Chapter 5

The Link between Operations and Finance

To the reader new to the area of operations management, the previous chapters might have appeared more technical than expected.[1] After all, most of the performance measures we used were concepts such as balancing the line to increase labor utilization, reducing inventories, improving flow time, and so on. But WHY do we have to worry about these measures? Do they really matter to our job? Or, asked differently, what is the objective of all this?

The objective of most incorporated organizations is to create economic value. Those who have money invested in the enterprise want to see a return on their money—a return that exceeds the return that they would get if they invested their money differently, for example, in a bond, a savings account, or a competing organization. Economic value is created whenever the return on invested capital (ROIC) in a corporation exceeds the cost of capital (the weighted average cost of capital, WACC, is an important concept from the field of corporate finance). This is visible in the basic value equation:

$$\text{Economic Value Created} = \text{Invested Capital} \times (\text{ROIC} - \text{WACC})$$

Since the cost of capital cannot be changed easily in the short term, our focus here is on the return on invested capital. More details about corporate valuation can be found in Koller, Goedhart, and Wessels (2005).

In this chapter, we show the link between the operational variables we have discussed previously (and that are discussed throughout this book) and ROIC. This is an ambitious task. In many organizations, not to mention business school courses, the topics of operations management and corporate finance are rather remote from each other.

Given this fundamental disconnect, managers and consultants often struggle with questions such as "What performance measures should we track?"; "How do operational performance measures impact the bottom line performance?"; or "How do we go about improving processes to achieve various operational performance improvements, including cost savings, lead-time reduction, or increases in product variety?"

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