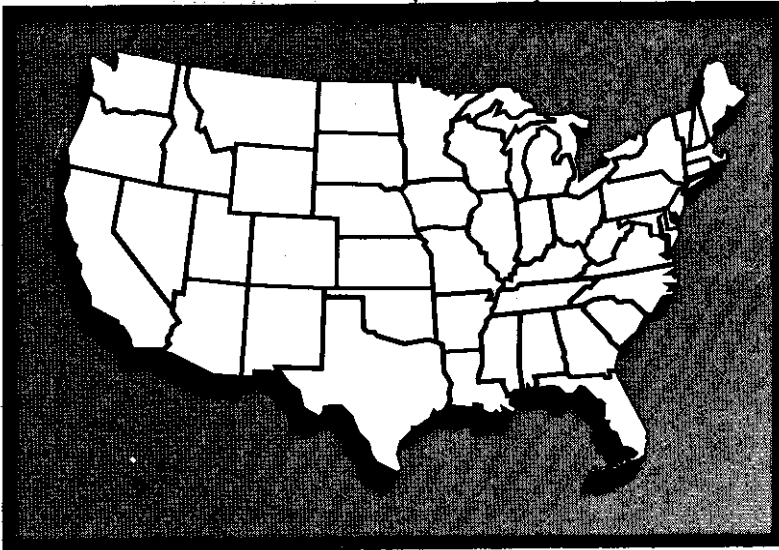


In many companies efforts to boost profitability have made financial planning the name of the game. But plans are only as good as the planner's ability to make them happen. Measurement and control methods must be installed to signal for corrective action when operating results deviate from the main strategy.



Control: Key to Making Financial Strategy Work

ROBERT L. DEWELT

For several years top management in many companies has been concentrating particularly hard on financial planning. This is the strategy development function where management maps out what course of action is to be taken in each major area of the business to achieve the established goals and objectives.

The importance of this planning process is quite obvious. Unless we have a soundly charted course of action, we will never quite know what actions are necessary to meet our objectives. We need a map to identify the timing and scope of all intended actions. This map is provided through the planning process.

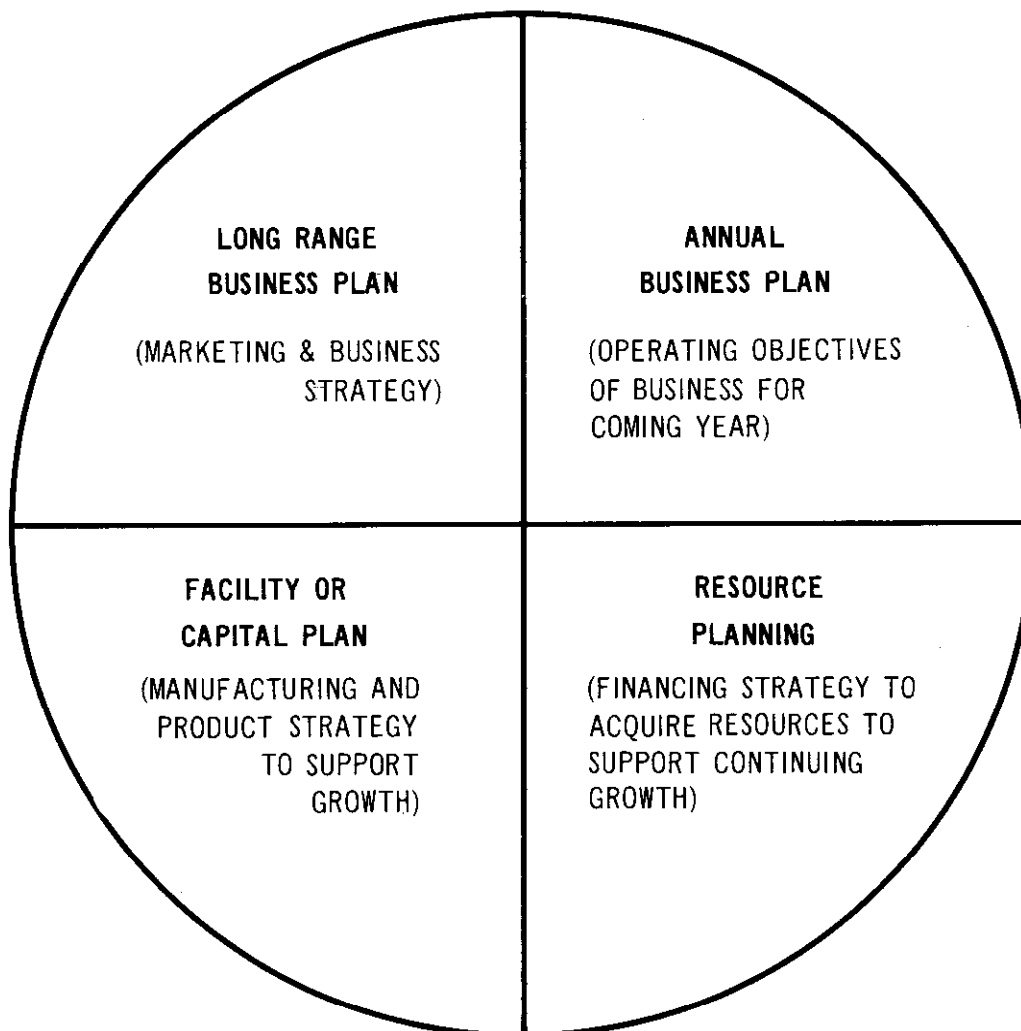
But simply making a map is not enough. If we don't follow it or if we make a wrong turn along the way, chances are we will never achieve the desired results. A plan is only as good as our ability to make it happen. We must develop methods of measurement and control to signal when deviations from the plan are occurring so that corrective action can be taken.

