that when the market rebounds they have lost contact with key customers.

Benchmark Continually—It is essential to have a precise understanding of how the firm performs on key profit drivers. This can only be done by benchmarking against other firms in the industry. Sometimes firms feel that benchmarking in bad times is fruitless. In fact, ongoing benchmarking provides insights into the pathway for profit improvement, even in down markets.

Moving Forward

The good news is that all recessions end. Even the so-called *Great Recession* ended with a sustained period of sales growth. While the next recession hasn’t even started, now is the time to plan for it. Furthermore, planning should not only focus on what to do during the recession, but how to build momentum for when the recover starts.

The bad news is that old habits die hard. A lot of firms will almost certainly forget the mistakes of the past. The firms that can develop meaningful approaches to avoid them will be the winners in the future.

About the Author:
Dr. Albert D. Bates is Principal of the Distribution Performance Project and a Senior Advisor to Benchmarking Analytics. His latest book, ***Breaking Down the Profit Barriers in Distribution***, is available online at Amazon and Barnes & Noble. It covers concepts that every decision maker should understand.

Exhibit 1
The Sales Decline That Will Move the Firm to Break-Even for an Illustrative Distributor

Income Statement--$	Current Results	Break-Even Results	Percent Change
Net Sales	$20,000,000	$17,500,000	-12.5
Cost of Goods Sold	15,000,000	13,125,000	-12.5
Gross Margin	5,000,000	4,375,000	-12.5
Fixed Expenses	3,500,000	3,500,000	0.0
Variable Expenses (5% of Sales)	1,000,000	875,000	-12.5
Total Expenses	4,500,000	4,375,000	-2.8
Profit Before Taxes	$500,000	$0	-100.0
Income Statement--%			
Net Sales	100.0	100.0	
Cost of Goods Sold	75.0	75.0	
Gross Margin	25.0	25.0	
Fixed Expenses	17.5	20.0	
Variable Expenses (5% of Sales)	5.0	5.0	
Total Expenses	22.5	25.0	
Profit Before Taxes	2.5	0.0	