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Dear Executive:

This quarter's executive letter contains a first. For the very first time a portion of the letter is authored by someone other that yours truly. One Saturday afternoon last autumn, I received an e-mail from my old friend and colleague Gary Cokins who was "holed up" in a Tokyo hotel sitting out a typhoon. For those of you not familiar with Gary, he's a key "thought leader" at SAS Institute and (in my opinion) the most prolific thinker, writer and speaker on 21st Century cost and performance management issues in the world. Although he and I approach many issues from very different perspectives – and often come to different conclusions – he is the one person whose opinions on those topics I respect most – and the person in second place can only be seen if you use binoculars. He's also the only person with whom I've ever consented to co-author an article for publication.

Never being one to waste time, Gary was also working on one of his regular columns for *DM Review* and attached a draft of the column to his e-mail for my comments. I made a few minor suggestions, but the only real problem I had with his article was that I hadn't written it. The subject and "attitude" were a perfect fit for one of these quarterly letters and being a generous fellow, Gary agreed to let me include the article in one of my letters after its appearance in *DM Review* so – since it appeared in November – here it is….

Rules for Assuring Poor Performance[1]

In 1773, Benjamin Franklin, one of the U.S.A.'s founding fathers, wrote a pamphlet aimed at the royalty of England titled *Rules by Which a Great Empire May Be Reduced to a Small One*. Satire is one way to get your point across. I apply my own style of satire here to appeal to organizations to cease their hesitation and skepticism and embrace the benefits of performance management. I apologize in advance if I offend anyone, but sometimes there is truth in humor.

Imagine you took over the management of a poorly performing organization and wanted keep it that way. What steps would you take?

At the top of my list would be to make sure that all of the managers or employees are totally ignorant of the executive team's strategy. That way no one will understand how the work they do each week or each month contributes to successfully achieving the strategy. Next, I would figure out ways to insure that managers and employees don't trust one another. I would discourage dissent and debate. It would be tricky to preserve some level of harmony by not allowing healthy conflict among managers that I already made distrustful of each other, but I think I could do it.

Next, I would avoid holding anyone accountable. That would be fairly easy because I would disallow reporting of performance measures. Anyone mentioning the phrase "The Balanced Scorecard" would be summarily fired. I'd allow employees to measure their local processes and results in dashboards. After all, I don't want the organization to go bankrupt. I just want poor performance. But I would restrict any measures from being key performance indicators (KPIs) because we would not want to monitor our progress toward any targets that are strategic. I would try to disallow setting of targets, but some managers have a nasty habit of liking them. I think those managers believe that if they could make it appear that they are better performers than others, that I would then reward them with a "pay for performance" bonus system. If I allow people to be motivated this way, performance might improve.

I would freeze our managerial accounting system to remain in its already archaic state. It was probably designed in the 1950s, but our external financial auditors would always be giving us an OK grade. As my efforts would cause confusion for everyone, I'd give in and allow managers to hire more support overhead to manage the resulting complexity. But I'd want to preserve the primitive overhead cost allocations to processes and products using those distorting and misleading broad averages, like product sales or number of units produced. Most employees would already know that these cost allocations cause big cost errors, but I would want to keep them guessing about which products make or lose money and what it actually costs to perform our key business processes. Freezing our accounting practices would be easy because most CFOs and controllers are fixated on detail and precision, but not relevance or accuracy. Accountants seem to have been born with their brains wired that way.

We would need to be careful about how much information we collect and report about our customers. Obviously we'd report sales data, but I would not segment our customers into any groupings. I'd keep reporting at a lump sum level. I don't want anyone asking questions like, "Which types of customers should we retain, grow, acquire or win-back from competitors?" To keep from tanking our company I would encourage sales growth by putting big signs in the marketing department saying "More sales at any cost!" I'd prevent the CFO from any thoughts of measuring customer profitability. But that would be easy because our arcane cost accounting system wouldn't be capable of calculating that information. The marketing people typically spend their budget with a "spray and pray" approach anyway. Any thought of targeting specific types customers and getting a high yield payback from our marketing spend would be outside their level of thinking. I'd maintain our advertising spending as the "black hole" that no one understands.

