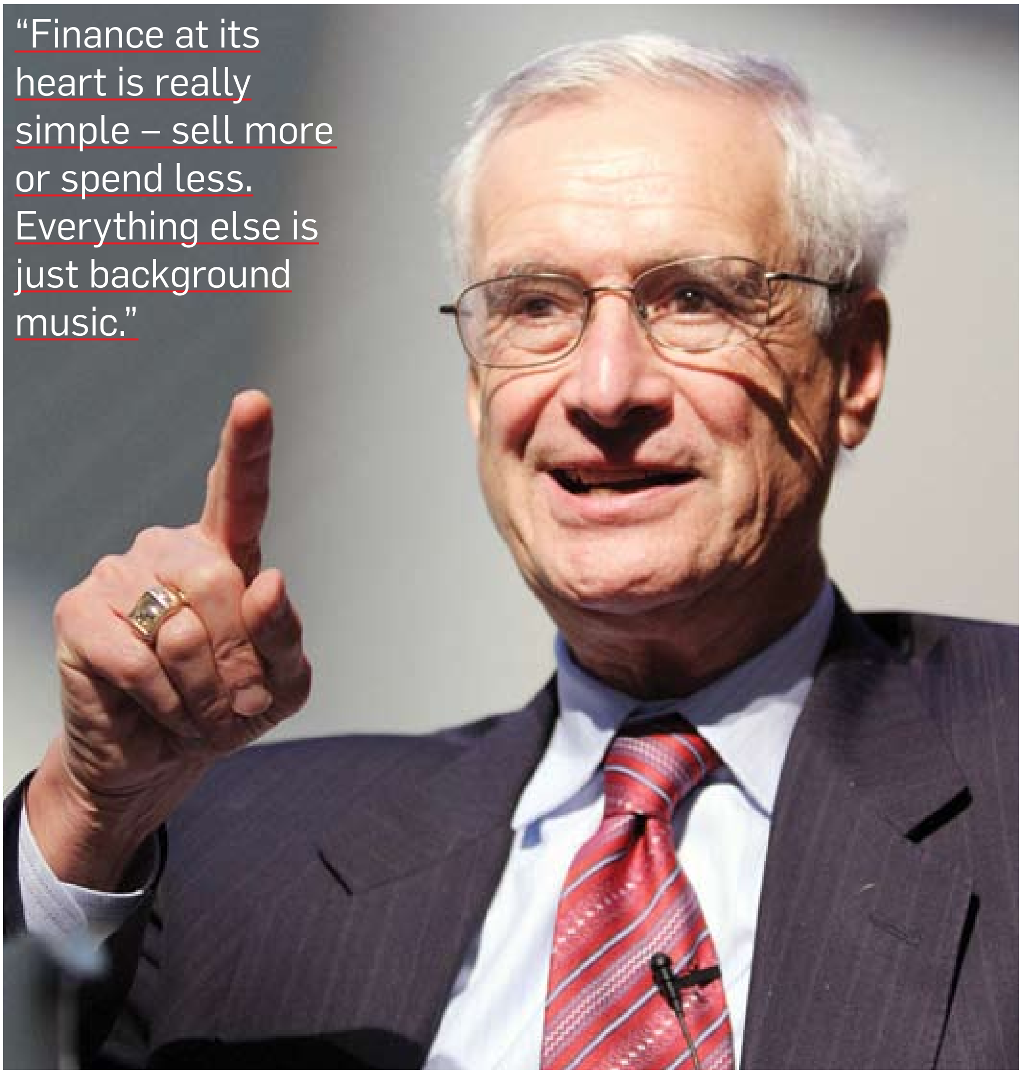

Noted business thinker Dr Robert Kaplan recently visited Dublin to give a presentation on the timely theme of managing costs. Gordon Smith went along to learn some lessons.

EASY AS ABC

Cuts of one kind or another look like being on the menu for some time to come in Ireland, but like so many things in life there's a right way and a wrong way to go about making them. That's why it's always useful when there's a doctor around to show people how to wield the scalpel.

In this case, the 'surgeon' is Dr Robert S Kaplan, Baker Foundation Professor with the Harvard Business School, who visited Dublin in October to speak before an audience of 150 senior executives.

Widely considered as a major contributor to the art and science of business strategy, Kaplan created Activity-Based Costing, a methodology for companies to calculate the true cost of providing products and services, so they can root out those lines of business that are unprofitable or incorrectly priced. He is also the inventor of the 'balanced scorecard', the most widely adopted management tool that links a company's actions to its strategic goals.

As such he is well placed to give lessons on how companies can perform better now that the downturn has exposed the inefficiencies in many organisations that growth during the good times had concealed. Kaplan's message was as simple as ABC: understanding cost and profitability as a way to drive performance.

