

Profit Improvement Report

Prepared for GAWDA
Vol. 10, No. 4
December, 2001

Now What?

By Dr. Albert D. Bates
President, Profit Planning Group

Currently, almost every firm faces a somewhat uncertain future; a few even face a frightening one. Depending upon the sector of the economy, sales range from soft to non-existent. Regardless of the exact size of the sales challenge, management faces the same issue. Namely, what actions need to be taken to ensure the success of the firm in the face of unknown future sales.

What management decidedly should not do is simply “ride out the storm” given that in uncertain times there are no clear choices for action. Such inaction is wonderfully stoic, but threatens the long-term success of the firm.

This report will attempt to provide some guidance on the issue of what to do now. It will do so by exploring three fundamental issues:

- **Volume Sensitivity**—Measuring with precision the impact that sales has on the firm’s financial performance.
- **Sales Offsets**—Identifying the changes in expenses and margins that are required to offset a decline in sales.
- **Action Guidelines**—Some specific suggestions for ensuring the continued financial health of the firm.

Volume Sensitivity

The very first requirement is for management to fully understand its degree of volume sensitivity. Every firm knows intuitively that if sales fall, then profits also fall. What is not so precisely understood is the rate at which profits fall in relationship to sales.

It is essential to understand this relationship as most firms track sales in a real-time basis. Profitability measures, even in firms with excellent accounting systems, often trail sales reporting by weeks or even months. Every firm must know the impact that sales declines are having now, while offsetting actions can be taken.

Understanding volume sensitivity is a straight-forward process. However, it does require knowing two ratios, both of which can be estimated:

- **Gross Margin Percentage**—This is simply the gross margin dollars produced as a percent of sales.
- **Variable Expense Percentage**—These are the expenses, such as commissions, bad debts, overtime and interest on short-term debt that tend to vary with sales volume levels. This ratio is expressed as a percent of sales, even though some variable expenses—such as commission—may be based upon gross margin.

The result of netting these two ratios, the volume sensitivity ratio, measures the impact of every lost sales dollar on profits. In formula terms:

$$\text{Volume Sensitivity \%} = \text{Gross Margin \%} - \text{Variable Expense \%}$$

A ratio of 25% would mean that every dollar of lost sales results in twenty-five cents of lost profit. Exhibit 1 uses this ratio to measure the impact of a ten percent decline in sales for the typical GAWDA member. As can be seen, given the size of the volume sensitivity ratio, even such a modest decline in sales decimates profits.

Exhibit 1				
Volume Sensitivity for the Typical Firm				
Volume Sensitivity Ratio				
=				
Gross Margin % - Variable Expense %				
=				
45.3% - 9.0%				
=				
VSR: 36.3%				
<u>Performance for the Typical Firm</u>				
	<u>Current Results</u>		<u>Ten Percent Sales Decline</u>	
	<u>Dollars</u>	<u>Percent</u>	<u>Dollars</u>	<u>Percent</u>
Net Sales	8,000,000	100.0	7,200,000	100.0
Cost of Goods Sold	<u>4,376,000</u>	<u>54.7</u>	<u>3,938,400</u>	<u>54.7</u>
Gross Margin	3,624,000	45.3	3,261,600	45.3
Fixed Expenses	2,560,000	32.0	2,560,000	35.6
Variable Expenses	<u>720,000</u>	<u>9.0</u>	<u>648,000</u>	<u>9.0</u>
Total Expenses	<u>3,280,000</u>	<u>41.0</u>	<u>3,208,000</u>	<u>44.6</u>
Profit Before Taxes	344,000	4.3	53,600	1.4
Decline in Sales			\$800,000	
VSR			36.3%	
Decline in Profits (Sales Decline times VSR)			\$290,400	
Percentage Decline in Profits from a 10% Sales Decline:				84.4

At the risk of being redundant, it is essential that this relationship be clearly understood by management. In most instances, management can maintain grace under fire as long as the firm is not losing money. It is only when sales have fallen precipitously enough to eliminate profits that management begins to consider more decisive action.

The short-run challenge is that many firms are experiencing sales levels that put them well below break even. In such instances, firms are actively exploring the avenues that will offset the more significant sales declines.

Sales Offsets

Luckily, the firm's profitability is also relatively sensitive to changes in other factors in the business. In particular, the firm is highly sensitive to changes in the fixed expense load and in the gross margin percentage. These two areas must be the prime focal point of any offset management program. Exhibit 2 examines how much of change is required to offset a ten percent sales decline.

Expense reductions are the most natural response to a sales decline. For most GAWDA members they are also probably the most effective in the short run. The challenges lie in knowing how much to cut and where.