Planning

In deciding what the actual needs and objectives of their companies are, many managements have taken great strides in developing complete programs to provide the planning tools needed to effectively operate their businesses. The total planning program encompasses various company levels, each with differing objectives and responsibilities. (See illustration, page 19.)

- At the corporate level, top management evaluates the business opportunities available to the company, selects the types of businesses in which they will participate, and makes an allocation of available resources.
- At the division level, management develops a strategy or approach to maximize the growth and profitability of its organization within the confines of its business charter and allocation of resources.
- At the plant level, operating management establishes measurable goals and objectives for each critical area of the operation. These benchmarks are then used to monitor day-to-day activities to ensure that each manager does his part properly to meet the commitment included in the annual business plan. They lay out a map of specific actions needed to make the plan happen.

Planning



The whole planning and reporting process is aimed at helping the company zero in on profits and develop a business strategy that will permit continuing growth and improved profitability.

Control systems

Once we have decided where we want to go and what it takes to get there, what controls are required to coordinate our efforts and direct our attention to the appropriate faces of the business?

Four major control systems can be readily identified:

- Asset control
- Budgets and expense control
- Production and inventory control
- Labor measurement and control

Each of these systems addresses a major segment of cost, and each interacts with and overlaps the others.

Asset control

The asset control system normally addresses the traditional accounting functions and deals with the administrative and internal controls needed to adequately safeguard the company's assets. It attempts to ensure that the assets reflected on the Statement of Financial Condition are conservatively yet realistically stated. In order to accomplish this, the other control systems attempt to identify and funnel them off for management attention. And, where appropriate, these controllable, efficiency-related costs are forced out as period costs rather than permitting them to be deferred to have an unfavorable impact on future period profits.

Budget and expense control

The budget and expense control system is the most commonly employed control system used in business today. This approach has been found to be effective in nearly all segments of the business, including manufacturing, marketing, engineering, and administrative. By using a combination of fixed and variable budgeting techniques, the budget and expense control system can be tailored to meet the requirements of each of these functional areas.

The budget and expense control approach identifies each manager's allocation of resources for accomplishing the organization's predetermined objectives; it also plots his progress during the year. And by integrating each manager's budget with an effective management-by-objectives program, top management can ensure that its resources are effectively used to ac-



comply the established goals and the objectives of the corporation.

But the budget and expense system alone does not do the whole job. It deals only with a small portion of operating costs, and many of these are directly impacted by the other control systems.

In a normal manufacturing operation, the budget and expense control system may deal with only 30 percent to 40 percent of the sales dollar—with more than half of that directly related to manufacturing. It seems obvious that profit will not be materially increased through reductions in administrative, marketing, or engineering costs alone. These are often the easiest areas in which to make immediate reductions, but the impact usually is small. For this reason we must broaden the scope of our control systems to encompass other elements of the manufacturing function. Thus a standard cost system becomes the vehicle we use for increasing control in the manufacturing area and for integrating production and inventory control and the labor-measurement and control segments into our overall control systems.

Production and inventory control

With many companies focusing increased attention on production and inventory control, much of their interest is directed toward a concept called material requirements planning (MRP).

An MRP system attempts to convert a current informal and undocumented manufacturing system into one that is formally documented. But the functions it performs are not new. Schedulers, expeditors, buyers, and foremen have been performing these functions for a long time. They determine what is needed and when it is needed. But this information is stored in their heads. As long as the scope of the business doesn't change, or the volume of work doesn't exceed their capacity to handle it, or they don't quit or get promoted, the system seems to operate reasonably well. But the inevitable is bound to happen. In tough times, weak systems tend to fall apart.

Many a housewife uses a form of MRP system in running her kitchen.

