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Operating Margin

by Magnus Bild

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CONTENTS/
AUTUMN/WINTER

016
MERGER MISTAKES
Owners of all kinds need to be more careful in approving international acquisitions, argues **Lars Engwall.**

018
PROFILE: THE WHIZ KID
Jukka Hohenthal has met the new CEO of ICA Gruppen and Uppsala alumnus **Per Strömberg.**

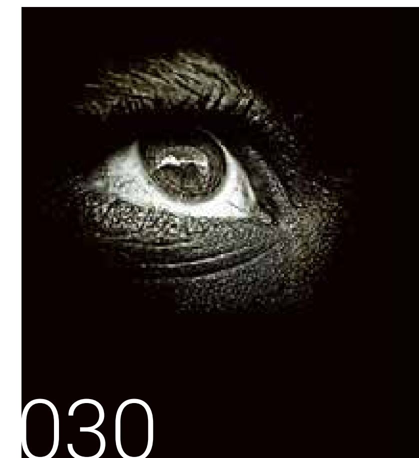
021
IDEAS: DREAM CATCHING
Tore Strandvik and **Anu Helkkula** put forward a new idea of how to discover innovations that customers will buy.

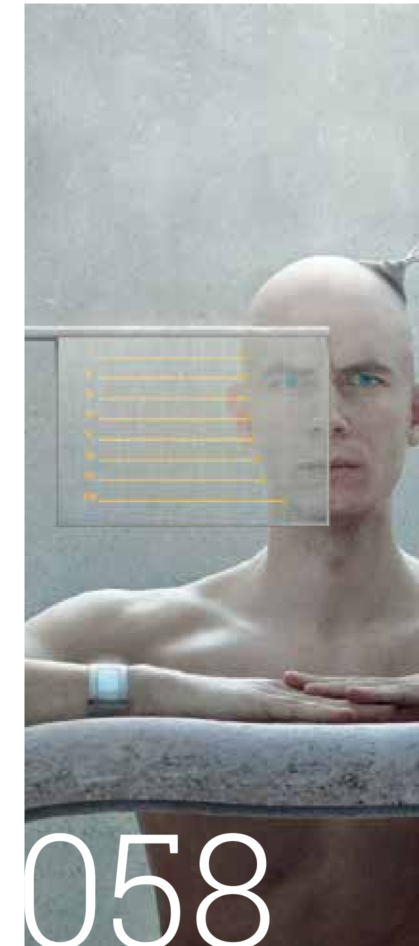
022
VALUE CREATION
Achieve your commercial goals by creating value for all stakeholders, argues founding partner of Prime **Carl Fredrik Sammeli**.

025
BOOK REVIEW: 'BIG DATA'
LSE researcher **Niccolo Tempini** reviews the work of **Viktor Mayer-Schönberger** and **Kenneth Cukier**.

028
THE FUTURE OF DIRECT SELLING
Magnus Brännström, CEO of **Oriflame** and Chairman of **SELDIA** - the European Direct Selling Association, provides his view on the future of direct selling.

030
LEGITIMACY FOR SALE?
Anna Tyllström walks us through the world of PR consultants, politics and the struggle for visibility.





038
EFFECTIVE AND HAPPIER
Carin Eriksson Lindvall explores the sense of meaning in our work.

040
DECEPTIONS OF CONSISTENCY
Public sector organizations cannot uphold consistency and coherency in what is to be communicated argues, argues **Josef Pallas**.

046
LEARNING FROM DISASTERS
Enikö Kaptalan-Nagy explores one of the biggest crises in the European Union: The Mad Cow disease.

052
THE ENTREPRENEUR AS COMMUNICATOR
As an entrepreneur you need to develop your storytelling skills, argues **Ivo Zander.**

054
THE SELLING OUT OF ART
Anders Björnsson comments on an indecent activity among Swedish corporations.

058
WHAT DOES IT TAKE TO GET YOUR ATTENTION?
Poja Shams examines how purchasing decisions are made in grocery stores using eye-tracking technology.

