

“THE OUTSOURCE DILEMMA: DO DOLLARS & CENTS ALWAYS MAKE SENSE?”

Scott C. Cohen

Dena D. Breece

W. Stewart Thomas

University of North Carolina at Pembroke

Having started the company from scratch a mere 10 years before, Tom Pettie, the owner and Chief Executive Officer (CEO) of Triangle Electronics, found himself faced with a crucial decision. To minimize fixed costs at the start of the company, Triangle Electronics elected to outsource its sales function to a group of manufacturer representatives who were familiar with potential clients and who had developed connections in the industry. So far, the ability to limit the costs involved with hiring and training an in-house sales department has served Triangle well. Since their cost to capture each sale was a straight percentage based on the dollar volume of the customer's order, Triangle knew that these costs would not overwhelm them, but they also realized that this cost would steadily increase as the business grew. The representatives have pushed for a higher commission rate for several years; however, Tom was convinced that the increase requested was just too much and would have a significant impact on the bottom line for the firm as it continued to grow. To get a better understanding of the costs and implications, the CEO decided it was time to get the advice of a trusted friend and accountant.

INTRODUCTION

It was a typically beautiful fall day in October 2011 in Apex, North Carolina as Tom Pettie, the owner, and Chief Executive Officer of Triangle Electronics arrived at work. Unfortunately, Tom's mood was not as bright as the weather. Just the day before he was given the projected income statement for the company. Things were looking desperate! While their top line sales were growing, their profitability was slow to follow. Having recently invested in new machinery to improve production efficiency, he was determined to improve their bottom line. If something did not change soon, their chance of expanding Triangle's product line and market penetration could be in jeopardy. To Tom, the future of the company that he had worked so hard to create was at stake. To add to the already stressed financial

condition of the company, he had received a notice from the independent sales group, which he relied on to help sell Triangle's specialized electronic components, requesting a meeting the very next day. The sales representatives had been requesting a 3% increase in their sales commissions for quite some time, and Tom knew that his ability to put them off had finally come to an end. Time had run out. It was time. Something had to be done now to turn things around and ultimately save the future of the company.

BACKGROUND

Having started the company 10 years before with fellow engineer and Chief Operating Officer (COO), Mike Campbelle, outsourcing the sales function seemed to be an effective way to control costs as the two engineers worked together to get the company off the ground. Both were great at designing and building electronics but felt ill-suited to take on the task of selling their products to their suppliers. For a small manufacturer of medical electronic components, 3% could cause considerable damage to their profit margin and impact their ability to use their cash flow to grow their business.

THE DILEMMA

After his meeting with the sales group, Tom walked slowly onto the production floor. Mike saw the concerned look on his friend's face and wondered what had happened. Tom motioned for Mike to meet him in an adjacent office. As they sat down, Mike said "How did the meeting with the sale reps go today?" The look on Tom's face told the story. "Not too good I'm afraid!" Tom said. "I've been able to hold them off before, but the group is demanding a 3% increase on their sales commission to offset some of their travel and other expenses." he explained. Tom continued, "While they do have a point, our margins are so tight that this 3% will really hurt our bottom line and prevent using the money to reinvest in new equipment and expansion." Mike knew his friend was right.

As Tom and Mike continued their conversation, Mike reminded Tom of a previous meeting they had with Steve Cowan, a friend of both men and owner of a mid-size accounting firm in town. Mike said to Tom, "Do you remember a couple of years back when we had lunch with Steve, and you had mentioned to him that the sales reps were always pushing for a commission increase?" Tom replied that he did remember the conversation. Mike continued, "I know this is your area, but if I remember correctly, I believe Steve said that our current commission structure would eventually cause an issue, and that we might want to see how we can either restructure the rate or consider hiring our own sales staff." Tom looked back at Mike with a glimmer of hope in his eyes. "You know, I think you are right. It's time we brought Steve into this and see if he can advise me on how to get the sales cost under control and to enable me to devise a system that will work for us as we

continue to grow.” With a bit of newfound confidence Tom left the small office determined to get professional help he needed to make the best decision for Triangle Electronics.

