

The Liability of Cost Cutting: A CEO's New Challenge

By viewing organizational assets as investments, not costs, companies can create more value and improve ROI.

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When financial results don't meet expectations, senior executives face five dreaded words that have become far too common: "We need to cut costs." Those expectations might have been set according to shareholders' requirements, past performance or metrics that seemed attainable. Explanations aren't always crystal clear. Regardless, the mandate goes out for every department to "do their share," whether by cutting travel, training, maintenance, engineering, marketing or people. Those who hit their targets are heroes, while the naysayers are labeled as whiners.

Budgets are set; reality sinks in later. Lower-level managers wonder how to run the business with reduced resources, but they're forced to cut costs in order to meet their tightened budgets. The accountants are happy. But wait - the year's end brings an unpleasant surprise: The top-line growth, revenue or profit is not there. The senior executives are scrambling for answers. The pipeline is weak and market share is falling. The knee-jerk response is to enact more cuts, and even deeper this time.

It's said that the definition of insanity is doing the same thing repeatedly and

expecting a different result. Unfortunately, not only does this scenario play itself out in every major industry, but it is considered to be "prudent and responsible" managerial conduct.

While cost cutting can be disappointing for the company's bottom line, there may be even more dire consequences. As illustrated by the October 2006 Chemical Safety Board's findings related to British Petroleum's (BP) 2005 Texas City Refinery Explosion, serious operational disasters can result from cost-cutting. The explosion killed 15 people and injured 180. BP has set aside \$1.6 billion in claims to families alone. An 11-member panel led by former Secretary of State James Baker concluded that, according to media coverage of the news, "Cost-cutting at BP was brutal. At the Texas City refinery, total maintenance spending fell 41 percent from 1992 to 1999, while total capital spending fell 84 percent from 1992 to 2000. On top of those cuts, BP challenged its managers to reduce costs an additional 25 percent after the company's merger with Amoco in 1998."

In the wake of the Baker report, BP's CEO John Browne announced that he would retire 18 months early. BP also issued a statement that laid the lion's

share of the blame for the explosion on lower-level workers and supervisors. However, the Baker report found that "BP's refineries are understaffed and that employees did not report accidents and safety concerns because they feared repercussions or thought the company would not do anything about them. Audits were focused on making sure that refineries were legally compliant, rather than ensuring that the management systems were making the refineries safe."

Why did BP make management decisions that put the company at such risk? Did it think it was doing the right thing by acquiring old refineries, consolidating and gaining "synergies"? What numbers could have been generated to promote the belief that cost cutting was prudent, necessary, even possible?

Certainly the BP example is not an isolated incident. From Ford to Pfizer, cost cutting is back in vogue on a grand scale. But these measures sometimes compromise the health of the enterprise and its long-term viability. In the future, will executives and board members be held criminally liable for these types of decisions, as they have been with other financial improprieties? Are there other ways to satisfy shareholders that don't involve risky cost cutting? Yes, there is, but it requires a new paradigm for the modern enterprise.

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THE LIMITATIONS OF FINANCIAL ACCOUNTING FOR DECISION MAKING

Let's assume that the capabilities of people, equipment maintenance, technology, supply chain and distribution channels are integral to the health and viability of the enterprise. Could these costs we are cut-

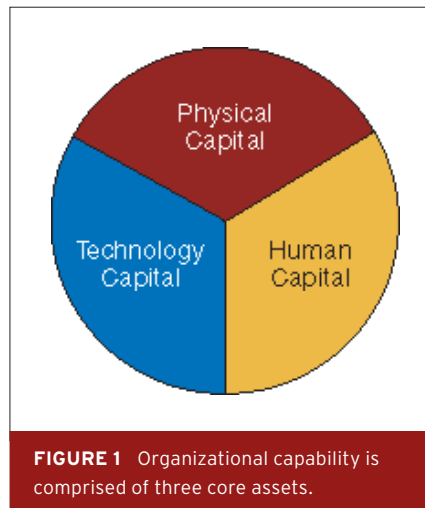
ting actually be investments with a value and, therefore, a return on investment (ROI)? Not according to financial accounting, they aren't. These expenses are generally considered "costs." Although the Financial Accounting Standards Board and the International Accounting Standards Board have several projects directed at formulating a new conceptual framework for handling "intangible assets" such as those listed above, the reality is that rules change very slowly. Modern financial accounting was born in a time when financial and physical capital were sources of competitive advantage. Now estimates show that 80 percent of the U.S. economy's value is derived from intangible assets largely unaccounted for by financial accounting, according to a February 2006 Business Week article.

