

Can I Afford to Hire More People? (Part I)

“KNOWING IS ALWAYS BETTER THAN HOPING”

CAN I AFFORD TO HIRE MORE PEOPLE? (PART I)

Am I getting my money's worth out of employees?

What employer hasn't wondered about that on payday as wages and tax deposits suck the cash out of our bank accounts leaving barely enough to pay the premiums on the group health plan.

Even when we are well pleased with our current team, how do we know if and when we can afford to hire more people to handle a growing workload? On the one hand, we're nervous about growing sales without the people to deliver, on the other hand we're just as nervous about hiring new people until we have the sales to pay for them.

As the saying goes, we are hooked by the horns of dilemma.

LABOR PRODUCTIVITY AND BUSINESS PROFITABILITY

In his book [Simple Numbers, Straight Talk, Big Profits](#), author Gregg Crabtree tells us that the number one predictor of business profitability is labor productivity.

Labor costs are more often than not our biggest expense, and labor productivity is a measure of how much we earn in return for all those dollars we spend on people (including ourselves).

Mr. Crabtree's clever idea is to create and budget for a "salary cap" that we can use to understand and measure labor productivity. The salary cap is not some arbitrary number we pull out of the air, but rather a calculated number with purpose.

The salary cap is a planning number, a **Key Performance Indicator** (KPI), that provides the information we need to make decisions about hiring and to manage labor costs to hit a target net profit.

THE SALARY CAP

Confused? Don't be.

The salary cap is easier to create and use than it is to describe, and all the information we need is on **our Profit and Loss Statements**.

Creating a salary cap requires us to think about profit in a different order. Most of us calculate profit as if it is something that happens to us. Our conventional calculations look like this:

$$\begin{array}{rcl} + & \text{SALES} & \text{XXX} \\ - & \text{EXPENSE} & \text{XXX} \\ = & \text{NET PROFIT} & \text{???} \end{array}$$

Sales come first, and "they are what they are." Expenses come second, and they also "are what they are." Net Profit comes last and is whatever happens to be left over.

The salary cap is created through a more intentional, disciplined way of thinking about profit. To calculate the salary cap we change the order of the calculation to look like this:

$$\begin{array}{rcl} + & \text{SALES} & \text{XXX} \\ - & \text{TARGET NET PROFIT} & \text{XXX} \\ = & \text{MAX TOTAL EXPENSE} & \text{???} \end{array}$$

In the second example, we started with sales and subtracted a target Net Profit goal to find the maximum we can spend on expenses and still hit the target. That makes sense, right?

The maximum we calculated above is for total expense including both people and non-people expenses. To find our salary cap, we have to separate the two. We do that by totalling all of the people related expenses on our Profit and Loss Statements - everything that has to do with people including wages, salaries, payroll tax, workmans comp, unemployment insurance, health insurance, retirement plans - everything.

We subtract that number from total expense, including both Overhead AND Cost of Goods Sold. That leaves our non-people expense which we use in a calculation that looks like this:

+	SALES	XXX
-	TARGET PROFIT	XXX
-	NON-PEOPLE EXPENSE	XXX
=	SALARY CAP	???

That's our salary cap, the Key Performance Indicator (KPI) that tells us the most we can spend on people and still hit our target profit.

USING THE SALARY CAP TO GUIDE HIRING DECISIONS

Here is the same calculation with some made up numbers. Let's say our sales are \$1 million and our total expenses are \$900,000, of which \$600,000 is people cost and \$300,000 is non-people expense.

Mr. Crabtree tells us our target profit should never be less than 10% of sales, so let's use that to make our target net profit \$100,000. The calculation looks like this.

+ SALES	\$1,000,000
- TARGET NET PROFIT	100,000
- NON-PEOPLE EXPENSE	300,000
= SALARY CAP	\$ 600,000

Let's say we actually do this calculation for our businesses (You will spend the twenty minutes to do it for your company, right?).

If our current people costs are equal to or lower than our salary cap, we can afford to hire new employees.

If our current expenses are higher than the cap, we can't.

Our example numbers happened to work out just right with a cap of \$600,000 and actual costs of \$600,000. But what if they don't? What if our actual people costs are higher than the salary cap? That would be both bad and good news.

The bad news is obvious, if we are over salary cap, it means that we cannot hit our Net Profit goal with our status quo people costs. The good news is that now that we know, we can do something about it. We can plan ways to increase our labor productivity, which means more sales with the same people costs, or lower people costs at the same sales or, preferably, both.

Knowing is always better than hoping, or even worse, finding out after the fact that the profit that happened to us was not good enough.

TRACKING FORWARD

The Salary Cap is a planning KPI - it provides a target to budget for in advance. However, because what gets measured gets better, we also need a way to track productivity throughout the year.

In my next article, we'll see Mr. Crabtree's method for reducing productivity to a single number that tells us how our plan is working by tracking employee productivity throughout the year.

HOW ABOUT YOU?

Do you have a target profit for your company? Do you know how much you can spend on people and still hit the target? Do you even know how much you spend on people? If you had a salary cap, would it **help with your decision making?**

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com



Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over \$52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.