The Smart Manager

Aug-Sep 05 VOL 4 ISSUE 5

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UK..................................£2.50
USA...............................$9.50
India..............................Rs100
paralysis by analysis

by Gita Piramal

To improve your profits, make cost a core competency. Define your drivers of profitability and don't monitor everything. Just ten numbers will be enough, advises Bala V Balachandran, Professor of Accounting.

If you want to improve your bottom line, should you concentrate your limited resources on pushing sales up or pushing costs down? Don't know the answer to this frequently asked question? It's time to turn to Bala V Balachandran, Professor of Accounting and Information Systems and Decision Sciences at Kellogg School of Management, Northwestern University, and the first Indian to become a member of its faculty in 1973.

The answer is simple, and depends on your variable costs. For example, if your variable cost is 80% of sales then contribution is 20%. Should you decide to push sales, a 5% increase in sales would translate into higher sales of Rs105, higher variable cost of Rs84, and an increase in the contribution margin to Rs21. But if you decide to lower costs by 5%, sales would remain at Rs100, variable costs would decline to Rs76 and contribution margin would go up to Rs24! But like all answers to trick questions, this answer is incomplete. To understand the theory behind these numbers, The Smart Manager caught up with savvy director of the Accounting Research Center who runs one of the world's most popular executive education programs, "Managing Cost Information for Effective Strategic Decisions."
REVENUE, which is a FUNCTION of MARKET share and price, is REALLY the MAJOR PIECE

We hear that your new research is on cost culture. Can you tell us something about what you are working on now?

When talking about cost management, most managers instinctively think cost cutting. But cost management is much much more than reducing cost. There may be mission critical areas where you have to increase the cost. In my opinion, in a business that is interested in profit, cost is only one management piece. Revenue, which is a function of market share and price, is really the major piece. Nobody can achieve greatness by simply shrinking. But I can grow very fast using cost as a weapon. So the starting point of my new research is activity based revenue management. I am also looking at long term value management and customer loyalty satisfaction.

Just as there is the CMM model (Complexity Maturity Model) in quality, I am developing a CMM model with five steps of costs. Level One shows the measurement of costs; Level Two, the management of costs. By Level Three, we move to trying to identify process improvements. This is where most people stop. I want to go further, to go to the next levels where cost is used as a weapon for supremacy or leadership. Cost has to be understood to find opportunities, and uncover risks where you are vulnerable.

Many Indian companies have tried to determine their costs through the activity based accounting (ABC) model. Yet most of them fail while American companies seem to be quite successful. Why and what is it that we fail to do?

We are too knowledgeable. Sometimes too much intelligence is a disadvantage. It is called paralysis by analysis. If I have one measure, I start thinking, no, two is better. Then we say, hold on, three is better. But is 200 better? No. Somebody has to think that the cost of a system can exceed the benefits it produces. The Americans understand this, not because of their knowledge and but because they are lazy. They cannot count more than four or five, and that is good in a way. We want to address everything and suddenly work escalates.

I have a simple rule of thumb. It is hard to teach a pig how to sing. It wastes your time and most importantly it annoys the pig. So keep your aspirations modest. How? Do an ABC exercise with just ten drivers (five drivers in the manufacturing side and five drivers in the selling and administrative side), and do it without sophisticated software and without consultants and with the team itself managing it. Everything can be done in two months and the company can make millions. Unfortunately some consultants want full time employment and ask for 300 drivers. Who loses? The company. Who gains? The consultants.

What are the steps a CEO has to take to move from cost control to strategic cost management?

When cost management is for a mission or purpose, or when I am managing costs to take advantage of a specific potential weapon, then I call it strategic cost management.

If there is no direction, there is no strategy, then there is no point in doing cost management.

At the same time you cannot price yourself out of the market, you have to operate in the market …

Yes, that is a crystal clear constraint. Then I have to ask, can cost management become my core competency. I may have the cost as the trump card like the Chinese, or I may have the time advantage. If a goal is first decided, and I use my strengths in the existing conditions, through strategic cost management, I can use cost as a strategic weapon to attack the entire target and the customer segments, and to keep them, and to continuously keep them.
In the end most companies have the same costs. What do you do then? Even if costs are identical such as labor and components, you still need to ask yourself, am I overdoing the specifications? Can I take advantage of some special device? What is the power of my innovation or my operational excellence or my client loyalty? What was the initial edge that gave me an entry into that particular company and which I now have to sustain? For sustainability, I have to create value for my customer, know them and realize that customers are not equal.

