

VIEWPOINT: 21ST CENTURY COST MANAGEMENT

COST AND PERFORMANCE MANAGEMENT IN THE AGE OF GLOBAL CHANGE

Paul Sharman

Knowledge migrates rapidly, and power goes with knowledge. The most valued company is one with intellectual property, fueled by new computing and communications technologies.

Thirty years ago in France, thousands of corrugated metal Citroen Deux Cheveaux automobiles with tiny engines ground slowly past hordes of cyclists. Each cyclist came complete with two loaves of bread poking from a shoulder bag, and the men commonly wore berets on their heads.

The pace of life was slow back then, and a rotary-dial telephone was a luxury. Not any more. Today, the same roads in France are replete with BMWs, Mercedes, and every other conceivable brand of vehicle shining brightly, vying for all remaining street space with hardly a bicycle in sight.

Journal of Cost Management board member PAUL SHARMAN is president of Focused Management Information, Inc. He can be reached at psharman@focusedmanagement.com.

Everything moves more quickly than ever. The media provides the mechanisms that drive expectations, and these change as quickly as innovations can be deployed. Billions of people become aware of new ideas, products, and services as rapidly as they are conceived.

The Internet has especially changed the pace of business and knowledge. Knowledge migrates rapidly and power goes with knowledge. E-anything is perceived as assertive and powerful. Although physical assets are still important, the possession of knowledge offers the promise of future power and potential cash flows. Indeed, a whole new way of determining stock market values has emerged, known as *economic profit*. Historic earnings performance is not as critical as future cash flow.

Industry, too, has changed. Manufacturing represents a relatively small proportion of the economy of the developed world, less than 20% of GNP. Service industries lead the way in creating jobs and value for shareholders.

Even accounting firms have changed. For example, auditing is a chore fraught with liability concerns for the large firms that make most of their money from consulting and other service offerings. Even the accountants want to do something else to make a living (though the SEC has begun demanding that accounting firms go back to basic tasks).

This is the environment in which cost management strives to contribute, and cost management is nevertheless, more important than ever. Along with the current rapid business pace and global markets comes the intensity and unprecedented competition that demands high performance from any person, company, or country that steps up to compete. Success is defined by the effective use of resources to perform activities that convert inputs into outputs that customers will buy. The most valued company has intellectual property that can be highly leveraged into driving significant cash flow.

THE FUTURE OF COST MANAGEMENT

In the changing human environment, the challenge is to think holistically. In the past, management approaches were developed in a functional manner. The new emphasis is on potential and innovation. Today, all measurement mechanisms must work together following a common set of principles as well as a common architecture. In other words, the pieces need to fit and work together. Characteristics of notable importance for the future include:

- An emphasis on human behavior
- Measurement and management methods
- A new mental model
- Knowledge versus rules
- Functional boundaries
- Business boundaries
- Technology-driven media

Each of these characteristics is discussed in greater detail in the following sections.

It is evident that change is difficult even in the simplest situations. People are attuned to what currently exists. Change requires that neural pathways in the brain go through a chemical, almost physical, restructuring. Changing an entire profession is orders of magnitude more difficult than individual change for the following reasons:

- The number of people involved
- The vested interests of the individuals involved
- Institutional inertia

Inevitably, change occurs as the old ways become redundant, and alternative, more attractive solutions arrive. The more attractive solutions are sensitive to the speed of change in the new economy.

Inevitably, change occurs as the old ways become redundant, and alternative, more attractive solutions arrive.

AN EMPHASIS ON HUMAN BEHAVIOR

The industrial revolution treated human beings as an extension of machines, and suppression of the human factor of production was a prerequisite to success (i.e., to enrich owners). In the new age of communications and computing—a world described by Marshall McLuhan as a “global village” in which the “medium is the message”—the media and new methods employed increasingly redefine the world. The essence of the Internet is organic; every person has a voice to use to communicate with anyone in the world.

Education has raised expectations as well as the degree of sophistication of people in general. Stock markets, electronic trading, pension plans, and mutual funds have broadened ownership to the masses. People choose their own solutions, whereas centrist command and control is a thing of the past.