Steve had been expecting a call from Tom Pettie for quite some time. While Steve has occasionally done work for Tom Pettie and Triangle Electronics, most of this was done early on when Tom was just starting the company. At the time, he was asked to assist staff with setting up the accounting procedures for the company. This time things seemed different. During his call with Tom, it was obvious that Triangle had grown to the point of really needing professional input regarding their finances and was at a critical juncture for long-term success. Steve agreed to meet with Tom at the Triangle Electronics facility in Apex, North Carolina and discuss the situation. To prepare for their meeting, Steve asked Tom to have his bookkeeper send over a copy of their current budget. Tom did indicate that he was concerned with the current commission structure and sales cost, but Steve wanted to understand the finances of the company, and not simply focus on one aspect (See Appendix A for their budgeted income statement)

A PLAN FORWARD

Steve arrived at the Triangle facility and was immediately led into a meeting room with Tom Pettie sitting at the end of the table. As Steve took a seat, Tom looked at him and said, “You know Steve, I owe you a bit of an apology. When we talked a couple of years ago, you warned me that the sales commission was going to eventually create an issue.” Tom continued, “If I would have just listened to you back then, we probably could have had this well in hand already.” Steve nodded his agreement with Tom and replied, “That may be true, but the best way to do this is to really analyze the issue from a variety of contexts.” He continued, “One of the most important things to remember is the dollars and cents don’t always make sense. It is important to control costs but is equally important to consider the long-term outcome of these decisions.” Tom looked at him quizzically and said, “Steve, it’s this sales commission that is killing me, everything else is going pretty good.” “That may be true, but you really need to consider a few other things as well in order to come up with a long-term solution” replied Steve.

At this point, Steve started asking Tom questions from a list that he had prepared to get a complete understanding of the issues. The first question Steve asked is “Are your customers loyal to you, or are they really loyal to the sales representative?” Tom looked back at Steve. After pausing for a minute, he said, “Well, I would hope that it would be Triangle Electronics, but the person that they really have the most contact with is the salesperson.” Steve continued. He then asked how Tom had decided his current commission structure. Tom replied, “Basically I found out what other companies were paying, and I just accepted that percentage as what I needed

to pay.” After a few more questions were asked, Steve turned to Tom and said, “In order to make an informed decision, it would be best to run a comparison to analyze the costs of outsourcing and compare that to what it would cost to bring the sales department in house.” Tom sighed and said, “I think bringing the sales in house would be even more expensive and make matters worse.” Steve replied, “It could, that is why you need to know all of the costs and options going forward. Besides in the short-term, I think the analysis should also look to address the issue that your client’s loyalty to the sales rep. The notion that your customers could be more loyal to the sales rep and not the product is a situation that will become more troublesome if not corrected.” (See Appendix B for details regarding the use of an internal sales team)

As Steve and Tom continued their discussion, Tom mentioned that he knew that a few other manufacturers have started using their own internal sales force when they paid a small, fixed salary and a lower (6%) commission rate. Steve said that he would run several scenarios (with both increasing and decreasing sales scenarios) based on the information and be back in touch with Tom for a follow up meeting in a couple of weeks. As Tom left the meeting, he was hopeful that Steve would be able to come up with a plan that would enable him to make the best decision to control Triangle costs, while still allowing them to continue to grow as a company. Tom found himself as determined to correct this issue as he was the day he started Triangle Electronics. The future that Tom had envisioned for the company was on the line. The time to act was now!

Appendix A

Triangle Electronics
Projected Income Statement
For the Year Ended December 31, 20XX

Sales		\$18,000,000
Variable Manufacturing Cost	7,380,000	
Fixed Manufacturing Costs	2,920,000	<u>10,300,000</u>
Gross Profit		7,700,000
Selling, General & Administrative Expenses		
Marketing and Administrative	2,340,000	
Sales Commission (13%)	2,120,000	<u>4,460,000</u>
Income Before Interest & Taxes		3,240,000
Interest Expense		<u>360,000</u>
Income Before Income Taxes		2,880,000
Income Taxes (30 %)		<u>864,000</u>
Net Income		\$2,016,000

Appendix B

Estimated Costs for Internal Sales Team

(These estimates include the cost of employee benefits, payroll taxes, etc.)

Sales Manager	\$ 125,000
Sales Staff	\$ 800,000
Travel Expenses	\$ 600,000
Advertising	<u>\$ 1,500,000</u>
Total	\$ 3,025,000