**Aligning Your Operations to Market Requirements**

Unfortunately manufacturing businesses, and this includes printing companies, have paradigms and have been taught that certain metrics are vital to their business. Two such metrics are gross margin and profit. In this article, I will talk about both of those and two better replacement metrics that you should be focusing on instead. I will explain why below.

**Profit**

Profit includes some things that do not consume cash or generate cash. Two simple examples are labor and overhead expenses associated with producing inventory. Accounting rules require the deferral of certain expenses until the product that “used” them is sold. So labor and overhead expenses associated with production, that have actually been paid, are put into inventory on the balance sheet instead of hitting the income statement. Cash is consumed but profit is generated, even though none of that inventory was sold. So how can a company make money by putting something on a shelf?? This defies logic but follows the accounting principal of matching expenses with revenues.

Just as a side bar, I once worked with a company that made product like crazy in December, hoping that they would sell it early the next year. They did this so they could defer labor and overhead, thereby generating profit through making inventory. They received profit target bonuses based on this action. It was a bad business decision from a cash flow standpoint, but a smart one for making a bonus.

Another example is depreciation, which is a non-cash expense. It reduces profit but has nothing to do directly with cash flow. Depreciation is associated with equipment, etc. and the cash flow associated with that is either the amount paid to buy the equipment or the cash payments on any loans used to finance the purchase.

The Statement of Cash Flows, which is typically not even looked at in monthly financial reviews, is more important to look at than the income statement. What is generating and consuming cash is most important. If you don’t believe this, consider that you actually manage your personal life finances by understanding cash flow. Most people don’t generate personal income statements, but they know where their cash is coming from and where it is going. If you generate a personal P&L, you would be depreciating your dishwasher, your furniture, etc. instead of worrying about how much they cost.

**Gross Margin**

Gross margin is the revenue generated by a product less the expenses “incurred” to make the product. This is a hypothetical number for several reasons.

One, gross margin doesn’t exist until you sell a product. So, it is calculated in the computer system and then varying price lists, sales or customer service negotiations with customers change it, etc. We kid ourselves with gross margins.

Two, it is calculated by again assigning labor and overhead to the costs, which has multiple problems associated with that. One, fixed costs are treated as variable. A portion of rent gets charged to products based on some factor that the accountants came up with (that is another story) and whether this is accurate or not can always be questioned. Just because a number can be calculated on a spreadsheet does not make it relevant. Two, labor is split between direct and indirect and then it is assigned to product based upon some standard that has been agreed upon by operations, accounting and top management. Then everyone plays games to make gross margin look like they want it to. Operations always wants to make it look good, so they play games with reporting of machine time and labor. Accounting usually likes to be the bearer of bad news, so they are on the lookout for items that did not meet the standard. Then top management needs to sort it all out. Why play these games?

**Better Metrics**

There are two metrics that should replace gross margin and profit. They are *throughput* and *cash generated from operations.*

**Throughput**

Throughput is simply revenue generated less the materials (print media, ink, supplies) and outside service costs used to produce the product. There is no labor factor or overhead factor assigned to products. In accounting terminology, this is called “direct costing”. It does not follow GAAP, so it cannot be used for external financial statement reporting purposes, but GAAP distorts data so that in many cases it is not suitable for measuring business operations. But there is no reason why you cannot use both. I have run two companies, and within weeks I have converted operational metrics so that they do not use labor and overhead in calculating product costs while still using GAAP based statements where they’re needed.

One factor with throughput-based accounting is that it does not give credit for making money if you do not sell something. Being reasonable, set a goal based on excellent business practices. So, if product should be moved within three weeks of being produced, then revenue generated within three weeks of production can be counted, if not, there is no revenue, only cost. There is a paradigm change. But logically if something sits on a shelf, it generates cost, not revenue or margin. I typically do not give revenue credit to a job for the portion of what is produced it that takes longer than four weeks to sell.

There are several variations that use throughput as a basis that very insightful, such as understanding how much cash flow a constraining resource, such as a valuable lithographic printer generates per hour. Throughput per constraint hour. Using this method completely changes your outlook on what makes you the most money and makes your business successful.

**Cash Flow Generated from Operations**

You can find the cash flow amounts from adding up the received payments from your customers in your accounts receivable ledger or your accounts payable ledger for payments you make to your suppliers, the landlord, the utility companies, insurance, etc. Payroll checks are another source of cash used in the business, both office, shop, direct, indirect, etc. All payroll and employer related payroll expenses should be available from your payroll provider or your payroll system.

**Summary**

Understanding what generates cash and consumes cash in your company is a key to making money. It should be the primary metric used in your business. In the companies that I have worked with, most focus on the income statement and a little bit on the balance sheet. Cash is real and easy to measure, so focus on that.

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**About the Author:** Bob Krausert is the owner of STRATE***X***, a Twin Cities based firm that works nationwide. Bob is the author of the book, ***Extreme Lean***, published in 2018. Bob has worked with over 60 printing companies, mostly mid-sized companies, but also with larger companies like Jostens and Banta, now part of RR Donnelly. During his career, Bob has trained over 12,000 people at both public and private events. Bob has been working with PIM since 2010, periodically providing educational seminars for its members. Bob can be reached at [stratexlean20@gmail.com](mailto:stratexlean20@gmail.com) or by phone at 612-743-8706. If you would like to have a specific question or topic covered in one of the articles, feel free to make the suggestion.