The question is whether the Internet and computing powers will survive in a way that benefits the population at large, not only an elite few. Given the changed expectations and degree of wealth provided by the new communications and computing capabilities, cost management methodologies must facilitate human behavior in an environment in which individualism is respected.

Therefore, all measurement systems must be designed with the single intent of driving organiza-

tional performance to achieve a desired future state. This requires that those responsible for designing cost management and measurement systems must be educated in the principles of human behavior.

MEASUREMENT AND MANAGEMENT METHODS

As technology advances, so do the things that can be accomplished with the use of technology. Methods have been defined in the past by the limitations of human knowledge. Initially, cost management methods were subordinated to the needs of accounting to provide a fair and balanced perspective of the earnings and to value balance sheets; however, that has all been changed. Accounting and auditing practices, though still important, are perceived more correctly as scorekeeping, whose purpose is to report on what has transpired. Cost management in the context of accounting is retrospective.

In the past, retrospective reporting was the important source of information on company performance. Companies were valued on the basis of some multiple of earnings per share based on reported earnings. This, too, has changed.

Projections of future cash flow, discounted by the cost of capital, now often replace earnings as the method of choice for determining company valuation. Stock market values are influenced by perceptions of whether managers and business prospects are likely to create additional value beyond returning at least the cost of capital employed, and premium prices are awarded to those companies that succeed.

Hence, the emphasis shifts from accounting to planning and exe-

cuting. Vital interest focuses on the prospective view rather than the retrospective. Accounting information methods remain important to ensure that organizations are run properly and that discipline is maintained—however, energy is now focused on creating value.

To do so, measurement systems must emphasize value drivers and analysis of alternative actions that can be taken to increase value. In this context, cost accounting becomes a minor interest, whereas understanding and managing cost becomes the major issue. Although operating profit margin is a powerful driver of value, financial specialists who are responsible for managing all aspects of performance must also understand other value drivers.

Methods to manage and project value are, therefore, central to the role of organization performance going forward. The notion of cost management, relative to historical methods, is too functional. A more meaningful perspective is that of value management, wherein understanding and managing all aspects of value creation and value drivers is critical. Value-based management (VBM) is the super-system of measurement and management, within which cost management is subordinate.

The methods to deploy VBM are familiar (see the following list). The trick is to construct them in the right way and to identify the linkages between them. These mechanisms or tools are interesting in isolation and provide useful outcomes; however, in combination with each other, they create a natural and powerful structure.

In addition, the structure involves a series of decision support software tools (e.g., web-based in-

Methods to manage and project value are therefore central to the role of organization performance going forward.

formation distribution and simulation modeling) to facilitate development of the measures, track performance, and distribute performance results to managers whose job it is to manage performance. The process includes:

- Analyzing stakeholder needs and strategy
- Managing risk
- Developing organization goals (e.g., analyzing critical success factors, critical business issues)
- Analyzing activities
- Analyzing processes
- Developing measures and collecting current performance data
- Identifying internal and external benchmark comparisons
- Developing measures
- Performing simulation modeling of alternate choices (i.e., cost/benefit analysis)
- Deploying activity costing and assignment to processes and to cost objects
- Analyzing the roles and responsibilities of staff with respect to activities they perform within each process
- Providing job definitions and organization design
- Performing activity- and process-based budgeting
- Overseeing change management
- Developing information portals or web-based distribution of performance data

A NEW MENTAL MODEL

If what has been discussed so far is correct, the overall frameworks that are employed by staff in their efforts to create value must be examined. It is evident that different employees have different perspectives that are formed on the basis of assumptions they have made either personally or that are embedded in what they were taught. For example, law represents a patina of rules and interpretations that have been constructed over many years on the basis of social conscience and that have been shaped by personal bias and intellect.

Likewise, business functions develop and use various rules and conceptual constructs. Accountants work from their own set, as do quality specialists and information technology specialists. It is rare, however, for anyone to have the perspective of more than one functional view.

The challenge for managers is to operate within this tangle of different perspectives and to develop a more robust and multifaceted model in which all of the components interact in a logical and intentionally designed fashion. Value management (or enhanced cost management) should address the opportunity of integrating all of the pieces into a logical framework, a single multifunctional mental model.