Exhibit 2			
The Change in Fixed Expenses or Gross Margin Percentage Required To Return to the Typical Profit Level			
	<u>Ten Percent Sales Decline</u>	<u>Expense Reduction</u>	<u>Gross Margin Improvement</u>
Net Sales	7,200,000	7,200,000	7,200,000
Cost of Goods Sold	<u>3,938,400</u>	<u>3,938,400</u>	<u>3,648,000</u>
Gross Margin	3,261,600	3,261,600	3,552,000
Fixed Expenses	2,560,000	2,269,600	2,560,000
Variable Expenses	<u>648,000</u>	<u>648,000</u>	<u>648,000</u>
Total Expenses	<u>3,208,000</u>	<u>2,917,600</u>	<u>3,208,000</u>
Profit Before Taxes	53,600	344,000	344,000
Moving Back to The Typical Profit Level			
Percentage Reduction Needed--Fixed Expenses		11.3	
Percentage Reduction--Non-Payroll Expenses Only		23.4	
Typical Gross Margin Percentage			45.3
Required Gross Margin Percentage			49.3

The first column of numbers in Exhibit 2 merely repeats the results of a ten percent sales decline for the typical GAWDA member. The second column

traces what the firm would have to do in terms of a fixed expense reduction to return to its original profit level.

As Exhibit 2 indicates, the reduction required in fixed expenses is slightly larger than the reduction in sales that drove the firm down to break even in the first place. In every business, regardless of profit level, it is always true that fixed expenses have to be reduced slightly more than sales in order to maintain the existing profit level. The problem is that fixed expenses are largely intractable. As always, saying they have to be reduced is much more difficult than actually reducing them.

Most managers, especially in smaller firms, would prefer not to have to make reductions in the payroll area. The reality, however, is that payroll and fringe benefits represent by far the largest single expense category for virtually every firm. Some fairly spectacular expense reductions will have to be made if payroll is going to be off limits.

The final line in the second column indicates the percentage reduction required in non-payroll expenses alone to move the firm back to its original profit level. As can be seen, the required reduction is well beyond the ability of most firms. This means the firms cannot make the reductions required without examining payroll.

Firms must make the conscious decision to either maintain profit levels today or maintain existing staffing levels in hopes of a better tomorrow. It is not an easy decision. What managers should not delude themselves into thinking is that they can avoid payroll reductions and still keep profit levels up.

The final column in Exhibit 3 looks at the change in gross margin percentage that would be required to also move the firm back to its current profit level. The last two items show the current gross margin percentage and the required gross margin on the reduced sales level. For most firms the required change is daunting, especially when there is a downward pressure on gross margin.

Exhibit 2 does nothing to make life any easier for managers of GAWDA companies. What it does do, however, is identify the size of the challenge they are facing. Managers must then decide if they want to attack expenses, gross margin or both. They also need to focus on the areas that will improve these two factors.

Action Guidelines

It is important to understand the volume sensitivity of the firm in order to know when to worry and how much to worry. It is also important to understand the sales offset options to provide a sense of direction on holding profit levels. However, it is most important to have some ideas regarding how to make the offsets work. In that regard, there are five critical actions for management:

- **Conservative Planning**—Given the uncertainty of the economic situation, firms must develop their financial plan around an extremely conservative sales forecast. If expense needs and margin opportunities are based on a conservative plan, the firm should be successful.
- **Contingency Planning**—If sales fall five percent, one set of actions are required. If they fall ten percent, then a second set is required. Firms should plan which expenses will be cut and by how much before sales problems develop. In this way the emotionalism of the moment can be avoided when it is time to make the actual cuts.
- **Avoiding the Classic Mistakes**—In an era of declining sales, one of the first things many firms think about doing is reducing their inventory and accounts receivable to raise cash. The results are almost always disastrous. The inventory reduction inevitably leads to out of stock situations and lost sales. The accounts receivable reduction also tends to antagonize customers who are anticipating actually paying slower. Any action that drives sales down even further must be avoided.
- **Emphasizing Inside Gross Margin**—Suppliers are also under pressure in a down economy. Extensive inbound margin improvement opportunities exist. If the firm has a strong cash position, it should even consider advance purchasing of key items. It is also a great time to ensure that proper controls are in place to control markdowns, shrinkage and other gross margin traps.
- **Getting Back to Basics**—The firm needs to get everybody focused on the customer. There is no such thing as too much service. Expense control and gross margin management can solve some problems as shown in Exhibit 2. Maintaining sales growth can keep the problems from arising in the first place.

Moving Forward

There is wide-spread disagreement as to the severity and length of the recession. If firms take the proper actions now, they will be in a strong financial position, regardless of the economic realities. If not, they have little choice but to try to “ride out the storm.” It may not be a pleasant experience.

About the Author:

Dr. Albert D. Bates is founder and president of Profit Planning Group, a distribution research firm headquartered in Boulder, Colorado.

©2001 Profit Planning Group. The association whose name appears at the top of page one has unlimited duplication rights for this manuscript. Further, the members of the association may duplicate this report for their internal use in any way desired. Duplication by any other organization in any manner is strictly prohibited.