STRATEGIC PROFITS

INTRODUCTION

Just because you can doesn't mean you should

This book reflects over three decades of observations of how the best companies make strategic profit decisions, and others simply make decisions that impact profitability.

Every choice has consequences, some short term and others over a longer horizon, and each is made in a context that may be of short or long term duration.

Should your company work with a domestic customer that wants you to expand internationally to support one of their foreign operations? Should you meet the competition's price on a large potential order? Is agreeing to supply that large corporation with custom products the right decision? Should your team work overtime to get an order out on time?

It depends. Where are you trying to go, what are your options, and where are you now?

Read on to discover key considerations in making decisions that drive Strategic Profits for your business.

IT'S ABOUT CHOICES

Building a successful business requires delegation

If there is more than one employee in your organization, decisions are made every day without your direct input. Every one of those choices impacts your resources, finances, supply chain participants and your options for moving forward.

Even if you believe most of those impacts are minimal, they occur: many times each day, by every employee, without your awareness.

Provide guidance for how to make decisions, coach after poor decisions are made, but do *not* try to make them all yourself or second-guess after they are made.

Unless, of course, you want good employees to run away as fast as they can.

Some businesses will not purchase materials or schedule capacity for an order on credit hold; others will produce it completely and wait to ship. Every company has different policies, different thought processes, and different goals. No employee can walk in the door understanding how you want decisions made.

As a leader, it is your responsibility to put in place an effective framework for decision-making that supports short and long term objectives of the business. What should that framework address? Well, that's a choice you need to make!

Business factors impacting your framework include -- among other things -- size, industry, markets, competition, risk tolerance, cash position, and employee skill levels.

Start simple. What are the top 5-10 types of decisions that are likely to be made without your direct input? For each one of those, what would you like employees to consider in choosing how to move forward?

An example:

1. Spending money
    a. How soon will we get that money back?
    b. What happens if we do not spend that money now?
    c. If it were your own money, would you spend it this way and now?
    d. Will not spending it hurt a current customer or order?
    e. Will spending it now impact paying someone we already owe?

The types of decisions and considerations you define are specific to your business, likely to change over time, and can be identified by you as guidelines or as hard rules. Your choices.

If nothing else, this process will force you to think about your decision-making processes. Any hope for strategic consistency begins there.

STRATEGIC OBJECTIVES

If you don't know where you're going, you might not get there

I've seen all kinds of owners and CEOs. While each has some vision of what success means for their business, they are like snowflakes: similar in many regards, but no two are identical.

- Let's grow the top line; the bottom line will take care of itself.
- Let's grow the bottom line; the top line doesn't matter.
- Let's control the middle lines (costs), and the other lines will be fine.
- I'd rather run a simple small profitable business than grow it into a large complex higher-risk higher-reward company.
- We should always be pushing the limits
- We should act conservatively
- and on it goes………

There is no reason to expect your employees to coincidentally make decisions to fulfill your vision of success. Your chances improve if they understand what you are trying to create and your risk tolerance. The more you and they understand real costs, alternatives, and strategic objectives, the more likely your vision will become reality.

One of the best executives I've ever seen is Alan MacDonald, former President of Stouffers. I worked with him there in the early 1980s. Alan met with all new salaried employees to listen, explain the company philosophy, and make very clear how we were to make decisions.

For example, we were to NEVER jeopardize product quality. Customer service was next, followed down the road by cost.

Did that mean we could spend like drunken sailors? No. It meant that if we had to incur higher costs to ensure quality and customer delivery, we would do that.

In the food business crop performance could impact our available supplies. We had to decide if we could locate and use alternative sources, or remove some or all affected products from the market until new supplies became available. Our management team had many knockdown drag-out disagreements about what was an acceptable risk, but we never argued about priorities or who had the final decision.

Another example: If Finished Good inventories of an item became too low to meet current demand, I could request an early release of product awaiting quality test results. That meant moving it to a warehouse closer to the customer to ensure fast delivery upon product release by our Quality department. Of course we had processes in place to ensure that any early-release product could not be shipped to any customers before approval was received.