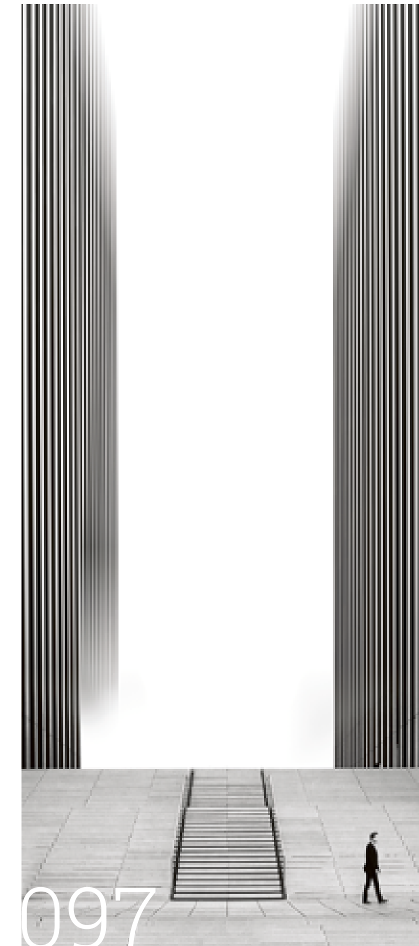
064
WHY NOT GET A CONTRACTOR IN?
When specialist knowledge is lacking in-house companies are forced to move outside their boundaries.

068
DON'T CRY WOLF!
Managing your intellectual property requires among other things collaborating with enforcement agencies.

070
MOBILE SERVICES AND OPERATOR BUSINESS
Spotify and Telia cooperate in Sweden but can this type of partnership be a role model in other areas of the world?

074
WHAT IS SERVICE?
Services are the backbone of our economy but we seldom think about them, argues **Bo Edvardsson.**

CONTENTS/
AUTUMN/WINTER



076
GETTING CLOSER TO CUSTOMERS
On the emotions your organization needs in order to be truly customer-centric.

080
REAL HUMAN BEINGS ARE A MEDIUM TOO
Magnus Söderlund focuses on a very traditional yet powerful medium we tend to forget — the face-to-face encounter.

082
JUDGING THE MANAGER IN MEDIA
Shallowness, superficiality, smartness, focus on looks and appearances - is that what we get from mediatization, asks Magnus Frostenson.

084
TRIPPLE BOTTOM LINE?
Culture quadruples the challenges, argue Lena Zander and Ciara Sutton.

088
HOW CAN ACADEMIA SUPPORT BUSINESSES?
Academia has a lot to offer businesses, argues Staffan Movin.

090
WHEN SCIENCE MEETS FINANCE
Different accounting calculations influence product innovation, argue Henning Christner and Torkel Strömsten.

097
OPERATING MARGIN
Magnus Bild discusses what probably is the most common financial indicator in business and uveils its delicate qualities.

102
WHAT DO AUDITORS DO?
Pernilla Broberg has observed autitors at work in Big 4 audit firms bringing forth an updated view of auditing and the role of auditors.

108
SWEDISH CONTROLLERS - SHAPED BY A BOOK?
Nils-Göran Olve tells a story about a book and its impact on a role.

112
LEAN MANAGEMENT
Göran Nilsson provides 14 principles for a nuanced view on the subject that provokes more feelings than any other management concept around.

115
SCIENTIFICATION
Throughout society the scientific method have gained momentum in managing and communicating work flows and organizational processes, argue Leon Michael Caesarius and Jukka Hohenthal.

118
LET'S DECIDE!
The process of decision making confuses Henrik Bäckström.

120
MANAGERIAL DEVELOPMENT
Is it a necessary investment or mere rain dance, asks Martin Rogberg.

122
NEED FOR SPEED?
Agile management is the key according to Tomas Gustavsson.

OPERATING MARGIN

Magnus Bild discusses what probably is the most common financial indicator in business and unveils its delicate qualities.

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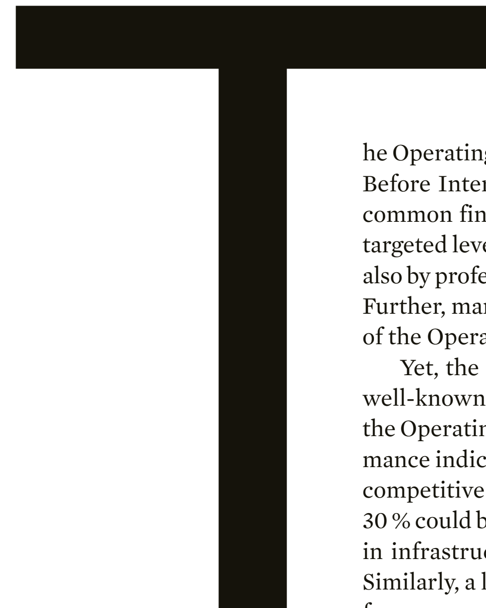

he Operating Margin, the ratio between operating income (EBIT, Earnings Before Interest and Taxes) and operating revenues, is probably the most common financial indicator in business. The outcome is compared to the targeted level, not only by decision makers inside a particular company, but also by professionals, such as business journalists and stock market analysts. Further, many employees have bonus schemes linked to the reported level of the Operating Margin.