You have been advocating the need to re-look at traditional cost accounting practices, saying that the traditional methods do not accurately reflect costs in a modern manufacturing environment, that the broken costs system of the 1960s is no longer good today. What is the way forward? In traditional accounting systems, assumptions are made about overheads such as material costs and labor. But in the modern organization, we do many more activities compared to fifty years ago. We use sophisticated software, hire for different types of jobs. But the traditional cost accounting practice puts all these new activities in one ‘overhead pool’. If I produce ten products which consume materials and labor in different proportions, there is no point in taking overhead and distributing it equally over these ten products.

Traditional cost accounting is based on labor dollars. At one time labor was close to 40%-50% and the overhead was close to 5%-10% of total costs. So it was clear as to what was the dog and what was the tail. And yes, the dog wagged the tail. And even if there was a mistake, the maximum error could be 10%. If I have a margin of 60%-80%, a 10% mistake is not a problem.

But once we started automating, labor costs reduced and overhead costs became significantly higher. Overheads became 60% and labor became 10%. Secondly, margins started being squeezed by as much as 10% to 20%. The potential error shot up to 60%. Managers couldn’t be sure whether they were making money or losing money. They could not make out that some products were over costed - and if products don’t make money, it is better to either scrap them or outsource. On the other hand, some products were under costed: managers accepted price reductions thinking that they were making money, and felt safe in under cutting competition. They felt they were doing fantastic sales but if allocation is wrong, losses are inevitable. This is where I think you need to do something different from the traditional methods.

Modern accountants should also look at processes?

At least the cost accountants should do so, I am not worried about the financial accountants. That’s why we should put cost accountants in the center of operations. His office should be right in the middle of the office.
to TRANSLATE STRATEGY into an IMPLEMENTABLE ACTION is key

He can then see and understand what is happening around him without complex analysis.

Coming to the service industry, where labor cost is actually quite significant, what happens then? In the service industry, labor is the raw material. In this case, ABC will not give you tremendous amount of value. The only question in the service industry is, now how do I use the time of the personnel effectively?

How is it any different from the time and motion studies done in the mid-1900s?
You are right, it is not much different. But the time and motion studies looked only at productivity, and what is the best way to do a specific job. They looked at cause effect relationships, and did not translate non financial measures into a financial.

But if the result is higher productivity, and productivity translates directly into dollars….
It directly translates into dollars on a total basis, not on an individual product basis, that is the difference. A time and motion study for a product establishes only the cost of production. It allows me to know that if I am making a product that is too expensive for the market, then I have two choices: to either change the material or change the activity.

In an article in the Harvard Business Review titled "What is Strategy?", Michael Porter wrote that the basis of sustainable profitability is one of two alternates: either a company does activities different from its competitors, or it does activities differently. There are two ways he used the word different. If I do just a couple of activities differently, it is copiable, but if I do seventeen different things, that permutation and combination is so remote that almost nobody can match the seventeen. That was his message. That one sentence of his is a phenomenal sentence. His point focused on differentiation, and my point is focused on activities. To translate strategy into an implementable action is key. That is why process is important and activity is important.

What should be the role of the modern cost accountant? Should it include the ability to cost change?
In my opinion the role of a modern cost accountant should be that of an internal consultant. And a good consultant knows not only what is happening in the industry but also has a radar screen about the kind of changes about to happen in the industry.

For example, take the Polaroid camera. It was a phenomenal product, there was a value proposition, tremendous good management of people, but the whole company went under water. Why? They did not see the digital camera and that innovation killed them. If they had been smart and had understood was going to happen, they could have applied their core competency to digital cameras and they could have become the best digital camera producers instead of Polaroid producers.

Now who will foresee the future? Of course it is the CEO’s job. But cost accountants can define core competencies, the slowly decreasing value proposition. He can see, before many others in the organization, that customers are migrating to a next generation product or a different product for the same function.

But certain functions require people of a certain attitude and aptitude. By the nature of the work of a cost accountant, how can you demand she should also be a futurologist?
That is why I want to have team leadership. The organization can be pyramidal still but there should be a concentric circle in each layer composed of managers drawn from all functions.

In India we have individual players and no choirs, no symphonies…
Even in the US, people did not work
ACCOUNTING and income STATEMENTS SHOULD run into THREE lines, not FORTY lines

in teams until 30 or 40 years back. We do not need to have an organizational change. You be the marketing manager and I will still be the financial manager, but why not we have at least lunches together? The caste system will go way. It’s okay if all the general managers of all functions have lunch together.

You said once that it does not really matter under what heads one allocates cost (eg direct or indirect, service or administrative); what is really more important in today’s modern organization is to understand whether a cost is fixed or variable. That is not quite what I was saying. See, we always ask which costs are fixed and which are variable. That is our culture. What I am saying is that fixed costs tend to be badly measured and variable costs are perfectly measured. That is why I prefer the concept of direct and indirect costs.