Some products had a higher probability (still extremely low) of troublesome results than others, and that had to be considered. Responsible for customer service, inventory and other key factors, I could NOT overrule the quality manager's decision on early release. If he said no, and customer orders were late, that was the right strategic business decision. It was my responsibility to ensure that no product was shipped to the customer before full quality approval, regardless of early release approval.

He and I could passionately discuss if the risks and costs of a specific internal recall balanced the time we would save in meeting customer needs, but the final decision was his.

Are decision-making priorities and responsibilities that clear in your organization?

Again, using Stouffers in the early 1980s as an example, there were grocery chains that were in our target market, and others that were not. Large chains often placed on us specific and expensive requirements that only benefited them; we discussed the strategic importance of the market, the customer, and any residual value to be gained by meeting the demands. As a management team, we agreed, or not, to meet the demands.

Not all markets are good markets; not all customers are good customers; not all orders are good orders; not all new products are good additions to the portfolio.

Does every member of your team know how to tell the difference? If they understand your prioritized strategic objectives and how decisions impact those objectives, you'll have much better odds.

List your prioritized strategic objectives; then test if your management team has that same understanding. If not, you know where to start. If they do, start moving down the organization chart to identify any break points in the communication.

If your strategic objectives are understood throughout the organization, it’s time to move on to other issues that impact profitability.

THE MYSTERIES OF MARGIN

Precision indicates neither accuracy nor value

Standard cost accounting leads to more poor business decisions than any other common management tool I can think of.

First, the basic assumptions of a standard costing system rest on a large batch mentality coupled with guestimates of future volumes and costs. That annual "make up numbers but hide the inaccuracy with the appearance of precision by including decimal points" accounting process is followed by the monthly "why didn't you hit my made up numbers?" inquisition of managers. What a lousy use of valuable resources!

Many, but far from all executives know that the peanut butter approach to overhead (spread it evenly across everything) and the shotgun approach to overhead (assign those guestimate costs to the products you think should feel them) are equally dangerous and misleading.

Are you a job shop that charges time and material to jobs? In most cases, that is a complete waste of time and resources. Job shop businesses were often trained to do this, as some alleged manner of knowing which jobs made and lost money.

But, seriously. If a higher paid craftsman worked on a specific job because he was available, should that job "eat" the higher labor costs? If a job incurred problems and extra materials were required, should that job "eat" the higher materials costs? Should that job "eat" some arbitrary overhead allocation?

"No" to each of those. The days of "cost plus" pricing and passing along your inefficiencies to the customer are long gone. The market sets the price; it is the responsibility of operations to determine if they can make jobs at market prices and contribute appropriate margin to the company. They can be right most of the time, and will likely be wrong sometimes.

Examine that "target costing" process and improve it. Understand factors that impact your costs or responsiveness negatively, and improve those processes. Don't waste time interrogating a production supervisor why s/he was wrong on some specific job under some very specific set of circumstances.

Not a job shop? Your "standard gross margin" numbers are still not helping you understand how and when you make and lose money.

The reality is that you will pay the electric, gas and water bills regardless of any single order. Barring major adjustments in volume, you will neither hire more nor lay off workers. Minor adjustments in volume are unlikely to impact your payroll. You know the materials your products should take. You know the amounts of depreciation accounting will book each month, defined by the IRS I might add, regardless of product mix or volumes. So why are those factors treated as making some products profitable and others less so?

"Standard margin," and "gross margin" are numbers that bear little resemblance to actual profitability of individual products, orders or customers.

Does all of this mean you should give up trying to understand how you make or lose money? Of course not, but it does mean

you shouldn't count on job costing or standard costing to give you the answers.

How helpful are your current financial reports in truly managing your business in support of your goals? If they are not, and most are not, don't waste time with them. Instead invest those resources in better understanding what would help you. Give unto the government what is owed, but do not ever let it tell you which numbers provide you with useful information to run your business.

CONSTRAINED RESOURCES

Promote what you can make and sell now

Selling something that you can't make now may increase your backlog, but it doesn't help cash or profits. It certainly doesn't make financial sense for your sales and marketing efforts to focus on products you can't make now. When a constraint is limiting your output, sell things that do not use the constrained resource. They can sail through, helping both cash and profits.