Because financial accounting takes such a limited view of a company's assets, its measures support the idea that a reduction in expenses will lead to improvements in profitability. If, however, these "expenses" are really investments in intangible assets, then these reductions are, in fact, "de-capitalizing" the business. The result is less ability to create value - less output, less revenue.

Most operating managers do recognize that cost cuttings and downsizings sometimes sacrifice critical capabilities. They know the equipment is not being maintained to perform at its optimal level. They understand the risk. So why don't the numbers back them up?

THE MANAGERIAL CHALLENGE

Managers need to make decisions based on theories and numbers that illuminate, not obfuscate, what is actually happening in the business. Boards and senior executives need to provide sound explanations for those decisions to their employees, their shareholders and their customers. This requires a new paradigm - a strategic framework and analytic techniques that describe and predict the returns they will actually achieve with the investments they make every day (such as human capital, physical plant equipment, facilities, and technology like processes and IT).



The remainder of this article presents core concepts of a framework developed by ProOrbis. It's usually discussed in the context of improving productivity (the asset concept of ROI); however, as risk and value are flip sides of the same coin, the framework will be explored here from a decision-making standpoint that addresses both risk and value improvement.

A NEW PARADIGM

For an enterprise to understand its tangible and intangible assets, there are three key requirements:

- **Classification** - definition of all investments and sources of value in an enterprise;
- **Integration** - connection of all elements into one integrated model; and
- **Link to Value** - a model that produces value and can be measured.

By putting assets in this context, the investments and the value they create are causally linked, giving the model its predictive power. The framework has some specific definitions of terms and analytic concepts to meet these three requirements.

First, organizational capability is everything the organization "can do" with its assets. There are three core assets - physical capital, including all tangible assets; technology capital, including product technology, R&D, information technology and process technology; and human capital, including employees and contract staff (see Figure 1). In this model, an asset

- tangible or intangible - is any productive means the organization materially controls that can be used to create value. There are also some intangible assets, such as brands, channels, customer relationships, intellectual capital, knowledge management and networks that were created by the three core assets in the past but can be used over and over again.

Core assets are combined into production functions (see Figure 2) that are designed to take inputs, such as raw materials, and generate valuable outputs, called throughputs, which are the company's offerings (products and services).

Core assets are not purchased to be resold directly. They are purchased to be used by the organization to develop its products and services from which derive their value. Therefore:

$$\text{Throughput} - \text{Input} = \text{Value of the Core Assets}$$

This form of valuation assumes the company is a going business concern, as opposed to the value placed on assets when a firm is going to be shut down. Liquidated assets are only worth what you can sell them for, not what you can make with them. Going-concern valuation involves the combination of assets and the way they are intended to be used to create value.

Since the assets in combination create the value (T-I), then the return on the asset investments of the enterprise can be calculated:

$$\begin{aligned} &\text{Throughput} - \text{Input} = \text{Value of the Core Assets} \\ &\text{Investment in Human, Physical and Technology Capital} \\ &= \text{Return on Investment} \end{aligned}$$

All assets in an organization are used either to create throughput or to manage assets (asset management systems), as shown in Figure 3. For example, you need the HR department to manage

