PROFITABILITY AND COST MANAGEMENT

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The difference between a profitable and a failing business

KOEN L. PERIK

Warden Press

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For Lauwine, Silke and Davine

About Koen L. Perik

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He is a member of the supervisory board of Erasmus University Rotterdam's Executive Master of Finance and Control program and he also teaches at this university.

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An individual without information cannot take responsibility; an individual who is given information cannot help but take responsibility.

JAN CARLZON, FORMER CEO OF SAS

By 1925, virtually all management accounting practices used today had been developed.

H.T. JOHNSON AND R.S. KAPLAN

Preface

It is surprising that many companies and institutions have very little perspective on exactly where they make their money or, in the case of a non-profit, how they are able to break even. Especially at a time where management books appear to hold all the answers and spreadsheets appear to contain as much detail as you like.

Apparently, there are still industries that, until recently, were simply rich enough not to have to subject their return on customers or customer groups to monthly or annual reviews. Nor had the need to look into the efficiency of their operations. This seems to be the case especially in the services industry. While the manufacturing industry brought in smart cost controllers several decades ago and has generally implemented effective cost management practices, industries such as health care, finance, and professional services seem to have far more limited insight into their profit margins and costs.

The days where they could afford to be indifferent to such key metrics are now well and truly over. For many organizations, and service companies in particular, the time has come to (further) develop a management and cost accounting mindset. In this context, cost accounting is based on the simple principle that you must first make sure you know which costs relate directly to that which you want to cost, such as a project, product, or a customer. Next, you allocate the so-called indirect costs, such as overheads, to those products or customers using a clear allocation key. Easy does it. And yet, many companies struggle to implement and update cost systems.

Cost accounting and identifying the level of efficiency and returns is fairly industry-specific. Where some organizations mainly consider their costs to be fixed (software development costs or a hotel's costs, for example, are barely related to the number of guests or customers), costs in other industries, such as trade, are predominantly variable (more business means more costs). This distinction has major consequences for the design of the cost system.

That being said, designing a cost system is not overly difficult, especially not if you, as the management team, get together with your finance man or woman and put some time and effort into it. Whatever you do, don't just

lump it on the finance department. At many companies, these kinds of projects have stranded because the finance department was expected to just do customer or product profitability on the side.

In cost accounting, it helps when you keep the cost system as simple as possible and make the outcomes – such as the profitability of a product group – transparent for the management. This is where the basic principles of the Time-Driven Activity-Based Costing concept, as (re)developed by Robert S. Kaplan in 2004, come in, especially for companies in the services industry.

In this day and age, you can no longer afford to run your business based solely on monthly reports for each individual department or on financial accounting information that is submitted to shareholders or the regulator once a year as required by law. After all, that information is, by definition, not up to date and does not cover product and service profitability or operational efficiency. For a great many companies, it is high time that they pursued cost and profitability transparency. After all, a business decision based on proper cost management could make all the difference between a profitable and a failing business.

Koen L. Perik
Amsterdam, April 2023

1

Introduction

Organizations want to know what they generate in earnings on their products and services. And what those products and services cost. Actually, they increasingly need that knowledge because they cannot be competitive otherwise, for instance because their former state-owned company now operates in a competitive market, or because the new shared services center needs cost prices. But this kind of information is often difficult to get to the surface, if it is available at all. How come? And how do you get that insight?

1.1 Insight into cost and profit

Financial information on customers, services, and products is generally not readily available, and if it is, the information is not always as reliable as it should be. Insight into profitability and, consequently, into cost is the most essential requirement for a company to be able to manage their finances. Particularly at larger companies, managing finances based on reliably attributed costs turns out to be far from easy.

Cost accounting is not an exact science and is based on the simple principle that you must first make sure you know what costs relate directly to that which you want to cost, such as a project, product, or a customer. Next, you allocate indirect costs to those products or customers using a clear allocation key. This is, in theory, not very difficult.

