Cost Leadership *for the* Current Challenge

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Until recently, we had enjoyed many years—almost a full generation—of strong global and domestic business growth. Much of the growth in the U.S. was fueled by a prolonged period of low interest rates and readily available credit that helped drive an unprecedented commercial and residential real estate surge. Beyond our shores, Brazil, Russia, India, and China have grown in dramatically different ways but have increased the global demand for basic commodities including oil, gas, aluminum, and steel.

The U.S. recession, however, has impacted the rest of the world. It certainly isn't the same as it was in the 1980s when economists would joke, "America sneezes and Japan catches pneumonia." Nevertheless, in spite of the significant and impressive growth of other economies, the world is increasingly interdependent economically. You can see this by the number of global financial institutions that have been affected by the subprime mortgage debacle. Compared to the "S&L crisis" of the 1980s in which the same industry was affected—and for many of the same reasons, including lax controls surrounding approval of high-risk loans—our current crisis dwarfs that debacle in magnitude, reach, and complexity.

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Given most managers' lack of orientation, preparation, or temperament for a recessionary period, their first response and reaction is usually:

- I must protect my turf,
- We're under siege,
- Batten down the hatches,
- It affects everyone negatively,
- All general ledger categories should be cut, and
- Finance's perceived role is headcount reduction "executioner."

These negative and dysfunctional reactions will proliferate and will influence and dominate an organization that isn't proactive in promoting and creating a cost leadership culture, strategy, and practice that's backed up with coherent planning, initiatives, and actions.

The purpose of this article isn't to bemoan or critique the past but to focus on how finance and accounting professionals can (and must) flex and change to meet the needs of the new economy we face. In every business challenge context, there have always been winners and losers. We would like to share how we accounting and finance professionals need to alter our focus to help improve opportunities for business success in this challenging time.

We propose that management accountants and finance leaders embrace the evolution from cost management to cost leadership as depicted in Figure 1.

Cost leadership is reflected in a culture that, independent of macroeconomic circumstances, pursues a low-cost, high-quality, customer-centric approach to managing the business. Cost leadership is characterized by four primary criteria: (1) recognition as the lowest-cost producer in one's industry, without compromise in quality or customer focus; (2) realization of a long-term cost-centric culture where cost consciousness is a *strategic and leadership preoccupation* across functional lines and independent of the vagaries of financial markets; (3) dissemination of cost information with regard to customer, product, distribution channel, and the like that is timely, understandable, credible, and actionable and is made available to decision makers to fuel continuous improvement; and (4) aggressive and balanced performance targets are established across the value chain. Achievement of these targets is recognized, rewarded, shared, and celebrated. There is no "resting on one's laurels." For example, Toyota's Production System embodies this approach. (For more information, see "The Open Secret of Success," *The New Yorker*, May 12, 2008.) Wal-Mart Stores, Inc., is another company that embodies this approach. Their blend of cost consciousness and customer focus across their value chain, including key suppliers, is part of what's sustaining them as a leader in this challenging economy, especially for retailers. Note that Wal-Mart's cost leadership achievement was built, established, and embedded in their culture during the "good times" that preceded the current recession and not as a reaction to it.

Lessons Learned

The last major recession spawned a renewed interest in rigorous, detailed, and sometimes effective cost management practices. Several companies we were working with at that time improved their profitability, productivity, and performance as a result of rigorous, systematic, and efficient use of tools such as business process analysis, activity-based costing (ABC), and cycle time compression metrics. Accounting and finance professionals built career-lasting reputations for excellence in the context of leading these initiatives with the cooperation and support of their business partners. These "cost" leadership initiatives not only yielded a competitive advantage in efficien-

Figure 1: Evolution of Cost Leadership

THEMATIC FOCUS	ATTITUDE	TIMING	ORIENTATION
COST LEADERSHIP	PROACTIVE	NOW	BUSINESS GROWTH
COST MANAGEMENT	REACTIVE	1980s	COST CONTROL
COST ACCOUNTING	SCOREKEEPING	1960s	GL-BASED COST REDUCTION

EVOLUTION

cy, but they often also produced improved "top-line" results from better and renewed customer focus. (For more information on the relationship between cost leadership and improved customer focus, see the article by Joe and Catherine Stenzel, "Employee Access to Cost and Financial Information," in the January/February 2002 issue of *Journal of Cost Management*.)

