

Diverse Perspectives

The relative financial impacts of operational and marketing strategies

Many people believe the only functions that bring money into a company are marketing and sales. That idea is the genesis for this department, as it provides the opportunity to communicate the impact of operations in financial terms. We do so via the strategic profit model and a table of two comparable scenarios—higher usage from operational strategies versus increases in sales.

The strategic profit model illustrates a company's performance by combining elements of its income statement and balance sheet into one chart. For example, Figure 1 shows company XYZ is a profitable manufacturer in a competitive industry with total assets of \$140 million, sales of \$100 million, net income of 6.4 percent, and return on assets of 4.5 percent. However, leaders are not satisfied. Suppose they are considering two simple options for improvement—relatively small changes in operational strategies versus comparable increases in sales—and company decision makers have chosen the following operational initiatives:

- Manage inventory more efficiently by increasing inventory turns from 8 to 9.
- Reduce labor expenses by 10 percent.
- Cut variable costs by 10 percent.

Operations management professionals may believe these initiatives are reasonable and doable over a one-year time frame, and they can make certain assumptions about the underlying operational strategies and tactics that are deployed to achieve them. For example, the reduction in average inventory could be achieved by more heavily relying on the flow of demand-based information from major customers. The actual tactics may require substitution of information for inventory by more dependence on enterprise resources planning systems, particularly demand forecasting,

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customer relationship management, and supplier relationship management capabilities. Strategies to achieve the 10 percent reduction in both labor and variable cost may include layoffs, out-

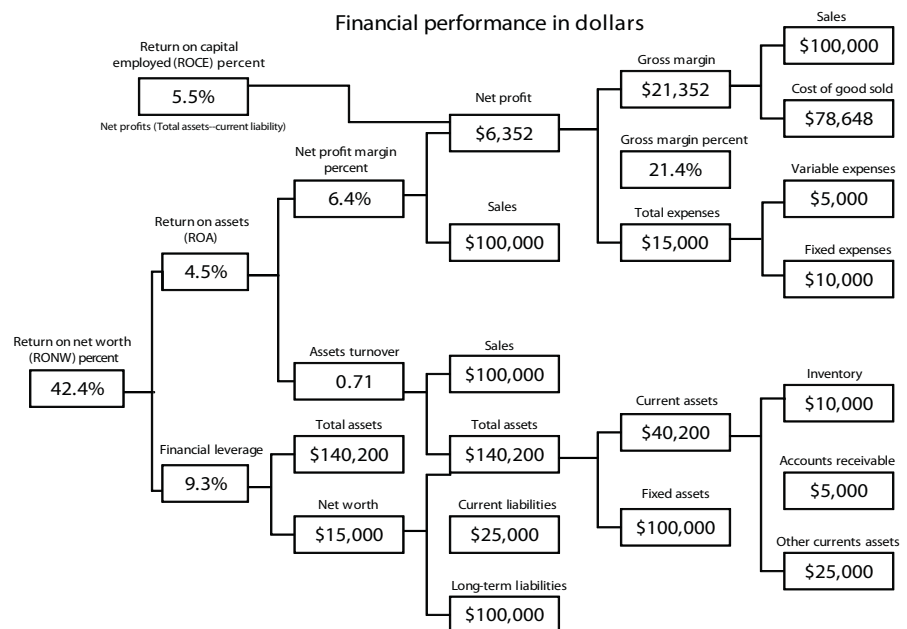
sourcing, and reductions in rebates and price cuts required to move inventory.

What would marketing and sales professionals think about these initiatives? Is it reasonable to assume that a manufacturing company can successfully increase sales by 10 percent from both new and existing customers over a one-year period? What strategies and tactics—involving product, price, placement, and promotions—would be used to achieve this objective?

Keeping in mind these two previous scenarios, let's compare the possible outcomes on the financial statements as shown in Figure 1. First, the top-line revenues for the increased sales option are noticeably higher. However, the relative increases in cost of goods sold (COGS) result in gross margins that are relatively close (22 percent for operational strategies versus 21 percent for sales increases).