Such a model requires people to examine their existing assumptions and beliefs. They may need to drop some models and adopt new ones. For example, accountants should reexamine the GAAP model of "fair allocation of overheads to products" in cost accounting. It must be replaced with something far more demanding if accounting is to address the value management needs of service or-

ganizations and modern manufacturing. The concept is archaic and distracts people from reality.

Because of the authority of the accounting profession, the concept is perceived to be a fundamental truth, which it is not. It is therefore damaging. Indeed, in cost accounting, the concept of standard costing needs continual review, because it is often woefully inadequate in the new environment.

KNOWLEDGE VERSUS RULES

With the growth of knowledge and increased speed at which things change in the new environment, value management specialists (i.e., enhanced cost management specialists) need to learn to be flexible and open to new concepts. In the past, cost management specialists have been trained to function within the context of a set of rules (e.g., GAAP, tax, and other laws) and their primary mode of operating has been to apply the rules for the purpose of compliance.

In the new environment, value management specialists' primary goal must be to create value. This means that they need to keep current with many aspects of the world and its changing perspectives. The application of knowledge to create value must be more important than the slavish adherence to the rules. Legal compliance is necessary, but must not be treated with apathy. Knowledge of the rules is important to ensure that they are challenged as is appropriate.

FUNCTIONAL BOUNDARIES

Within organizations, human performance is enhanced by specialization. Consequently, staff members are organized into functional

Value management specialists' primary goal must be to create value.

groups (e.g., finance, marketing). Capability, language, and concepts define functions. The differences between functions are highlighted by huge mental and methodological chasms. Sometimes, it seems that departments are fighting each other. Often the problem is more profound and results from the lack of an integrated framework and common language.

The staff in highly competitive organizations must be in accord and focus on common objectives. Employees must understand how their activities and outputs contribute to the performance of the organization in total. They must also understand how they contribute to performance of subsequent steps in the process, regardless of which departments or functions in which they occur.

Value management specialists can contribute to organizational performance by using such tools as process analysis to create understanding of cross-functional relationships. This approach can be used to define language, measures, expectations of performance, and identify root causes and cost drivers

BUSINESS BOUNDARIES

Boundaries between corporations or government bodies are huge—much greater than those between functions within organizations. Roles and responsibilities define relationships within organizations. In cases in which organizations act as suppliers or customers of each

other, they have a vested interest in their mutual performance.

For the purpose of driving value, it is to the advantage of organizations to promote efficient interactions across boundaries. As in the case of functional boundaries, value management specialists can contribute by understanding supply chain relationships and using process analysis and contractual methods to define language, measures, and expectations of performance to identify and eliminate "disconnects" (e.g., root causes or cost drivers).

TECHNOLOGY-DRIVEN MEDIA

People behave as they are measured. In the new environment, sophisticated methods with access to vast sources of knowledge are being used. It becomes more critical than ever to establish a common vision, with a consistent understanding of expectations and goals. Unless mechanisms exist to focus employees, individualism drives them to maximize their own satisfaction.

For example, television has provided a hugely successful mechanism to convey images of desirable concepts (e.g., wealth, products, and situations). McDonald's restaurants can be seen serving up American hamburgers worldwide, because television has broadcast the image of this highly successful food chain using advertising and promotional images artfully focused on children. Until recently, an organizational communications mechanism with as much power as television has not been available. Now, a new information portal exists, powered by Internet technologies.

Information portals offer organizations a communications vehicle

that provides a ubiquitous interface of the same ilk as television. Information portals can be used to convey consistent images to employees and, at the same time, permit personalization of information. The power of information portals lies within its ability to focus people on what is expected of them and how they are performing. Value management spe-

cialists have the opportunity to influence human behavior with the organizations they serve by driving the design and deployment of information portals for their organization.

A NEW PROFESSIONAL FRAMEWORK

Society and industry are ready for a new style of professional.

The new professional framework must deal with measurement and management in a holistic sense. Emphasis should be placed on human performance, driven by measurement techniques grounded in financial performance and empowered by computing and communications technologies. ■