Yet, the Operating Margin is a subject of criticism. Michael E. Porter, well-known Professor of Strategy at Harvard Business School, claims that the Operating Margin (or Return on Sales, ROS) is an inappropriate performance indicator, since it fails to account for the capital that is needed to be competitive in an industry. In other words, a high operating margin of, say, 30 % could be unsatisfactory for a company that has made large investments in infrastructure, e.g. power generation or telecommunication services. Similarly, a low operating margin of, say, 3 % can be more than satisfactory for a company that has not invested in heavy plants and equipment, and consequently have a lighter asset side of its balance sheet. Examples of such companies would be retailers operating in rented facilities, or pure construction companies without real estate investments.

I agree with Porter however, in this article I will share three additional characteristics of the Operating Margin, characteristics that I believe need to be considered by every company that evaluates its business with this particular key performance indicator. I base my reasoning on more than 25 years of experience of teaching executives from many different companies, countries and levels.

MOST PEOPLE ARE UNAWARE OF THE COMPONENTS OF THE OPERATING MARGIN

I meet executives and their employees in training programs several days every working week. During the last five years I have tested these participants' understanding of the components of the Operating Margin, i.e. revenues (net sales) and costs (expenses). The participants were executives or experts in larger, mostly Scandinavian owned, companies. They were divided into pairs and were given multiple choice questions on various key concepts in accounting and finance as a warm-up. Each pair submitted their answer by using a clicker, a device similar to the remote control used to change channel on the TV. As soon as all pairs had answered a question, I showed them a chart with their voting, and based on that we discussed the various alternatives in depth.

My results reveal that around 25 % of the pairs selected the right alternative for when revenues occur, and that roughly 50 % of the pairs selected the right alternative for when costs occur. Clearly, most pairs do not know what is imbedded in their most important performance indicator. The fact that the answers were given by pairs, and not by individuals, probably means that the proportion of correct answers was increased. If you want, you can yourself answer the two multiple choice questions by following this link *www.bildrunsten.se/Mercury*.

What might be the possible explanations for these results? I believe that semantics play a role here. In private life, we use words as 'sales' or 'costs' almost as synonyms to cash inflows and cash outflows. If we then are asked when sales and costs occur in a business setting, it is easy to draw on the private life use of these terms. But, in business, sales and costs are not synonyms to cash flow. Instead, sales (revenues) have to do with performing a service and cost (expenses) has to do with using up resources.

What might be the financial implications of these observations? I claim that if the executives and their employees are not fully familiar with the meaning of their businesses' most important key performance indicator, then there is a risk that the businesses will not develop in the most desirable way. I do believe, however, that it is fairly simple to improve the shortcomings. The solution is basic training and in addition to that a frequent and clear communication around the Operating Margin and its components.

THE OPERATING MARGIN COULD LEAD TO AN EXAGGERATED FOCUS ON COST CUTTING

At one occasion, I was invited to follow the discussions in a PEP project group in a large Scandinavian company. There, PEP was used as an acronym for Profit Enhancement Program. The role of the project group was to come up with a list of potential activities that could restore, i.e. increase, the company's

Operating Margin. The project members where very surprised when a newcomer to the project group suggested that a revision of the company's pricing strategy should be added to the list of activities. The initial reaction of the others was that the suggestion was not within the scope of their mission, since pricing strategy is related to the top line (revenues), while they were appointed to discuss how the profit could be improved. After some debate, they finally realized that increasing revenues could also enhance profits, and that their mission after all was not just about cost cutting. It was remarkable to notice how the energy level and creativity rose in the project group when the scope was extended to also embrace revenues.