The following three practice illustrations reflect the cost leadership approach that resulted in lower cost, improved customer focus, and enhanced market share:

1. Less Is More: Several years ago, the soft insulative padding attached to the interior of a car roof, the "headliner," was made up of several pieces that were assembled and attached to the roof. Then one of the suppliers offered a new one-piece headliner with a 10% price increase over the multiple-piece product. Only one automobile company, which had an accurate (ABC-based) knowledge of the behavior of its overhead components, understood that the savings realized from reduced stock-keeping units (SKUs), faster assembly, less handling, fewer defects, and lower warranty expenses would more than offset the cost of the new part.

2. Customer Profitability: A very large construction company reported return on sales of just under 3%. The company builds stadiums, hotels, schools, office buildings, and high-rise apartment buildings. The controller couldn't explain which customer contracts were profitable and which ones weren't. A newly introduced ABC analysis reflected which contract types and customer types consumed disproportionately more overhead resources. This helped the company better understand related cost drivers in the contracting process and, in turn, how to realize enhanced profitability in the future.

3. Secret Recipe: A global pharmaceutical company witnessed a decline in profitability, even during a period of increased sales. An ABC study focused on disposal costs at the plant revealed that two of the many vitamin ingredients required costly, disruptive, and time-consuming hazardous waste disposal protocols. When the vitamin was formulated 40 years ago, this environmental issue wasn't illuminated by environmentalists, legislators, or regulators. After consulting with its R&D department, the company found substitute ingredients with similar efficacy and replaced the original ingredients. The result was immediate realization of lower cost and enhanced profitability.

Common Trends

These practice illustrations are representative of the ongoing commitment to low cost, customer focus, and process improvement required to sustain profitability and grow market share. The nature of cost leadership reflects a cultural understanding that focusing on lower-profile "base hits" is more critical to long-term success than an occasional "grand slam" in the context of process improvement and building a sustained competitive advantage.

Cost leadership skills include, but aren't limited to:

1. Project management;
2. Process improvement;
3. Business and industry acumen;
4. Critical thinking;
5. Performance metrics and management;
6. Quality metrics, including cost of quality and statistical process control;
7. Activity-based cost management (ABCM);
8. Benchmarking;
9. Change management;
10. Influencing;
11. Communication; and
12. Behavioral and emotional intelligence.

Also, many of these skills are common to the suite of skills needed to be an effective "business partner."

Recently, a senior finance executive from a large global consumer goods company remarked to us, "We have an entire generation that doesn't know of real economic contraction or recession, and they don't have rigorous cost leadership skills or sensibilities in their DNA." It's also interesting to note that the reformulated Certified Public Accountant (CPA) exam reduced the content related to managerial and cost accounting. As a result, many academic programs in accounting have lessened their emphasis on this subject.

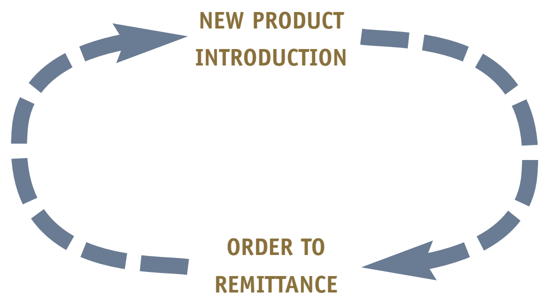
In contrast, a leading global pharmaceutical company, in its early-career finance leadership development program, requires a cost accounting job rotation of all its program participants during their first two years with the company. This reflects the high value placed on the skills, exposure, and experience derived from this rotation. Also, the important distraction and focus on controllership practices resulting from Sarbanes-Oxley Act (SOX) compliance lessened a focus on finance and accounting's role in promoting more effective and efficient business practices and processes. Few companies leveraged SOX effectively as an opportunity to focus on creating leaner, streamlined business practices and financial processes. Other distractions for finance leaders and their staffs include prolonged, painful, and costly implementation of so-called enterprise resource planning (ERP) systems that often haven't yielded anticipated gains on a consistent basis. Some contemporary ERP systems are crippling the business they are intended to serve and also standing as obstacles blocking finance and accounting people from advancing the business.