Due to the complexity and multitude of data, however, many companies are struggling to implement systems for management information and cost accounting and keep them up to date. Many companies and institutions lack a well-functioning cost system due to their large number of products, customers, and distribution channels. As a result, they do not know exactly how much money they are making on their products and customers or where they lose money, and department heads complain about internal cost transfers.

The so-called finance function plays a key role in all of this. Throughout their career, every manager or director will have to deal with finance managers,

who are known by different job titles, ranging from accountant and controller to finance director and chief financial officer (CFO). Just as there are many different job titles and job holders, there are many different finance managers at companies. It is an occupational group made up of many different personalities with different levels of education, expertise, and experience.

A finance manager basically has only two tasks. The first is to provide relevant information about costs and profits to fellow managers and, for example, shareholders. The second is to run a reliable accounting system. The motto of the role could be "to inform and to keep accounts." While this turns out not to be so easy in practice, the importance of the finance manager's role of informing managers and directors must not be underestimated. Good finance managers know how to inform a management team in time and accurately, while at the same time keeping reliable accounts.

WHAT THIS BOOK COVERS

Any organization, regardless of its size, will have formulated its goals, strategy, and plans for the coming year in one way or another. This can be captured in a straightforward annual plan, or in a detailed strategic plan, including a vision or mission, and an analysis of strengths and weaknesses. On the other hand, every organization needs to have its accounts in order, partly given their obligation to have their books audited by an external auditor. The strategy and goals are generally described in some form, as are the procedures of accounting, leading to a coherent outcome.

A bottleneck for many companies is, however, the lack of reliable information for management to make decisions. In more and more industries, decision making is decentralized as operations are organized in different divisions, business units, and/or product/market combinations. This operational split creates a market mechanism within the organization, which, in turn, leads to new information needs, and the information available in the accounting system is mostly not good enough to meet these needs. Where it gets difficult is when you want to improve the quality of that information. The information has to be related to the strategy and a constantly changing environment, while also being rooted in accounts that are "set in stone."

The following factors explain why companies can no longer afford to sit back when it comes to professional management reporting and cost accounting:

- Increasing pressure on profit margins: this is happening in, for example, industries where companies traditionally operated and competed on a local level and are now facing international competition. As a result, there is pressure on them to lower their prices, at the expense of their profitability.
- Deregulation: various companies have had to give up their monopoly position over the past decade. As a result, management needs new information to be able to respond to competition, which puts new demands on the information system, cost prices, and the accounting system.
- Company growth: growth can lead to the accounting system no longer delivering the right information when there are few finance professionals involved. This is when it suddenly becomes unclear, for example, what customers make or lose you money, as this is not something that a standard printout from the accounting system shows.
- Mergers, acquisitions, and demergers: during organizational changes, such as a merger, primary processes such as sales and production receive most of the attention, which is a good thing, followed by support functions like the accounts department. However, a merger has major impact on access to information and the accounting system. It can lead to existing and sometimes high-quality management information simply disappearing, and it may take a while for management to get around to returning information quality to the usual level.
- Professionalization: certain government agencies and other organizations operating in the public domain are increasingly lagging behind and forced to manage based on "output." They have to work in a way that is more transparent and result-driven for their customers and clients, which is very demanding on their internal and external information system.

On the back of these developments, companies and organizations are going to have to improve their internal information system and can no longer rely on administrators, accountants, and their accounting systems for information. Periodic reporting by quarter, not to mention every year, simply offers a management team or board insufficient scope for their decision making. Information on product and service profitability, and on the costs of business units and business processes, becomes essential to be agile. This is precisely when we need effective management reporting and cost accounting and where well-trained finance managers come in.

