Portate Bien!-How to Quickly/Accurately Identify Opportunities to Lean-Up & Clean-up Operations

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Premise: *Prioritizing and accelerating investments in cost management excellence can produce absolutely outstanding ROI, dramatically faster pay-backs, at minimal investment risk than just about any initiative available to organizations. This initial conversation is Part one in a multi-part series of articles that discusses why this must always remain top of mind, top of the list and how to develop and maintain this critical capabilities premium.*

1. ***Priority.***
2. ***Focus.***
3. ***Discipline***.

Simple words, fundamental concepts, and yet is there anything more elusive and challenging to capture and leverage. In business, or especially even in life.

Who doesn't want to achieve more with less, to get a better yield per hour of effort? To have more capability, more capacity and more productivity in our day? You probably think I'm talking about the business day, amirite. Shoot, I'm talking about life, man. I distinctly remember the precise moment at KU in our organizational behavior class when we started talking about motivational theories; what starts the engine in the AM and keeps it humming throughout the day.

Not getting a dime for this plug but you're nuts if you skip out on ***Ford Vs Ferrari***. One of my favorite movie lines of the best several years is when Shelby details why he does what he does:

That day in Org Be class at KU, I finally figured out who I was and what made me move; *The Need to Achieve* (McClelland). That was a revelation for me and it has stayed true to this very day. It's my Shelby 7,000 RPM rush that sustains me. But to be perfectly candid, that drive and that need for speed demands priority, focus and discipline to maintain and to feel the rush that comes from tackling something new, taking risk and then blowing your mind when you succeed.

In my opinion, the secret and elusive sauce of priority, focus and discipline is the path to where the gold is buried and in particular, in driving year on year earnings increases at increasing rates of growth. It's about behavior, changing behavior and identifying the "right" ones while identifying and stopping the "wrong" ones.

You know, Portate Bien!!

Behave yourself!!

Cost Behavior-The Elusive Secret Sauce of Priority, Focus & Operational Discipline

This initial introductory article and the others that will follow will focus on the following critical priorities to instill and ensure operational discipline within our organizations:

I. Cost management excellence is indeed a "sexy," essential strategic imperative to sustain with prioritized, disciplined on-going investments. Guaranteed pay-back and as quickly as any investment we can make.

II. Unfortunately, there are indeed "gaps" in religiously following GAAP (https://www.cfo.com/financial-reporting-2/2019/10/bridging-the-gaps-in-gaap/) that must be bridged. There is simply no "one size fits all" systems solution for excellence in cost management that conforms with GAAP financial reporting requirements for product costing, reporting cost of goods sold, and segregating period from product costs within the income statement. GAAP indeed falls short in terms of decision support; but that's ok as these gaps can be filled with economical, and relatively easy to deploy systems solutions.

III. Cost management excellence demands razor-sharp focus and sensitivity to the various prisms we must utilize to maintain relevant decision perspective:
   a. Product costing & product profitability reporting.
   b. Customer profitability & reporting.
   c. Process costing & operations management.
   d. Process value analysis-Value added (VA) & non-value added(NVA) costs.
   e. Critical operating metrics; break-even analysis, margin of safety, sustainable sales growth, degree of operating leverage, combined operating-financial leverage, and Altman 4-variable Z-factor solvency indicators
   f. Contribution margin vs traditional GAAP income statement reporting fundamentals.

g. Tensions between working capital throughput velocity vs customer service performance.
h. Costs of complexity (https://www.linkedin.com/pulse/complexity-costs-tony-wayne/)
i. Forward-looking forecasting modeling for decision support.
j. Corporate growth initiatives-M & A as well as organic.
k. Capital budgeting & expenditure authorization policies and controls.
l. Managing selling and marketing, administrative resource allocation/efficiency/effectiveness.

Bridging GAAP Costing Gaps-The Fatal Flaw in Cost Behavior Modeling for Decision Support

As we discussed in ***Bridging the Gaps in GAAP***, Generally Accepted Accounting Principles are not infallible, and their primary purpose is to ensure conformity and consistency with external reporting. However, the over-riding criteria for management accounting and reporting are:

1. It must be reasonably accurate.
2. The financial, managerial and operational information must be timely.
3. Relevance-Decision makers' needs can vary a great deal and reporting must fulfill the demands of the decision at hand.

The limitations and resultant inaccuracies in GAAP-based costing are because it requires segregation of costs by type/category (cost of goods sold, operating (SGA) expenses), and the fact it ignores cost behavior in response to changes in activity levels. Management decisions are forward looking and require forecasts and estimations of sales and production levels, which in turn can and does impact costs. In working in/with literally well over 100 manufacturing, wholesale and retail firms over the past 25+ years, I have noted the following predominant pattern:

- Most companies attempt to utilize but one cost system to try and serve the demands of both internal and external reporting.
- They use a GAAP-compliant traditional income statement format both internally as well as externally.
- The contribution margin income statement format which segregates costs based on behavior is not used for forecasting or decision making.
- They use only one overhead allocation method/basis to combine and allocate diverse types of overhead expenditures to product costs. Usually, this single, plant-wide rate is either based on direct labor hours or dollars, machine hours, or a fixed dollar amount per unit manufactured.
- Because it does not conform to GAAP, they opt not to develop and implement relatively simple activity-based costing and management systems, which in turn can and does distort both product as well as customer profitability reporting.
- Decision making is impaired by the inherent flaw of assuming costs are much more fixed, or much more variable than they are in reality.