Table 1: Cost Leadership Initiative Killers, Show Stoppers, and Red Flags

1. **Complexity—**If you can't explain the basics of your model or tool to someone in less than three minutes, it may be too complex.
2. **Lack of cross-functional support—**If key stakeholders don't buy in—aren't "bought in" at the outset—you can almost assure failure.
3. **Strategic articulation—**Your initiative must resonate, articulate, and be in alignment with key top-management goals.
4. **Proof of concept—**Be prepared to demonstrate the efficacy of your cost leadership initiative in a pilot project.
5. **"Doctor, heal thyself"—**The finance and accounting community reputation has significant bearing on the ability to marshal support across the value chain.
6. **Impatience—**Your team must be able to deliver actionable recommendations within a four- to six-week time frame or face losing support, enthusiasm, and credibility.
7. **Project management—**Top-flight project management skills are required for this type of initiative. It isn't necessary for an effective project manager to have a finance or accounting background.
8. **Reputation—**The reputation of the initiative team members and the tools themselves depend almost entirely on the ability to drive positive, sustained change that can be quantified in simple, understandable metrics—e.g., net cash flow.
9. **Underresourcing—**Some managers feel that they are building personal equity by underresourcing the initiative; in reality, they are crippling their racehorse at the starting gate!
10. **Lack of articulation with organization learning structure—**Successful organizations leverage existing pathways, networks, and internal channels to enhance the speedy proliferation of internal "best practices."
11. **Orientation and education—**A systematic commitment to orientation and training is critical for this initiative. Executed effectively, it can be the key to reducing fear and apprehension, enhancing data integrity, and marshalling cross-functional support.
12. **Undercommunication—**To be successful in this type of initiative, communication is critical, and we would err on the side of excess. Initiative branding is often required, and early significant wins should be publicized, celebrated, and recognized by top management.
13. **And our favorite:** "The new system will fix everything!"

The aforementioned issues and effects may cause you to be less than optimistic. But this shouldn't be the case. As W. Clement Stone, the founder of Combined Insurance Company who was raised in poverty in Chicago in the early 20th Century, would say, "There are no problems, only opportunities." In the next section of this article, we suggest a remedy and diagnostic blueprint aimed at refocusing the energies of accounting and finance professionals where our internal customers, stakeholders, and suppliers need us most and with a view toward avoiding the pitfalls, missteps, and errors of the past with respect to advancing effective cost leadership solutions.

Figure 2: Business Process Model



Don't Repeat the Errors of the Past

Advanced cost management practices, like any tool in business, can be used and abused. Those of us who are experienced enough can remember failed initiatives that were caused by poor planning, ineffective communication, lack of quality implementation, poor teamwork, unstable stakeholder buy-in, gratuitous complexity, and overdependence on outside "experts." It's interesting to note that the August 4, 2008, issue of *BusinessWeek* contains a two-page advertisement from a global consulting firm offering to take over accounting, finance, human resources, information technology, and even customer contact functions. Although it's hard to fault a business for aggressive marketing, we're still concerned today about the negative impact of too much outsourcing on effective leadership development, decision-making objectivity, and the appearance of conflicts of interest. Some individuals actually blame the "tool" for the failure. If we don't address these shortcomings, the logic, benefit, and utility of even the best tool won't be realized. Also, the credibility of those associated with the project or initiative will be damaged—in some cases, beyond repair. In Table 1 we've summarized these important initiative killers, show stoppers, and red flags that a company should consider before designing a cost leadership initiative.