1.2 Management and cost accounting

My definition of effective management and cost accounting is as follows:

> *Effective management and cost accounting supports management with accurate and timely information on the profitability of products and services, and on the efficiency and effectiveness of business processes. Management and cost accounting enables unequivocal measurement of the performance of organizational units, processes, products, and services. This fundamentally includes cost and transfer pricing systems, as they enable accurate pricing and decision making on the ideal product and customer mix.*

The process of compiling financial information can, of course, be split up into sub-processes such as budgeting, management reports, variance analysis, cost accounting, and the use of key performance indicators. While sub-processes are most certainly relevant to finance managers if they want to analyze or improve their own activities, the split into different sub-processes is less relevant to the target group for whom effective management and cost accounting information is generated, i.e., the management. Managers are interested in output, not in the process that produced it.

Management and cost accounting – and thus profitability and cost management as well – is not an isolated discipline. It is part of running and controlling an organization, which means charting a course and staying on that course. Merchant[1] calls this "management control." Management and cost accounting is part of the management control system.

The link between management control, management accounting, and cost accounting

Scientific literature on this subject distinguishes two explicit purposes of management and cost accounting:[2]

- Firstly, information may be important for a manager's decision-making process in the performance of their job. This can be considered the "ex-

ante" role of management and cost accounting. An example of this is the role that information plays in a manager's make-or-buy decisions.
- Secondly, the information may be relevant in the performance review process, which can be considered the "ex-post" role of management and cost accounting. This purpose of information is geared towards motivating the manager and their direct reports to perform at the peak of their ability.

In relevant literature published in the U.S. and the U.K., management and cost accounting is often also referred to as "managerial accounting."[3] [4]

In this context, it is interesting to briefly go into the scientific substantiation of the use of management and cost accounting at companies and institutions. Historically, in microeconomics and other theories, the concept of "organization" is approached as if it were a "black box" that aims for profit or value maximization. The internal structure of the enterprise plays no role whatsoever in this theory. In 1983, Jensen[5] argued that there is no organizational theory that provides a good explanation of the internal structures of organizations. In addition, organizations do not seem to have any trouble motivating people or problems with management and cost accounting. The absence of information is simply not an issue in these theories because all the information that is needed is always available. Needless to say, this ignores the fact that up-to-date management and cost accounting is, in practice, not "automatically" and "always" available at companies.

Scapens[6] subsequently stated in 1985 that what is lacking is an explanatory theory of management and cost accounting. You could say that science does not provide an explanation of why we need management and cost accounting. Scapens does, however, continue his description of the application of accounting data in organizations by remarking that many companies' management accounting uses "responsibility accounting" techniques to achieve goal congruence. With this remark, he does provide some kind of explanation of why organizations use management accounting techniques.

This book will answer the following questions:

- What information does an organization need for the management team or board to be able to have effective meetings and make effective decisions?
- What kind of insight into product, service, and customer profitability does a manager or director need?

- How can a controller and their management team improve substandard information?
- What role do management accounting tools such as cost accounting and transfer pricing systems play in this respect?
- What role do communication and interaction between general management and financial management play here?
- What steps should be taken to develop and implement a cost accounting system on products and services?

WHO THIS BOOK IS INTENDED FOR

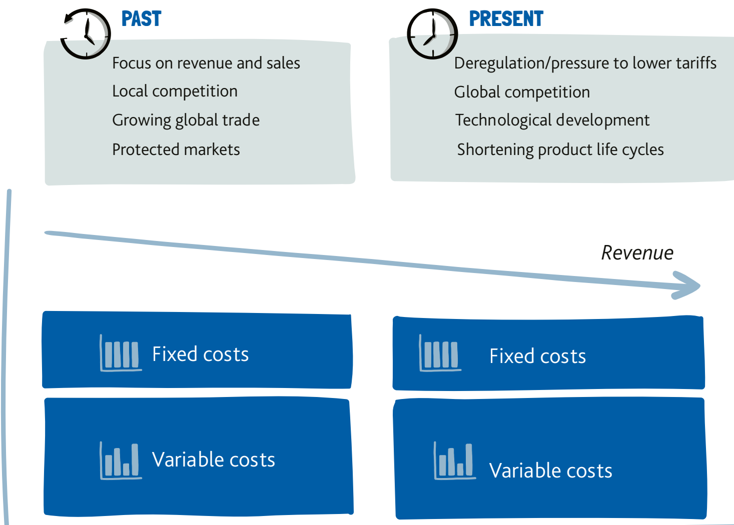
This book is written for finance managers, controllers or CFOs who are personally involved in efforts to improve management and cost accounting in their organization. These finance managers are usually on the management team or board, which also means they are the first responsible financials at an organizational unit, group, or business unit. The finance manager to which this book refers has a "dual role" problem. On the one hand, they are considered the organization's financial and regulatory conscience, preferably with some independence, and on the other they also take part in decision making and running the team. In that latter role, getting financial reporting right is not their only challenge, because they also frequently have things such as new legislation and the implementation of IT systems on their plate. This causes efforts to improve cost accounting to soon end up on the back burner.

