

Profit Improvement Report

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Bridging the Profit Divide

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The economic challenges of the last several years have created a "profitability divide" in the industry. Historically, the top-tier firms have always generated higher profits than more-typical firms. Now, they are generating a lot more profit. Slowly, but steadily, the profit divide is widening.

Quite understandably, most firms aren't particularly concerned about something as vague as a profit divide. Instead, they are looking to ensure their economic viability today so they can continue to compete in the future. The assumption the typical firm makes is that it can catch up in subsequent years.

The reality is that the higher-profit firms are not only enjoying better results today, they are building a profit advantage that will be increasingly difficult to overcome in the future. This report will examine the nature of the profit divide and some of its implications for FPDA members. It will do so by looking at two different issues.

- **The Implication of Different Profit Levels**—An analysis of how higher profits today pave the way for much higher profits in the future.
- **Making Desired Profitability a Reality**—An examination of the essential steps that firms must take now to get on the right side of the profit divide.

The Implication of Different Profit Levels

To understand the implication of different profit levels for future performance, it is necessary to review some simple information for the typical FPDA member. That information and some assumptions about the future are shown in **Exhibit 1**.

Exhibit 1 is presented in two sections: Current and Potential Results. The current figures in the first column of the exhibit reflect the typical FPDA firm. This entity has sales of \$20,000,000 on which it generates a profit of \$780,000, or 3.9% of sales. To generate this level of sales and profit the firm invested \$7,250,000 in total assets. This produces a pre-tax return on assets (profit before taxes divided by total assets) of 10.8%.

The remainder of the top half of the exhibit demonstrates the performance of firms with higher rates of return on assets. The middle column reflects a 20.1% ROA which is the level currently being generated by the high-profit FPDA firms. Finally, the last column shows a 30.0% return on assets. This is well beyond the performance level that the Profit Planning Group has suggested as an industry goal for many years. It is truly outstanding performance.

It should be noted that in all three current scenarios the sales and total assets are identical. Only the profit numbers are different. This is very close to the reality of the industry at present.

The bottom half of the exhibit reflects the potential results the firm could achieve in five years. The results rest on two assumptions. First, it is assumed that the firm reinvests half of its pre-tax profits back into the business to increase its asset base. Secondly, the increase in the asset base will be used to support equally higher sales. That is, if the asset base is increased by 5.0%, then total sales can be increased by 5.0%. Neither of these are perfect assumptions, but do reflect the long-term performance pattern in the industry.

The key result is that the typical firm has reinvested enough profit dollars to increase sales from the current \$20,000,000 to \$25,113,076 from internally-generated funds. This is an increase of 25.6%. In very sharp contrast the high-profit firm with a 20.1% ROA has the potential to increase its sales by 51.7%, also from internally-generated funds. With a 20.0% ROA the results are even stronger, reflecting the potential for a dramatic 51.4% sales increase.

The assumptions in the model can be debated at length. What is not open to debate is the fact that the high-profit firms are building a financial base that has the potential for supporting much more rapid sales growth in the future. It represents the ability to slowly crowd the typical firm out of the market.

Making Desired Profit a Reality

The clear challenge for the typical FPDA member is to get on the positive side of the profit divide. There also needs to be a sense of urgency to do so. Every year the divide exists, the difficulty in catching up increases.

Making the improvements in profit performance will require two different actions. The first is that traditional budgeting procedures need to be overhauled. The second is that the firm needs to refocus on the things that really drive profit.

A New Approach to Planning—As strange as it may seem, firms need to stop budgeting. Well, that may be a little strong. They need to stop budgeting the way they do now and start over in an entirely different format.

Budgeting, as practiced traditionally, is overwhelmingly a top-down process. The firm starts with a sales plan, tries to improve its gross margin a little and control expenses effectively. After that, profit is "budgeted" by subtraction—gross margin minus expenses must equal profit. There is no attention paid to what the firm's

profit level should be. Instead, profit ends up being what is left over. Such a conventional approach does nothing to help the firm reach its full profit potential.