The business process has changed radically over the last 20 years, but the good news is that business-process-based tools are still useful. This makes the argument for a focus on key business processes as a rich source of potential improvement. GE, in its extensive process improvement journey, relies on a user-friendly, adaptable model (see Figure 2) that provides a common framework to understand varied businesses and enable internal best-practices sharing and proliferation. The model can be disaggregated into components that represent process steps, activities, and decision points. Also, based on surveys at a variety of companies in various industries, we believe that the overall reputation of the finance and accounting function and leadership has improved materially over the last 20 years. Managers and leaders in product development, marketing, manufacturing, logistics, distribution, and other functions may be more open to what an accounting or finance professional can offer with a view toward supporting profitable business growth.

But there's one caveat: Finance and accounting professionals must know the business, know the business jargon, and know the personality type of their target customer. Only then can they play a value-adding role that transforms challenging times into a period of growth, enhanced self-confidence, and innovation-driven success. Table 2 includes a checklist of symptoms to identify in the context of planning an effective cost leadership initiative. A broadly accepted "burning platform" of concern is required to support the business case for change.

Also keep in mind that a successful cost leadership initiative often involves more than a single tool. Imagine trying to complete a repair project in your home with a limit of one tool; it would be virtually impossible to complete the project effectively. The same is true in cost leadership initiatives. For example, in the MiCRUS Harvard Business School case focusing on an IBM business unit (*MiCRUS: Activity-Based Management for Business Turnaround*, Harvard Business School Publishing, 2001, pp. 1-19), the company and its leadership required several process improvement tools in concert (defect rate analysis, activity-based costing, and cycle-time compression) to effect a "game-changing" business turnaround in the extremely competitive global semiconductor fabrication business. The initiative resulted in the unit's exceeding world-class standards for both cost and quality. This result was recognized beyond IBM. MiCRUS won the "Semiconductor International Top Fab of the Year" award. Its business valuation also increased dramatically.

How to Reach for Success

The time may be ripe to pursue aggressive, well-planned, and sophisticated cost leadership initiatives. First, however, it's of paramount importance to lay a strong foundation for success by considering many of the behavioral, measurement, cultural, and communication issues in the planning phase. In our experience, we rarely found fault in the philosophy or nature of a process improvement tool. Far more common is a naïve, unsophisticated, and sometimes arrogant approach to promoting positive sustained change that assures failure. What we've tried to provide is guidance aimed at considering these inhibitors with a view toward enhancing and advancing both personal goals and the success of the organizations that we accounting and finance professionals serve in turbulent times.

We recommend that companies revitalize their process improvement competencies and skills as a response to the contracting economy. They should perform a cost leadership readiness assessment so they can deliver appropriate orientation and training in the most effective and efficient manner. A clear understanding of the resistance to change and pitfalls to anticipate is also critical. And it's very important for finance and accounting professionals to gain the confidence of operating management by showing them they understand the symptoms and ramifications of reduced profitability and market share. This confidence will enable them to better influence and facilitate cost leadership initiatives. The revitalization that follows should integrate action learning with practical execution. It should involve cross-functional expertise deployed in teams for maximum effect. A holistic perspective that builds on a balanced understanding of costs, customers, and processes is the underpinning required to realize and sustain cost leadership status. **SF**

Table 2: Cost Leadership Symptoms Checklist

1. Ambiguity, uncertainty, and primarily anecdotal evidence regarding product profitability
2. Proliferation of SKUs
3. Gratuitous business process complexity
4. Lack of customer focus, understanding, and insight
5. Frequency of unscheduled maintenance
6. High staff turnover (especially top performers)
7. Salesforce incentives largely based on achievement of "top-line" goals
8. Lack of transparency regarding channel profitability
9. Lack of understanding of customer profitability
10. Where "cross-subsidization" masks true product or service profitability
11. "Low-hanging fruit" cost savings have been "harvested"
12. "Sacred cows," fear of change, and lack of viewpoint diversity

The good news is that these symptoms virtually assure a "target rich" environment for your cost leadership initiative.

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