I would, of course, implement an enterprise resource planning (ERP) system. I don't want to be at a cocktail party with other executives like me and say I don't have one. That would be like a teenager without an iPod. It would be too embarrassing. But I realize that ERP systems produce mountains of transactional data for daily control but not meaningful information from which anyone could make wise judgments or good decisions.

Our budgeting system would be another way that I would assure our poor performance. Regardless that the budget numbers are obsolete a couple of months after we begin the fiscal year, assembling it in the prior year would provide a great distraction and prevent anyone from working on more important things. Plus I'd love to send the budget back down a few times to be re-done to lower the budgeted costs. Everyone would moan. I would be very stingy about giving managers budget for one-time projects. When those kinds of initiatives sneak in, companies always get jolt of productivity improvement which is counter to poor performance.

We'd squeeze our suppliers. We could talk about partnering and collaboration but any attempt to actually do so would be squashed immediately. Never trust a supplier. If you drive one out of business, you can always find another.

I don't think I could stop employees from using spreadsheets. They are contagious. But since every department would have their own, it would be like a Tower of Babel down there. Employees would waste a lot of time trying to make their numbers match. I might allow a few departments to purchase a common data base to warehouse their information. But fortunately I'd know there would be lots of incorrect input data in it, so that bad experience would bust their bubble. Those employees with spreadsheets might want to use them for forecasting and planning. I'd put a stop to that by calling it gambling and promote our company as being conservative. Gambling is for fools, so I'd set a policy forbidding risk taking.

I know that operating a poorly performing business is an extremely difficult job, but I think I'd be up to the task. Suppressing the efforts of all those employees and managers who want to think, contribute, and make the business successful requires constant vigilance. The business world is full of subversive ideas that could hamstring my efforts to keep the business floundering aimlessly, but I believe that with hard work and dedication, I could keep it from reaching its profit-making potential.

COMMENTARY

Did you recognize any organizations you know in Gary's description? I can think of scores of companies that exhibit at least three-quarters of the characteristics Gary highlights in his article – particularly manufacturing companies – particularly auto suppliers. Unlike Gary's manager who is consciously trying to be mediocre, I can't believe manufacturing executives are deliberately trying to balance themselves on the precipice of bankruptcy. Most of the top executives I have gotten to know well are very intelligent and expert on at least one aspect of their company's business – usually engineering, marketing or operations. You know these folks aren't deliberately "screwing up."

There many reasons given for the decline in manufacturing in this country ranging from free-trade policies to high health care costs to slave wages paid to workers overseas. For auto suppliers, there are also the frequent outrageous demands made by the two 800-pound gorillas in their supply chains – the one that provides them with their raw materials and the one that purchases their products. These and many other reasons all contribute to the problem. But one that is seldom discussed is the faulty navigation information given to company decision makers by their accounting staffs. Here in the 21st Century, when companies must traverse through rough seas and adverse winds, their accountants still provide them with the inadequate and inappropriate navigation information that was used in the 1950s when seas were calm and winds were favorable.[2]

Consider performance measures. At most firms with any kind of manufacturing activity the only performance measure that isn't directly related to manufacturing activities is EBIT. Other than that one "global" measure (whose appropriateness for measuring overall performance is flawed to begin with), things like direct labor efficiency, scrap percentages, and overhead spending vs. budget are the primary measures. This is true even when manufacturing costs are a relatively small percentage of the manufacturer's overall costs.

A prime example is a manufacturing client I acquired several years ago. This manufacturer's cost profile was 40% material cost, 40% engineering, marketing, distribution and fulfillment costs, and 20% manufacturing cost. Every day they held a one-hour production meeting. They constantly measured scrap, efficiency and overhead spending. They beat the production managers "about the head and shoulders" constantly. But they never measured the effectiveness of their marketing efforts, distribution channel maintenance, or fulfillment activities. They never held meetings to beat the engineering, marketing, distribution or fulfillment managers about the head and shoulders. Yet their strategy for growing and thriving into the future was driven more by the success of engineering, marketing, distribution and fulfillment efforts than manufacturing.