The only budgeting approach that works is Profit-First Planning or PFP. It starts with setting a profit goal, then working backward to determine what sales, gross margin and expenses must be to support the profit goal. PFP is a management process. It is not a financial process and it certainly isn't an accounting one. Management must determine how much profit the firm needs to generate. It also is up to top management to identify in clear and precise terms the specific actions that have to be taken to ensure that the firm reaches the profit goal.

After the overall plan is in place, the nitty gritty details can be left to the accounting staff. However, top management must lead. The phrase "my accountant handles the budgeting" must be removed from the lexicon.

Focus on What Matters—In every business there are lots of things to worry about. In a world in which an extensive support staff no longer exists, more and more of the things to worry about fall to top management. The result is that management frequently sees a lot of trees and not the forest.

Management needs to step back and re-think the level of emphasis it places on every aspect of the business. In that re-thinking process two factors must come to the fore—gross margin and payroll expenses.

The author has harangued about gross margin and payroll in other Profit Improvement Reports and will not duplicate those comments here. However, when firms are obsessed with improving gross margin and payroll expense they are focusing on the two factors that matter most in terms of profit enhancement. No other profit drivers have as dramatic an impact; not even sales volume.

Moving Forward

If typical firms continue to act typically, they will slowly but systematically put themselves at a disadvantage they ultimately cannot overcome. Every firm needs to cross the divide to high-profit results.

High-profit is not an automatic state of affairs. Getting there requires re-thinking some of the central things that firms are now doing. The budgeting process needs to be turned on its head. Further management needs to be singularly focused on gross margin and payroll control.

About the Author:

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A Managerial Sidebar: This Isn't as Easy as it Sounds

One of the challenges with being on the wrong side of the profit divide is that the changes required to get to the right side may be rather dramatic in nature. This is why traditional, top-down budgeting is ineffective. It doesn't directly address what needs to be done.

The following exhibit indicates the sort of changes that are required for the typical FPDA member to move from typical to high-profit. The gross margin scenario assumes that all of the profit improvement comes from enhanced margin efforts. The payroll scenario assumes that all of the improvement is generated from payroll control. Finally, the mixed scenario produces half of the improvement from gross margin and half from payroll.

The magnitude of the required improvement suggests that the profit divide cannot be overcome in one year. It also suggests that if it is to be a multiple-year plan, then efforts must be started today.

Making the Leap to High-Profit Performance

Income Statement--\$	Current Results	Gross Margin Scenario	Payroll Scenario	Mixed Scenario
Net Sales	\$20,000,000	\$20,000,000	\$20,000,000	\$20,000,000
Cost of Goods Sold	<u>14,300,000</u>	<u>13,622,750</u>	<u>14,300,000</u>	<u>13,961,375</u>
Gross Margin	5,700,000	6,377,250	5,700,000	6,038,625
Expenses				
Payroll and Fringe Benefits	3,600,000	3,600,000	2,922,750	3,261,375
All Other Expenses	<u>1,320,000</u>	<u>1,320,000</u>	<u>1,320,000</u>	<u>1,320,000</u>
Total Expenses	<u>4,920,000</u>	<u>4,920,000</u>	<u>4,242,750</u>	<u>4,581,375</u>
Profit Before Taxes	\$780,000	\$1,457,250	\$1,457,250	\$1,457,250
Income Statement--%				
Net Sales	100.0	100.0	100.0	100.0
Cost of Goods Sold	<u>71.5</u>	<u>68.1</u>	<u>71.5</u>	<u>69.8</u>
Gross Margin	28.5	31.9	28.5	30.2
Expenses				
Payroll and Fringe Benefits	18.0	18.0	14.6	16.3
All Other Expenses	<u>6.6</u>	<u>6.6</u>	<u>6.6</u>	<u>6.6</u>
Total Expenses	<u>24.6</u>	<u>24.6</u>	<u>21.2</u>	<u>22.9</u>
Profit Before Taxes	3.9	7.3	7.3	7.3