MAKING THE CUT Speaking before Kaplan's presentation, KBC Bank's chief economist Austin Hughes set the scene by raising two major risks to businesses in the current climate: paralysis in the face of uncertainty and death spiral of continual cutting. "When making cuts, it's better to use a scalpel than an axe. You need to know your anatomy and don't just cut off an arm," said Hughes.

Kaplan took up the theme in his two-hour talk. "Before we do something drastic in a panic and apply across-the-board spending cuts, we have this notion of fairness, that everybody has to take cuts of, say, 15 per cent. This is a very

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bad idea," he said. "Let's find out where we're not in trouble, where we have products that are earning good margins and customers that are profitable, and we don't want to do any cutting that affects the profitability of those products or those customers – otherwise it's going to get worse," he added.

If a company is producing a product in low volume and no important customer is using it, and where there is no opportunity to turn this around, that is where a disproportionately high level of cuts must be applied, said Kaplan. He stressed the importance of profitability analysis and understanding its role to drive better business performance and to root out where the poorly performing parts of the business are, leaving the others intact.

Whereas traditional cost-accounting divides costs into fixed and variable, Kaplan contended that there are very few fixed costs in an organisation. Costs don't just rise because a company is producing the same thing at a higher volume. It could be because variety and complexity have been introduced, or maybe the company is competing in more regions. "Your costs go up as you try to do more things," said Kaplan.

When measured by the so-called fixed costs of sales, distribution, marketing and administration, two roughly similar customers, possibly in the same sector, might appear to be equally profitable. With activity-based costing, in reality customer A has hidden profits and customer B has hidden costs.

TIME IS MONEY To hear Kaplan explain it, activity-based costing is as easy as the acronym makes it sound. ABC is, in essence, a more rigorous approach that drills down to a finer level of detail about how people in a business spend their time on a particular activity. So, the 'fixed' costs end up being nothing of the kind. Hours in the working day taken up by marketing and technical support, service, travel to customers, handling customer orders and shipping reveals the truer picture.

Seen through the prism of ABC, customer A has narrow product lines and standard shipping arrangements, whereas customer B asks for variety, special customisation, tailored packaging, overnight delivery and features that ramp up the real price, Kaplan outlined. "You do it because they're a big, important customer. But until you trace the cost of doing all those special things, you don't realise this can add up to a lot and not just be a profitable customer but barely breaking even."

Actual customer profitability after ABC analysis is radically different, and the ideal customer emerges as one that combines high profit with a low cost of sale. "It's important when you know you have a customer like this, because there is nothing you should not do for that customer," said Kaplan. "We have to change to being customer-focused from being customer-obsessed."

The 20 per cent of your most costly customers – the most profitable of your customers can in reality generate 180 per cent of the profits, Kaplan argued. Unprofitable products or customers can cost a business between 40 and 80 per cent of your profits. While Kaplan conceded it's possible a customer may be unprofitable because it is a new account so there is the cost of acquiring that customer to be considered, "but if you have that customer for five years or more, then you have a problem."

CUSTOMER FOCUS Businesses need to identify customers that use their buying power to ask for a lower price or lots of customised service or features. Armed with better information, the business can choose not to do business with that customer because the costs are too high, or renegotiate for more favourable terms. "Among the things you discover is that you were doing foolish things, but it's because you didn't have the data," said Kaplan. "At times like these, we realise the gaps in our management systems."

Kaplan also modestly admitted to the failings in earlier versions of the model when it was first introduced in the late Eighties. Then, the time and effort involved in interviewing people made ABC very costly to implement, but now he said much of the information needed to make it work is available in companies' ERP systems.

Befitting an academic rather than a smooth salesman pitching a product, Kaplan didn't look to play down the effort involved in putting an ABC system into place within a business. "It is work, this doesn't come for free and the heavy lifting comes at the front end," he warned.

Once companies understand profitability at the individual customer level, they can target actions to improve by introducing process improvements that lower the cost of serving customer demands – that could include online ordering, or web-based self service, for example.

Kaplan suggested that companies should hold a complete strategic review every three to four months, and devote monthly meetings to one particular area and spend an hour on that in drill-down detail. The key is to go looking for the information that will provide real insight, he added. "Don't fall into the accountant's trap – if I can't measure what I want, I'll want what I can measure. It's better to have a soft measure than no measure... Finance at its heart is really simple – sell more or spend less. Everything else is just background music."

What causes a customer to be unprofitable? ABC analysis reveals:

- Extensive discounting and allowances
- Order size discount
- Invoice price is less than the list
- Extra discounting if the customer meets the payment terms
- Co-op marketing or advertising allowance
- Annual volume bonus
- Freight allowance.

Highly profitable customers, on the other hand, tend to show these traits:

- No discounting or allowances
- Standard product orders
- High order quantities
- Predictable order arrivals
- Standard delivery
- No changes in delivery requirements
- Electronic order processing
- Little or no pre- or post-sales support
- Few inventory support requirements
- Pay on time.