Their management accounting system was simply their archaic cost accounting system that was based on the direct labor-based model of the 1950s. This was true despite the fact that they had instituted a myriad of lean manufacturing initiatives that reduced direct labor, in-process handling and in-process inventory, shortened cycle times, and accelerated throughput. Included in these initiatives was the creation of flexible manufacturing lines and work cells – changes that made the traditional direct-labor based measures both inaccurate and irrelevant.

They did, however, spend thousands of person-hours developing and reworking their annual budget. This budget, however, was not an actual planning tool that helped guide management in the months to come. Instead it was a political document designed to placate the corporate executives who wanted their targets met – even when those targets violated the laws of physics. The constant reworking was required as the accounting staff had to figure out how to create a believable work of fiction. As the CEO of one company said, "I want to get fired because of actual results, not because of a budget." He got his wish. He got fired when they couldn't meet a budget that violated the laws of physics. At least he kept his job for one more year.

Back in 2003, Ernst & Young and the Institute of Management Accountants conducted a survey in which 98% of corporate financial executives indicated that they believed the cost information they gave to their executives for decision making was inaccurate. More disturbing was the revelation that less than 20% planned on doing anything about it.[3] There are a number of possible reasons for this lack of action on the part of financial executives – several of which are included in my Autumn 2006 letter. One reason that I'm finding more and more often is the problem of "Harpies."

In Greek mythology you'll find the story of Phineas, King of Thrace, who had the gift of prophecy. Zeus became angry at Phineas because he used his gift to reveal too much. As a consequence, Zeus punished him by putting him on an island with a buffet of food that he could never eat. Harpies, winged death spirits, would always arrive when Phineas attempted to eat and stole the food out of his hands right before he could satisfy his hunger.[4]

In a similar vein, many of today's financial executives understand that the management information they provide management is flawed and would like to do something about it. Unfortunately, the micro-managing Harpies – either corporate executives or financiers in their mahogany offices on the east coast – demand so much historical financial information – sliced and diced in so many different ways – that the time financial executives could spend developing information that would help operating managers make their companies more profitable is spent explaining why they aren't making the profits demanded by the Harpies. They snatch the food that could nourish the company right out if its decision makers' hands before they can satisfy

their need for the accurate and relevant, fact-based information necessary to make sound decisions and take effective actions.

Unless financial executives can somehow find the time to address these serious issues, companies will continue to appear to be managed by individuals with the motivation of the manager in Gary's satirical article.

UPDATE

After procrastinating for many years, your half-Luddite, half-Neanderthal author has finally set up a website that you can access at www.dthicksco.com. The website includes copies of many of our past Executive Letters, white papers on a variety of topics, a schedule of upcoming events, copies of some of my recent presentations, case studies, and a variety of other information. Anyone interested in learning more about a forward-looking, value-adding, decision-support view of management accounting is encouraged to visit the site. Hopefully, you can find an item or two that can help you fight off the Harpies and help your organization be more successful in the future.

I hope you all had a great holiday season. I look forward to hearing from any of you who have questions or comments regarding this month's letter. As always, please feel free to forward a copy of this letter (or mention our new website) to anyone you believe would be interested.

Very truly yours,

Doug

Douglas T. Hicks, CPA, CMC
President

Check our new website at www.dthicksco.com

1 You can find Gary's article on-line at http://www.dmreview.com/news/10000124-1.html
2 A more detailed discussion of "The Navigator and the Management Accountant" was provided in my Autumn 2006 Executive Letter. You can find a copy of this letter archived on the D. T. Hicks & Co. website at www.dthicksco.com.
3 *2003 Best Accounting Practices Survey*, Ernst & Young / Institute of Management Accountants
4 Many of you may remember the Harpies from the classic 1960's move *Jason and the Argonauts*.