What I described above was when I first came across a conundrum that I have met during an uncountable number of later occasions. Namely, the conundrum that profit improvement for many people is seen as the same as cutting costs. When I work with companies, especially those that are performing below their targeted level for the Operating Margin, I nowadays ask them what actions will help them to meet their target. Still, the typical answer is a variety of various cost cutting suggestions. It has made me curious about why there is such a lack of revenue boosting ideas.

My thinking is that there are at least two reasons. First, cost cutting programs are more frequent in business than revenue improvement programs. As a consequence, it comes easier for the participants to suggest cutting down costs. Second, the way the Operating Margin is communicated makes it more intuitive to go along the cost cutting way. In companies' annual reports, and quite likely also in their internal documents, the Operating Margin is explained as the ratio between the operating income and operating revenues. That explanation might lead to the erratic conclusion that increasing revenues will cause the Operating Margin to fall. I have noted a considerable difference in the character of the participants' suggestions if I instead talk about the Operating Margin using the following expression:

When using this more lengthy explanation, the proportion of revenue boosting actions increases. So, in order not to lose the focus on revenues and the customers, it might be worthwhile for companies to start explaining the Operating Margin in the more lengthy way.

Please observe the words I used in the mathematical expression above. I deliberately picked 'revenues' and 'expenses' rather than the alternative words 'net sales' and 'cost'. I did so because, as I pointed out in section 1, many people seems to link net sales and costs to cash flow, which in an accounting sense is not the correct meaning of these words.

THE OPERATING MARGIN FOCUS CAN TRIGGER A VALUE DESTRUCTING BEHAVIOR

According to economic theory, value is decided by the size, timing and riskiness of expected future cash flows. Put simply, to create value is then about making the cash inflows large, collect them early and make them safe, while at the same time keeping the cash outflows small and distant. Obviously, there is an abundance of situations where the five cash flow features need to be balanced in a proper way.

In accounting theory and practice, there is a well established idea that revenues and expenses should be matched. For a trading company this means that the expenses for purchasing and storing products will occur in the income statement as an expense when the products have been sold by the trading company, i.e. not when the trading company makes its purchase. In accounting jargon we talk about 'cost of goods sold' to articulate this matching idea. For a construction company, where the projects often stretch over several reporting periods, it becomes a bit more complicated to adhere to the matching idea. For some projects, the 'percentage of completion' approach is applied. It means that revenues are reported in a given period based on how much of the project's total estimated expenses were spent in that particular period. To exemplify, if 40 % of the total estimated construction costs were spent in 2012, then 40 % of the total estimated revenues could be reported, and consequently also 40 % of the total expected profit of the still ongoing project. Please observe that this reporting method does not require that the customer has paid the invoices from the construction firm, in fact the invoices do not even have to be issued at the reporting date.

In training programs, I have met many participants who have described a conflict between creating value and reaching the targeted level of the Operating Margin. Some of these participants were employed by construction firms, but since the percentage of completion approach is relevant for many other industries as well, the problem they describe goes well beyond the borders of the construction industry.

The conflict is the following: When approaching the end of the financial year, project managers are asked by superiors to call their suppliers to make sure that these suppliers send their invoices as soon as possible. If the suppliers act accordingly, the construction company (or whatever industry it might belong to) can prove that they have faced expenses and consequently they can report larger revenues and profits. So, this line of action is beneficial for the Operating Margin.

But is this in line with economic theory? Well, in that context it is pretty clear that it would be better not to call the supplier, thereby possibly being able to wait longer with paying the supplier's invoice. As pointed out in the first paragraph of this section, it is better to pay late than early. (Please observe that this is not an argument for paying your suppliers too late, but rather that it is better to pay on the last day of the agreed credit period than on the first day of that period.)

What I described above was just one example among several, where someone held responsible for the Operating Margin tries to do as good as possible, while disregarding the negative side-effects of that action. In a wider sense, the Operating Margin is not any worse than other one-period financial measures when it comes to putting emphasis on short-term goal fulfillment rather than on long-term oriented value creation.

CONCLUDING REMARKS

Many executives that I meet explain their preference for the Operating Margin by claiming that it is a simple and easily understandable key performance indicator. In this article, I have illustrated that it is an alluring simplicity. In fact, the Operating Margin is barely understood by people who are evaluated on it, and the use of it has at least a couple of negative side-effects. From a management point of view, the best that could be done is trying to mitigate these drawbacks, being aware that there is no such thing as a perfect indicator, or as the economist Oskar Morgenstern stated "*he who begins to count begins to err*". ■