Next, look at the earnings before interest, taxes, depreciation, and amortization (EBITDA) in Figure 2. This is perhaps the purest metric to communicate the financial impacts of operational strate-

Figure 1: XYZ's strategic profit model



gies, where the advantage goes to the operational strategies (8.8 versus 7.5 percent).

But wait—what about interest, depreciation, allowances, and taxes? Let's assume they are the same percentages in both cases so that the after-tax profit is relatively close. Notice that this is not the end of the story because of other significant benefits offered by sound inventory management strategies. For example, by simply increasing inventory turns from 8 to 9, the company's net worth is noticeably lower (\$13.2 versus \$16.5 million). However, the financial benefit is revealed in return on assets (6.35 versus 5.82 percent), which has a multiplier effect and results in a higher return on net worth (66 versus 50 percent).

While this is a simplified example, things are not that different in the real world. For example, consider the situation faced by a large manufacturer of aluminum products. Existing operations were focused on maximizing machine efficiencies for a series of large extrusion presses. The business strategy was designed to keep costs at a minimum, thereby enabling aggressive pricing strategies. Because senior managers had a marketing and sales mindset, large amounts of inventory were considered desirable because inventory was produced so cheaply, and aggressive pricing meant it would all be sold eventually.

This strategy worked fairly well—as long as sales were strong. Then, a downturn in the economy caused sales to decline. More sales calls, more advertising, and more aggressive pricing had the desired effect, and sales rose to previous levels. However, increased selling, general, and administrative costs in combination with deep price cuts caused profitability to decline by 5 percent. The company became unprofitable.

To reduce expenses, managers then laid off employees. They rationalized a 10 percent drop in the direct labor

Figure 2: XYZ financial performance comparisons

CATEGORY	BASE YEAR	BETTER USAGE	GREATER SALES
Sales	\$100,000	\$100,000	\$110,000
Cost of sales	\$78,648	\$77,723	\$86,513
Labor	\$9,248	\$8,323	\$10,173
Materials	\$55,000	\$55,000	\$60,500
Overhead	\$14,400	\$14,400	\$15,840
Gross margin (in dollars)	\$21,352	\$22,277	\$23,487
Gross margin (percentage)	21.35%	22.28%	21.35%
Variable expenses	\$5,000	\$4,500	\$5,250
Fixed expenses	\$10,000	\$9,000	\$10,000
EBITDA (in dollars)	\$6,352	\$8,777	\$8,237
EBITDA (percentage)	6.35%	8.78%	7.49%
Inventory	\$10,000	\$8,235	\$11,000
Inventory turns	8	9	8
Accounts receivables	\$5,000	\$5,000	\$5,500
Other assets	\$25,000	\$25,000	\$25,000
Fixed assets	\$100,000	\$100,000	\$100,000
Current liabilities	\$25,000	\$25,000	\$25,000
Long-term liabilities	\$100,000	\$100,000	\$100,000
Net worth	\$15,000	\$13,235	\$16,500
Asset turnover	0.71	0.72	0.78
Return on capital employed	5.52%	7.75%	7.07%
Return on assets	4.54%	6.35%	5.82%
Financial leverage	9.33	10.44	8.58
Return on net worth	42.35%	66.31%	49.92%

workforce to balance costs. In truth, because labor represented about 11 percent of the COGS, the 10 percent drop represented only a 1 percent drop in COGS. Unfortunately, though not surprisingly, understaffing caused machine efficiency to worsen and exacerbated problems rather than fixing them. Performance levels also waned.

Managers soon realized that costs were out of control because of the decisions they had made years before this downturn. They decided to produce only what the customer ordered; thus, by changing their operating philosophy, costs were reduced significantly. Plus, focusing on a more responsive operational model made it possible to continue pricing aggressively, if the need arose. Ultimately, many customers benefited from faster response to orders. This responsiveness turned into a great sales pitch, and customers would

pay more for the company's products because faster response meant lower total cost.

The next time you have a discussion with your marketing or sales counterparts, tell them about the tremendous leverage that operational strategies can offer. To be effective in this discussion, however, you should know how your operational strategies are reflected on your company's income statement and balance sheet. Do you have that information?

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