PURDUE UNIVERSITY

TALENT AFFECTS FINANCE

by Michael Gunderson

Agribusiness professionals seem to view the chief financial officer (CFO) as a no-nonsense type with a singular focus on the numbers. They might feel stymied in conversations with the CFO when the topic drifts to leadership, people skills, and talent management.

It is clear, however, that nothing is more important to a company's financial performance than talent management. So why is it so hard to communicate with the CFO about that topic?

One reason might be that financial statements — income statements in particular — are not designed to measure the role of talent in creating and capturing customer value in an obvious manner. When analyzing financial operating performance, CFOs and analysts focus on the return to assets.

The assets represent investments in primarily physical resources, such as inventory, plant, property and equipment. Less often do CFOs and analysts publically use financial metrics related to the role of talent in creating returns.

Return on assets is the product of return on sales (operating profit margin) multiplied by asset turnover. Talent management affects both of these ratios. The impact on return on sales is more obvious. Consider a generic income statement (Table 1).

Table 1. GENERIC INCOME STATEMENT

INCOME STATEMENT ENTRY	CALCULATION OR DEFINITION
REVENUE	Price × Quantity Sold
COST OF GOODS SOLD	Variable Cost Per Unit × Quantity Sold
GROSS MARGIN	Value created and captured by the firm
SALES, GENERAL AND ADMINISTRATIVE EXPENSES (SG&A)	Fixed Costs
DEPRECIATION AND AMORTIZATION	Cost allocation of long-term assets
EARNINGS BEFORE INTEREST AND TAXES (EBIT)	Earnings left to repay financial capital

All firms' income, or P&L, statements start with revenue at the top. Revenue measures the total value created and captured. The first cost subtracted is sharing with suppliers the value they contributed to revenues. Gross margin measures the valued created and captured above the firm's cost of inputs.

Talent management comes in next. Accountants typically expense employee salaries as part of the sales, general and administrative expenses. SG&A expense also includes marketing, advertising, utilities, insurance, property taxes and fleet maintenance, among others.

Finally, accountants use IRS rules to determine the amount of cost from long-term assets allocated for depreciation. This leaves earnings before interest and taxes (EBIT) to pay for financial capital (debt and equity) and corporate income taxes. Operating income is synonymous with EBIT. To calculate operating return on sales, CFOs divide EBIT by revenue.

The math suggests that to improve return on sales, a firm should reduce SG&A expenses. In an economist's world where we can "hold all other things equal," this is a mathematical certainty.

Unfortunately, things are not likely to remain equal when we reduce SG&A. Reducing SG&A means either laying off employees or a salary cut across the board. Neither reduction will result in revenue remaining the same. When improving return on sales, firms should optimize SG&A expenses.

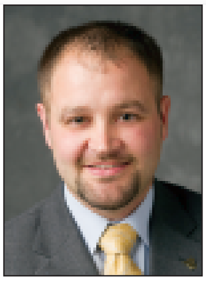
A big focus of talent management is to maximize the revenue generated per dollar of fixed expense. Ratios that incorporate the amount of revenue per dollar of salary or revenue per worker can begin to illustrate the ability to optimize SG&A expenses.

Expenditures on employees will have varying impact on motivation and engagement. Commission programs that focus on rewarding performance with cash could appear to be the obvious choice for motivating and engaging employees.

Why, then, do so many firms invest in trips to reward high-performing employees? Perhaps dollars invested in trips have ancillary benefits that are hard to capture in the no-nonsense CFOs numbers. After all, not everything that can be measured matters. In addition, not everything that matters can be measured. If this were not true, there would be no need for managers.

In the **Center for Food and Agricultural Business**, the faculty have begun a research agenda to understand the role of talent management in the success of the business. When employees rate performance management processes well, the firm is likely to have stronger financial performance relative to its peers.

The center's Agribusiness Finance for the Non-Financial Manager program, July 26-29 in West Lafayette, discusses this trade-off and other finance topics. Learn more: *http://agribusiness.purdue.edu/finance*. **AM**



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