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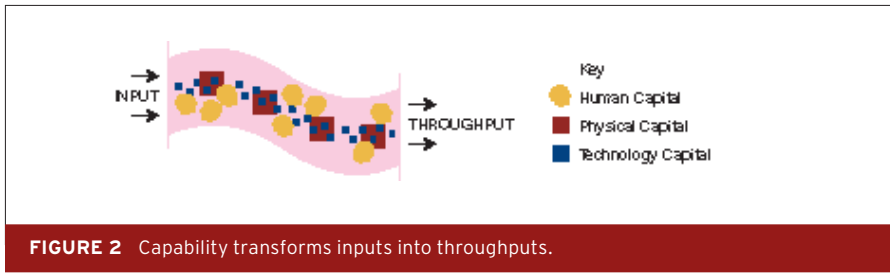


FIGURE 2 Capability transforms inputs into throughputs.

your human capital. The right number of people with the right skills; they have to be acquired and managed. Therefore there is no “overhead” or “fat to cut.” These assets and the asset management systems that create them also have an investment and, therefore, an ROI.

Risk, such as has been discussed in this article, is like negative through-put. Risk is defined as the potential for assets to perform in a way that destroys value. For BP, lost production, fines and claims to families were, in essence, subtracted from the value created by the refinery. One wonders how much BP could have invested to avoid \$2 billion in destroyed value. Viewing those cost reductions as de-capitalizations is what will shift the conversation from “how much money did we save?” to “how much value did we destroy?”

MAKING BETTER DECISIONS

Managers can use this paradigm to improve decision making in several ways.

- **Putting Investment in the Context of Value and Risk.** This entails reframing asset “costs” as investments needed to create value and then determining the effect on the value (T-I) when those investments are reduced. The new goal will be to improve value to investment ratios, not just lower costs.

- **Taking a Comprehensive Approach.** Managers must consider a decision’s impact on the entire enterprise, including the assets, inputs and throughputs (value and risk), to predict a real outcome. When faced with any single asset reduction, they should consider the impact on the other two assets in the production function.
- **Making Decisions in the Right Order.** By beginning with value, then formulating the needed capabilities and identifying the requirements for assets and asset management, decisions are fed with the proper data. Making decisions “out of order” turns an opportunity into a constraint. For example, if a manager cuts training “costs” (a human capital asset management investment), there may be a decline in production (capability) due to less competent human capital (asset). Instead the manager should start with the design of the work process that delivers the required production (capability) and determine the requirements for human capital performance (asset). From there the manager can decide upon the right investment in training (human capital asset management investment).
- **Making Decisions Transparent and Actionable.** By articulating the compre-

hensive nature and the causal relationship between decision-making factors, managers make their rationale more easily accessible to broader audiences. This builds credibility for the decision and gives managers a command of the facts required to execute the change. Transparency in decisions and their relationship to outcomes creates a clear path that people can understand, engage in constructively and reasonably support.

- **The Hidden Advantage - Productivity for Growth.** This article has discussed the serious liabilities of mislabeling critical investments in organizational assets as “costs.” ROI is another word for productivity. By optimizing the relationship between value and investment, significant resources are freed up, as companies discover new ways to remix assets to create higher-return production functions. For industries expecting significant growth such as nuclear utilities, scarce resources can be redeployed to new operations and create opportunities for real growth.

The remarkable benefit of following this paradigm is the way it allows an organization to solve its intractable problems. It’s not a silver bullet, but with everything to gain and not much to lose (remember our definition of insanity), this shift in perspective might be worth exploring. ■

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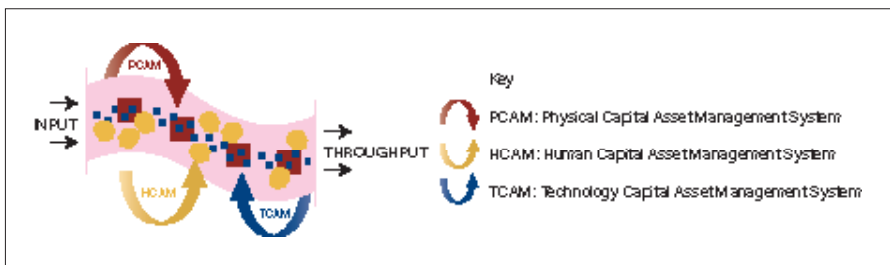


FIGURE 3 Every asset requires life cycle asset management to ensure that assets perform as required for the capability.