1. First she makes out a menu for the next couple of weeks: What am I going to make? (*Master Schedule*)
2. Then she checks recipes for the dishes on the menu to determine the ingredients. (*Bill of Material*).
3. In the next step she checks what items are already on hand or on order. (*Stock Status*)
4. Then she prepares a shopping list. But if money is short around the house that week, she may decide to buy only the items needed for the current week and delay until the following week those not required until then. (*Time-Phased Material Requirements*)

When an organization attempts to follow this procedure manually on a large number of items in its manufacturing system, the clerical detail becomes quite voluminous, and the activities are either not completed or are



Product Definition

Many companies agree that product standardization is a good concept, but believe it wouldn't work for them because every product they make is "unique." This conclusion is often the result of an improper definition of what their products really are.

The difference between a unique and a standard product often depends on the level at which you look at that product. Most businesses could never duplicate for each new customer order all the engineering effort and cost that went into the initial development of a product line. What is normally offered is an established product with some minor modifications to meet special customer needs.

We all tend not to look deeply enough into the manufacture of our products to identify the common elements. The simple

fact of whether we build an item for stock or wait until we have a customer order does not in any way affect the commonality of the items and should not be a determinant of whether or not the item will be covered by standard cost.

We must attempt to broaden our control systems so that they encompass as many elements of cost as possible. By properly determining what our products really are, we can greatly improve operations in many facets of the business. We can standardize the manufacture of many components. We can develop effective cost and inventory control systems to measure operating performance. We can simplify engineering redesign and documentation because only the affected segments of the product must be modified to meet special customer needs.

inadequately performed. Thus the current emphasis is on allowing the computer to help us run the manufacturing portion of our businesses.

To implement a computer system, we must tell the computer about our manufacturing operation:

What and when Master Schedule
How Bill of Material
Where and how long Routing File
How many Stock Status

The reason it takes so long to implement an MRP system is that many businesses have no formal documentation for their manufacturing systems. It takes them a long time to learn how they really make their product and to reduce that knowledge to formalized documents usable in an MRP system.

Think about it: If you don't know how you make your product, how can you possibly know how much it costs? The standard cost system is an accounting system, but it's also the vehicle that ties the manufacturing procedure for a product to the financial reporting on that product.

Standard cost system

Comparison of the key ingredients of a material requirements planning system and a standard cost system reveals the same basic requirements.



MRP is the name given to the material manager's applications from the production and inventory control system, and standard cost is the name given to the controller's applications from this system. Both are related and are part of an overall management control system.

Once the key ingredients have been developed, you are ready to begin developing standard costs (see chart, page 24). Usually the first phase in implementing a standard cost system is the development of a base standard cost. The base standard cost is used for valuing inventory and charging cost of sales. It represents a formal identification and recognition of the manufacturing procedure at a point in time, becomes the basic cost level used for the development of deviations, and provides the foundation for complete continuity of transactions. All other activities in the system are aimed at making the conversion from actual cost to the base standard cost and for identifying the underlying reasons for deviations.

Key Ingredients

	<i>MRP System</i>	<i>Standard Cost System</i>	<i>Computerized System</i>
Bill of Material	X	X	X
Shop Routings	X	X	X
Master Schedule	X	X	X
Stock Status	X		X
Unit Costs		X	X
Materials prices			
Labor rates			
Burden rates			
Item Master File			X
Where Used File			X

It is not necessary to implement all facets of a standard cost system in the initial phase. However, it is the ultimate objective of any good control system to establish measurements for all significant elements of cost, and, for this reason, it is expected that businesses will want to expand beyond a basic system to implement improved operational controls.

Maintaining current standards. Once we have base standards, it is immediately apparent that no manufacturing environment stays static for long and that many variances are created because of our inability to modify the system to deal with these changing circumstances. When this occurs, it becomes extremely difficult to differentiate between performance-related variances and those resulting from economic conditions or policy changes.

