# Who Produces High Profit and Why? Understanding the Three Key Profit Variables

The just completed 2007 CIPH PROFIT Report provides the most comprehensive set of benchmarks available on financial performance in the industry. The report suggests that there continue to be major differences between the typical firm and the high-profit firm. The differences are significant for both planning and control purposes.

**What High Profit Means**

The typical firm in the benchmarking survey is the firm exactly in the middle of all firms in terms of its financial results. That is, half of the companies will perform better than the typical one and half will perform worse. To a certain extent, typical can be thought of as "good enough." After all, the firm is performing as well as half of the firms. In reality, though, typical is simply not good enough.

The typical firm generates sales of $38,917,512. On that sales base, it produces a pre-tax profit of $1,634,535. This means the firm produces a profit margin of 4.2% of sales. Stated somewhat differently, each $1.00 of sales results in 4.2 cents of profit.

The high-profit company generates a profit margin of 8.1%. This means that *with the same sales base,* the high-profit organization would produce $3,152,318 in profit.

This would give the high-profit firm an annual profit advantage of $1,517,783. However, this does not tell the entire story. The high-profit company has more money available to invest in additional assets. If the additional assets are chosen properly, they will support higher sales. On those higher sales, the firm can then produce even higher profits. It is a cycle that allows the high-profit companies to move well ahead of the typical ones. Over time, the typical firm reaches the point where it simply can't catch up.

**How to Get There**

Reaching high-profit performance is a matter of identifying what is important and developing a plan to do better on those factors. In common parlance, the items that are important are called the critical profit variables (CPVs). The CPVs are outlined in Exhibit 1 with specific information on the results produced by both the typical and high-profit firm.

When considering Exhibit 1, it is important to note that no single business produces superior results on every single CPV. The successful firms are those that can combine the CPVs in a way that maximizes overall profitability.

All of the CPVs have the potential to be important for any given firm. However, in industry after industry, three factors stand out as being the most important. These are sales growth, gross margin and payroll expenses. Firms that can successfully control these items have a major financial advantage.

- **Sales Growth**—Rapid sales growth is not a requirement for driving higher profits. However, it is absolutely essential to generate at least moderate growth. Moderate is, of course, a subjective term. At a minimum, the firm should be able to increase its sales at least as fast as operating expenses increase. Ideally, it should target sales increases somewhere between one to two percentage points *faster* than operating expenses.

- **Gross Margin**—The ability to generate an adequate gross margin continues to be one of the major determinants of profitability. While the high-profit firm does not necessarily have a higher gross margin every year, it consistently has a higher gross margin over the long term. The pressures on gross margin, from both suppliers and customers, are not going to diminish. However, financial success necessitates producing small systematic improvements in the gross margin percentage every year.

- **Payroll Expenses**—Payroll is by far the most important expense factor, which means that controlling payroll is essential to controlling expenses. In recent years payroll has replaced gross margin as the single most important driver of profitability as payroll expenses have increased relentlessly.

  Probably the best ratio available to evaluate payroll is the Personnel Productivity Ratio (PPR). The PPR measures the percentage of every gross margin dollar that must be devoted to payroll and employee benefit plans. Computationally, the PPR is simply payroll and benefits divided by gross margin. Strategically, it measures how much it costs to produce the value the firm provides to its customer base.

  One of the major challenges faced by companies in every line of trade in recent years has been an expansion of the services provided to customers. While increased service automatically increases payroll costs, those expenses have not been reflected in higher gross margins. Of all the CPVs, the PPR is easily the most difficult to bring back into line quickly.

Firms that can control sales growth, gross margin and payroll are much more likely to generate high profits than those that do not. The other CPVs represent opportunities to fine-tune the business. They are important, but are secondary to the big three identified above.

- **Non-Payroll Expenses**—In analyzing non-payroll expenses, companies typically measure them as a percent of sales. In most instances, non-payroll expenses need only minor adjustments. Unfortunately, there are numerous areas within the firm that need to be examined. Controlling non-payroll expenses will probably always involve examining every expense category with the hope of making modest improvements in a number of different areas.

- **Inventory Turnover**—The rate of inventory turnover has a dramatic impact on cash flow. As a result, it has been a major area of concern for the last several years. It was suggested above that firms need to generate at least a modest rate of sales growth. If that growth is to be maintained without running out of cash, then inventory turnover must be improved, at least slightly. For most businesses that slight increase in turnover will be enough to ensure financial integrity.

- **Average Collection Period**—Like inventory turnover, the average collection period (sometimes called the *days sales outstanding*) has more of an impact on cash flow than on profitability. It also usually proves to be a very difficult ratio to improve. For most firms, a realistic goal is to maintain performance at existing levels.

In reviewing the CPVs in Exhibit 1 it should be remembered that the high-profit company is far from perfect. Individual firms may far outperform the high-profit firm on individual factors. What the high-profit firm does is put together a set of CPVs that results in greater profitability. It is a pattern that every firm should use as a role model.

Exhibit 1
The Critical Profit Variables

| | **Typical** | **High Profit** |
|---|---|---|
| **Net Sales** | $38,917,512 | $38,917,512 |
| **Profit Before Taxes** | $1,634,535 | $3,152,318 |
| **Sales Growth** | 4.0% | 3.3% |
| **Gross Margin** | 26.5% | 26.8% |
| **Personnel Productivity Ratio** | 49.8% | 44.0% |
| **Non-Payroll Expenses** | 8.4% | 6.7% |
| **Inventory Turnover (times)** | 4.3 | 4.3 |
| **Average Collection Period (days)** | 61.3 | 52.7 |