Cost Management Excellence as a Competitive Advantage & Capabilities Premium-OK Maybe Not Really, ***Really*** Sexy Albeit Certainly Strategic

Here's the challenge that holds back firm after firm from reaching a higher enterprise transactional value offer at deal time……..

What's the payback, what's the ROI from investing in more robust cost management capabilities???

I’ve had numerous business owners ask that question repeatedly of me and candidly, putting a hard, tangible value on that can be an exercise in speculation and assumption. And yet, same can be said for trying to quantify a firm number for any intangible asset; including and especially strategic premiums for anticipated “synergistic” combination value in a merger transaction. Rather, I have found that the hard financial justification process is really more of a qualitative analytical exercise, encompassing risk management considerations, investments in financial literacy, identification & realization of more lucrative operational improvement priorities/initiatives, and increased decision making precision in the face of rapidly changing external environments:

- Accelerated competitive pressures which seem to be coming out of nowhere due to globalization and technological break-throughs like IoT, big data analytics and business intelligence are dramatically shortening product and service life-cycles and compressing margins; all the while making it mandatory that cost reporting be razor-sharp in response.
- AI and robotics are expected to revolutionize the economic and business climates; including estimates that as much as 70% or more of traditional finance work activities will be replaced with automation. If accurate, it’s imperative that firms be proactive to exploit these technological break-throughs while avoiding being overwhelmed or destroyed by them.
- Global strategic partnership opportunities (and threats) will accelerate with the implementation of these changes, and sharing of data, leveraging core competencies via block-chain integration will demand a very sharp, keen forward looking command of costs.
- Because of dramatically shortened product life-cycles, and firm life-cycles, companies will need to constantly ask what businesses should we be in, what businesses should we exit, and how and who should we be serving. This will require very accurate product and customer profitability reporting grounded in reliable and relevant cost reporting foundations.
- With the likely accelerated impact of AI impacting essentially every sector, flexibility and breadth of worker skill will be at a premium which in turn must include enhanced financial literacy across a broader cross-section of the workforce. Proactive major accounting and consulting firms are already anticipating this need while investing hundreds of millions of dollars in training/development capabilities as job duties become much broader and less specialized going forward.
- Financial forecasting to support forward looking management decisions is an incremental process; the focus must be on relevant costs. Relevant costs are those that will be impacted by and change as a result of the decision, but it’s just as important to be able to isolate those sunk and unavoidable fixed costs that won’t change. And, as both blue as well as white collar labor is replaced via automation and technology, costs will become even more fixed than we’ve experienced the past 30-40 years with technology.

The Kaplan-Cooper 4-Stage Model

The following diagram/chart is from ***Cost & Effect*** (Kaplan-Cooper, Harvard Business School Press, 1998):

Exhibit 2-1 Four-Stage Model of Cost System Design

Systems Aspects	**Stage I Systems** *Broken*	**Stage II Systems** *Financial Reporting–Driven*	**Stage III Systems** *Specialized*	**Stage IV Systems** *Integrated*
Data Quality	• Many errors • Large variances	• No surprises • Meets audit standards	• Shared data-bases • Stand-alone systems • Informal linkages	• Fully linked databases and systems
External Financial Reporting	• Inadequate	• Tailored to financial reporting needs	• Stage II system maintained	• Financial reporting systems
Product/ Customer Costs	• Inadequate	• Inaccurate • Hidden costs and profits	• Several stand-alone ABC systems	• Integrated ABM systems
Operational and Strategic Control	• Inadequate	• Limited feedback • Delayed feedback	• Several stand-alone performance measurement systems	• Operational and strategic performance measurement systems

Although this book is over 20 years old, in my experience the overwhelming majority of firms are still primarily operatizing within Stage II, although certainly there has been a great deal of ABC stand-alone implementation attempts and many operating with some sort of Kaplan-inspired Balanced Scorecard KPI reporting in place. Very few firms have migrated to a full Stage IV integrated system and most who have attempted Stage III migration are large or large/middle market firms. Most manufacturing firms in the U.S. are niche-product industrials with well less than $ 80-$100 million in annual revenues.

Again, the perceived hurdles were delineated in the preceding section above.

Preview of Coming Attractions

As promised, this series will take a deep dive into the critical importance of prioritizing cost management excellence to achieve operational discipline and we will explore this from a variety of important perspectives. Yes, there are no one size fits all easy panacea solutions to the problem but that doesn't mean that very significant improvements are beyond the resource reach of most firms. On the contrary, indeed there is a manageable, incremental improvement path that can and should be undertaken by the smaller mid-market, and small market specialty niche industrial suppliers that dominate most of our manufacturing and industrial product market sectors.

Next up will be the contribution margin income statement format and why understanding cost behavior is integral to cost, volume & profit analysis which underpins our decision making.

ABOUT IRONHORSE LLC:

IronHorse is a K.C. based specialty consulting firm providing targeted, demonstrated solutions to complex legal and commercial finance problems; merger & acquisition capital sourcing due diligence, credit origination & administrative decision support, workouts & credit restructurings, commercial lending field exams and credit file Value Range services, and complex financial, commercial and transactional expert witness and litigation support.

Tony Wayne has spent his entire career working in and with specialty niche industrial firms; manufacturers and wholesalers in building materials, specialty industrial equipment suppliers, automotive after-market component manufacturers, the dairy equipment & farm supply industry, paper and specialty chemical processors, and alternative energy companies. He has served in both mid and c-level senior operations and financial executive capacities and has been instrumental to the successful turnaround and recovery of numerous under-performing as well as financially distressed firms. His service contributions include 5-years on the Advisory Board to the Center for Industrial Research & Service; the manufacturing extension to the School of Engineering at Iowa State University.