This book is also written for managers at medium-size organizations and multinational companies, and then specifically those managers who manage a finance man or woman or who are on a management team with one.

1.3 The development of management and cost accounting from 1920 to today

The development of management and cost accounting cannot be seen in isolation from developments in business in general. Since the 1920s, companies have evolved enormously. One hundred years ago, companies would mainly make labor-intensive products and barely faced any competition locally. Today, they run largely automated production processes that can be located anywhere in the world. Another impactful change is that product lifetime has reduced enormously for most products.

From the post-war period through to the early 1970s, companies ran their business based on sales and revenue. Selling was relatively easy, the problem was production capacity. Basically, publishing revenue figures and financial statements once a year was considered sufficient. During the economically harder times of the 1970s and 1980s, management accounting turned out to be more important than companies initially thought, as companies toppled because they did not have their affairs in order. Management and cost accounting developed further, especially in trade and manufacturing. Companies operating in the fast-moving consumer goods, automotive, and electronics industries in particular went all out to achieve cost transparency. On the back of the economic boom of the 1990s, management concepts emerged and companies found ways to make better use of IT.



Companies' and institutions' profits are under pressure

Global competition and the financial crisis between 2008 and 2013 put further pressure on companies' and institutions' profit margins. Modern consumers are more informed and empowered, with easy access to ways to compare products and prices, mainly thanks to the internet. Shareholders and other financial stakeholders also have increasing influence on operations. The focus is on short-term profit, while management concepts such as activity-based costing have faded into the background.

In this changing environment, the finance function is also constantly subject to new developments. After all, an efficient and decisive finance function is

of great value to any company. There is demand for effective management accounting on the one hand, and for efficient processing of big data on the other. Companies and institutions in domains away from trade and manufacturing, such as financial institutions and hospitals, are currently going all out to catch up in terms of management and cost accounting.

1.4 Market forces are the best accelerant

This book is based on a number of premises that are outlined below.

ABOUT MANAGEMENT AND COST ACCOUNTING

While the concept of providing the management and the board with good information may not be as old as the hills, it has indeed been around for some time. Nestlé, Heineken, Procter & Gamble and Shell have known for dozens of years how important it is to have good insight into profit margins and efficiency. Setting up effective management and cost accounting requires some knowledge of the industry, but it requires even more knowledge of the subject of financial operations for medium-size and large enterprises. Or in less cryptic terms, setting up management and cost accounting is not fundamentally different for a factory than it is for a cable company or a bank, as confirmed by the fact that companies such as Apple, Meta, Procter & Gamble and Unilever have all adopted the same approach to it. This concept applies to the manufacturing industry, but equally so to service companies.

ABOUT THE ROLE OF A FINANCE MANAGER OR CONTROLLER

A finance manager is perfectly able to take care of certain specialist tasks autonomously, without having to consult all that much with their fellow management team members. Implementing new accounting standards, such as IFRS[7] and improvements to the usual administrative processes, such as the consolidation process at companies made up of various units, are examples of things that a finance manager can handle on their own. These are tasks where social skills are less important.

However, when it comes to improving management and cost accounting, the finance manager has to work together with fellow management team members, since they are the most important users of that information. The finance manager has to constantly check with them what information they need and cater the information to those needs.