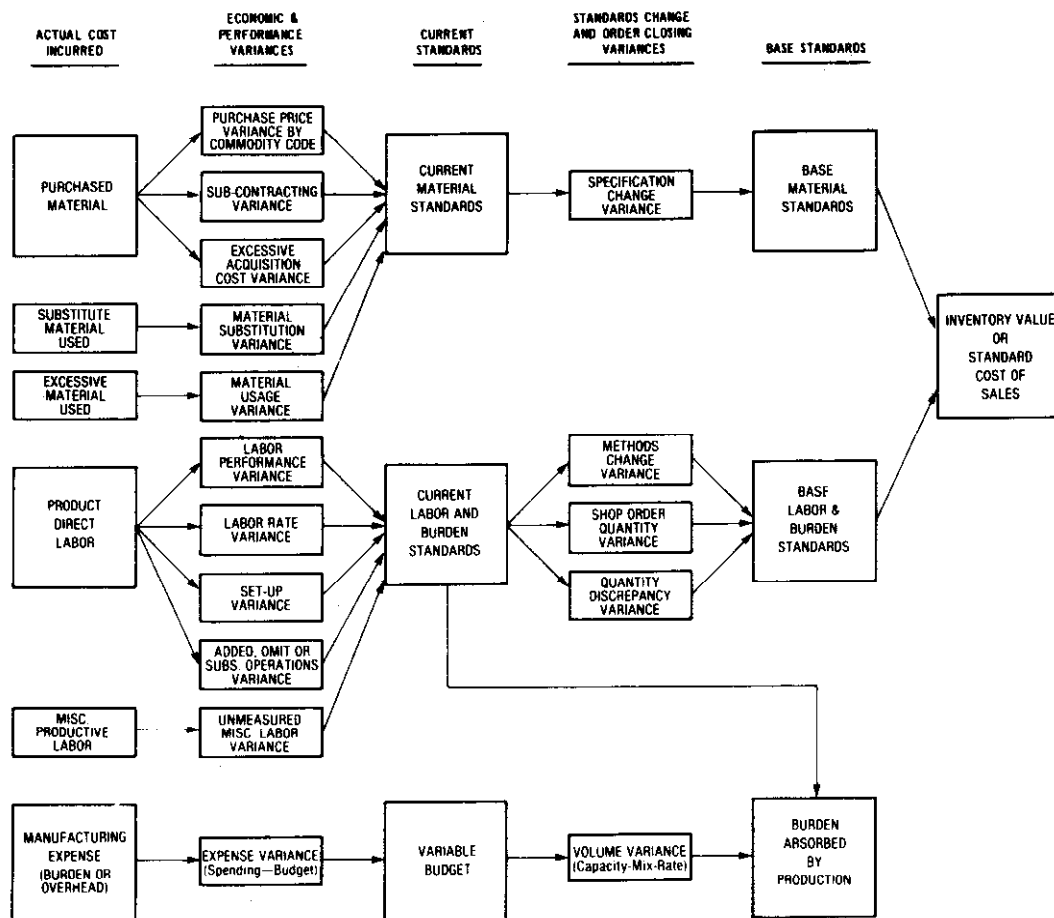
At this point the contribution of the cost system to aid management in running its business is limited unless we expand it to encompass the

changing environment. This is accomplished through the injection of current bills of material and labor routings into the cost system. Measuring individual transactions against current standard material and labor and reconciling these current standards to base standards through the use of order-closing variances, such as specification change and methods-change variance, permits us to attain the objective of using standards that always reflect current operating conditions.

The single biggest criticism leveled against the standard-cost concept after its initial introduction was its inability to constantly measure performance in terms of today's operating conditions. The modified technique outlined here is designed to eliminate this basic criticism and makes the standard-cost system an ongoing and always current tool for management.

With the latest product specifications and manufacturing techniques always maintained on a current basis, it becomes a simple matter to periodically load current material prices, labor rates, and burden rates to

Standard Cost System



permit the development of current product costs for the purpose of determining product contribution and evaluating current pricing strategies.

Labor measurement and control

At this point the system can be expanded to incorporate increased operational control. This can be accomplished by utilizing the current routing data to implement a labor measurement and control system. This system keeps management advised on a day-to-day basis of what is occurring on the manufacturing floor, measures manufacturing performance against predetermined objectives, and reports any deviations.

Throughout the process of developing control systems, you have to recognize the areas of your business where explicit controls are possible and to fully exploit those areas. Where explicit controls are not practical, you should establish measurements that are easy to maintain yet will prevent the function from getting out of control.

Monitoring performance

Most successful managements now recognize the need for planning and its usefulness in operating their businesses, and they now regularly establish objectives for the most significant elements of their organizations. But any plan is only as effective as management's ability to carry it out, and planning itself is not an end. To be effective, management must be able to measure performance to the plan, determine where deviations from the plan are occurring, and take corrective action where necessary. Knowing what the planned actions are and how effectively they are being carried out is essential to achieving the plan.

The development of techniques to monitor performance to planned objectives has progressed much more slowly in most organizations than the planning process itself. Increased attention must be focused, therefore, on the development of control systems to monitor performance to the plan and to identify deviations for appropriate corrective action. The approach outlined here provides a framework that can be structured to fit the needs of most organizations.

ROBERT L. DeWELT is corporate manager of cost systems and inventory control for Allis-Chalmers Corporation. Prior to joining Allis-Chalmers, he held various management and supervisory positions with Sheller Globe Corporation, Reynolds Metals Company, and U. S. Steel Corporation. A graduate of DePaul University, Mr. DeWelt is a CPA. A frequent speaker before management groups and professional societies, he also writes frequently for business and professional publications.