The first step to creating those strategic profits is to identify the bottleneck. If you use "push" scheduling techniques, it is fairly easy to do. The bottleneck is where the most inventory is sitting, waiting its turn. In a "pull" or "flow" scheduling environment, it's the resource constantly turning. If you think the bottleneck moves frequently, you have policy driven constraints. Keep in mind a constraint can be a machine, a skill set, an internal process such as Engineering, or other attributes of your business and production processes.

If you are not familiar with the work of Eli Goldratt, father of Theory of Constraints (TOC), I strongly encourage you to gain at least a rudimentary understanding. His work in evaluating the profitability impact of various products based on how much they utilize the constraint is especially important.

He has simply demonstrated that selling the item with the lowest labor and material costs and the highest gross margin may, in fact, hurt your profitability. While this thinking may be counterintuitive, the reality is that selling items that absorb the bottleneck limits what else you can make that requires that resource. Again, it's all about choices.

Understanding your order-to-cash process flows is the first step in making optimal resource allocation decisions increasing strategic profitability through sales.

COMPLEXITY

Intense complexity requires equally intense simplicity

Regardless of the markets you serve, customers are demanding to get exactly what they want. No more "any color you want as long as it's black." So we add sizes, colors, capability options, and every other distinguishing characteristic we can to satisfy the market.

Done well, that results in increased sales and profits. Done poorly, it can kill a business.

The costs of complexity are not easy to quantify, but they must be appreciated in product derivative and customization strategies. Just because each color part has the same purchase price doesn't mean that offering multiple color options doesn't increase your costs.

Every option you add injects inventory management complexities, opportunities for error in order entry and production, and additional transactions from purchasing to receiving to accounts payable. All of these are costs you must absorb. Eliminate or minimize those costs by creating systems that consider strategic complexities from the beginning.

Postponement processes– waiting until the last moment to finalize an item to meet specific customer needs – are a great way to simplify the complexity of mass customization. But if your product design team doesn't' understand postponement, and your products are not designed to support it, the costs of complexity can kill your profits. Your standard cost gross margins may not indicate it does, but your bottom line will.

Do not believe that shipping to one new country is easy since you already ship internationally. Don't believe that adding one more color or size or software option has no impact on costs. But do design scalable processes so that you are not reinventing the wheel each time. Design modular products with common parts and design processes that eliminate transactions. Ask and resolve the bigger picture questions before you take those first few steps in increasing the complexity of your business.

OPPORTUNITY COSTS

The benefits of what you coulda done if you woulda done that instead

All resources are limited. Money, time, materials, creativity, you name it. Because of those finite boundaries, every decision involves an allocation of resources between this and that, between now and later, between yes and no.

As you choose to enter certain markets, take on specific customers and sell particular offerings, you choose not to pursue others right now. Some decisions are very impactful, such as choosing to pursue new geographies or enter highly regulated markets, setting the stage for many smaller decisions to implement those determinations. Other choices seem small, like developing a "one-off" product in response to a customer request, but can in fact change your business significantly. Yet others, like purchasing materials to support an order you expect to receive, may be routine but nonetheless limit your alternatives.

As you look at every decision that impacts your profitability, it is very important to consider what those decisions will preclude. Directing your technical group to develop a parts rationalization strategy to reduce the number of components needed is also the decision for them to NOT work on some other worthy project. Assigning them many projects requiring limited resources and telling them "they are all important" is abdicating your responsibility to set priorities. Make clear how priorities tie into strategic profitability.

Sending every supplier invoice that is off by a small amount to purchasing to resolve consumes limited internal resources. This may be the very best use of their time and skills, but it may not be. What else would they, or more importantly, could they be doing to contribute to the long-term profitable success of your business? Chasing coins while letting real currency slip through unnoticed seems a bad choice.

DECISION MAKING FOR STRATEGIC PROFITABILITY

Serendipity is no way to run a business;
think strategic profitability instead

Any business needs to be profitable over time, but not all profits are created equally. This book highlights examples of the many choices that impact your profits in ways you may not have considered, and explains why a planned strategic approach to those decisions is vastly superior to the alternative.

By considering each chapter you and your team can develop a coherent model for decision-making aligned with your strategic objectives.

Think Strategic Profits. And then go get them.

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