A variable cost that is indirect and is commonly shared by the product is an allocateable kind of item. But it also creates a problem. The allocation is the problem. An indirect variable cost is as big a problem as an indirect fixed cost, because of the allocation.

Unfortunately for a long time we thought that one cost system was enough. But if I want to know which product should be axed and which product should be cultivated, measuring direct and indirect cost for a break-even analysis is the best way of dichotomization. It’s the difference between measurement versus management.

In India, there are is a malaise where companies believe they have a 30% contribution on every product, yet destroy value in the balance sheet year after year. Why does this happen? A good cost culture will divide contribution into different kinds. Even in fixed costs, some costs are completely fixed. But some fixed costs are less fixed than a CEO’s salary and are batch related. The problem begins when we mingle everything together as a lump sum. There is a hierarchy of costs, some vary on a unit basis, some on a corporation basis. Many companies cover the first three tiers of costs but do not progress to all five.

I have a feeling that pricing is going to be a critical issue in India. It was never an issue before 1991 because India was a controlled economy where a regulator, some IAS officer, decided the price. Whereas now you are competing with everyone, including China, leave alone new, maybe unorganized, competitors within

India. The original hierarchy is not good enough now.

Have you studied the partha, the manwari system? Any comments? It’s a phenomenal system, based on pure cash flow. I am the only guy in the US, talking about the partha system and how it works. All ABC remains in order in this system. It is simple and has focus: you know exactly whether you are value creating or value destroying.

I know companies where the bottom line looks beautiful but the cash flow stinks. I know this company will go bankrupt in three years but the earnings per share number, even the working capital number, goes up and up from Santiago to New England, and every auditor gives it all kinds of plus statements. But if you were to analyze the company using the partha system, surely you will come to know that this company is going to go bankrupt in three years. I tell you that the Birla family, or whoever created the concept, is great.

If it is so great, why do you think it is not popular? It is not sexy, it is a simple number. And also accountants love to create nightmares. In my class, I tell students their accounting statements and income statements should run into three lines, not forty lines. Top line sales revenue in terms of cash, middle line costs in terms of cash, and
you have to TAKE culture as GIVEN and work AROUND the SYSTEM

times we use the British legacy, other times the US legacy. But in no more than two years, we should have some core accounting principles in place, including corporate governance norms.

A manager may be successful for sometime by cheating but will he be successful all the time? Secondly, can you stand easily in front of the mirror after doing all kinds of unethical things? My Indianess somehow does not accept this. Take for example, Robert K Jaedicke, chairman, audit committee of Enron. He is a wonderful friend of mine. He was the Dean of Stanford Business School, and had a reputation as one of the best accountants in the whole profession, ethically strongly. And he was the audit committee chairman of Enron. After 68 years of hard work, the success is gone. One damn incident killed his career.

I was so happy when Bernard Ebbers, the Worldcom CEO, was given a 25 year sentence. Can his bonuses and incentives in millions of dollars help him now? Things like this have to be shown over and over in business schools. We professors are the culprits. There are certain things we should not do no matter what. In my classes, I tell the students, don’t talk salary when you interview for a job. Ask about the challenges you are going to be given.

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directors of one of their companies. Godrej has its own unique culture. Adi Godrej has decided he wants to have a powerful board which can ask questions without any hesitation. Of course Adi Godrej is signaling to the world that he runs a good company, one where even the promoter can be questioned. This culture, set by top management, permeates the company, even to the entry level manager. A message goes out that there cannot be cheating. But cheating is different from taking big tax advantages facilitated by the government.

Culture plays an important role in accounting practices. As the forces of globalization spreads from country to country, is there a set of best practices we should adopt? Should there be uniformity? Can there be uniformity? No, people will not change. The Chinese love the number eight. We want five and seven, it is our culture. Chrysler versus Mercedes, there is a huge cultural issue. The Germans are engineers, even the CEO has to be a PhD. The bottom line is, you have to take culture as given and work around the system. And what works extremely well in India, may or may not work in Germany.

Let’s take the Godrej group, where I am on the board of

bottom line net cash flow in terms of cash. If that is negative, then I do not want the rest of the forty lines. You can use sophisticated softwares, but I do not believe them. In fact, if the annual reports are unbelievably glossy, with wonderful photos and smell good, something is rotten there. The management is masking something, taking advantage of the 150 national accounting standards and cooking the bloody books instead of creating value of the company. The partha system is unbelievable.

Which brings me to the issue of monitoring and policing. There is a need for at least a base of accounting practices, some threshold, some core hygiene, which is accepted world wide. Of course. Thanks to the Internet and television, the globe has been mobilized. And there is a lot of discussion going on among countries to establish international accounting standards. Previously, the British decided the accounting system. Then came the US guys. They had some differences, for example between the P/L system (British) and the CAGR system (American). And we were caught in between. We do not know what to follow.