ICAI

54th National Cost Convention-2013

"India's Cost Competitiveness – Imperatives for CMAs"

18-19 January, 2013, Ahmedabad

Coping with the tardy growth of the economy
Analyzing concern areas and the role of CMAs

January 2013

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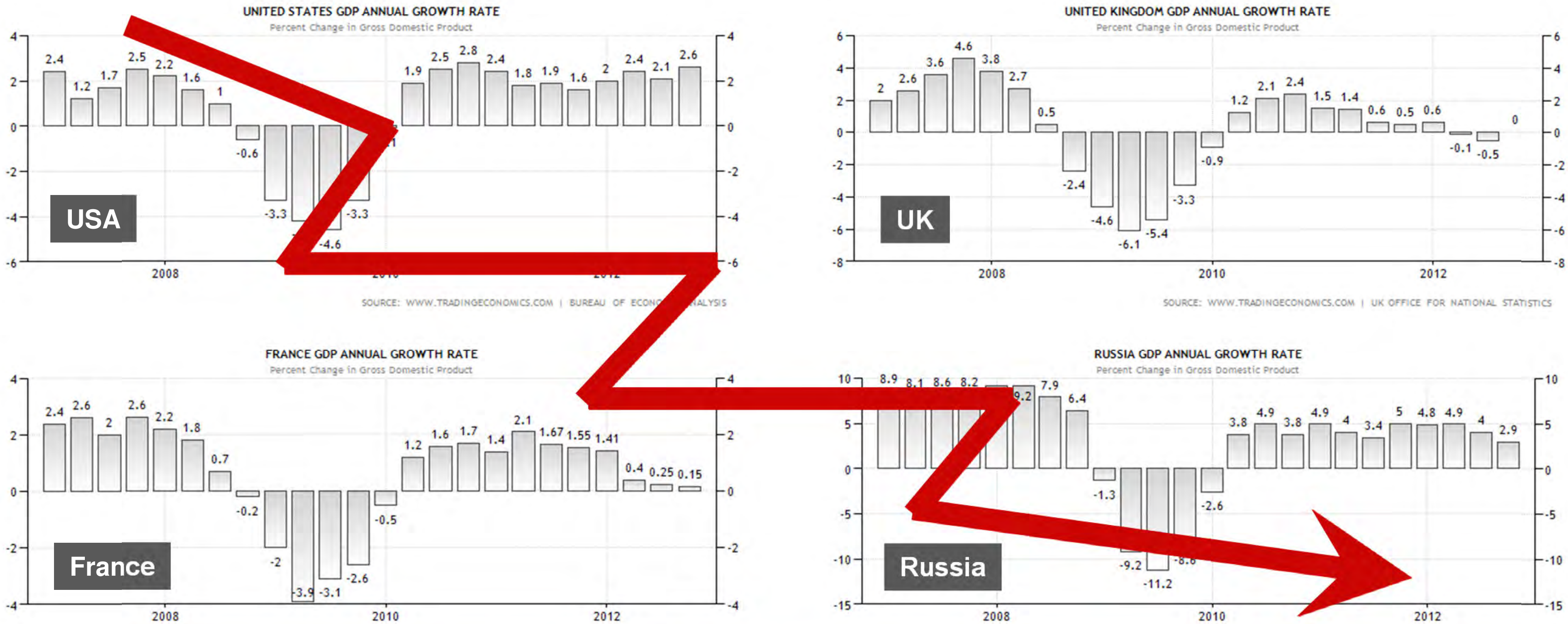
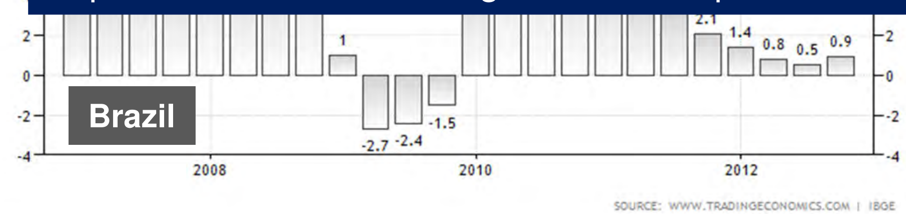
Global economy is witnessing a sustained slowdown …



The global economy is on a narrow path of slow and fragile recovery; Oil and commodity prices remain high and will continue to put further pressure on the global economy

Financial crisis is challenging countries in manifold ways, from liquidity problems and commodity market exposure to the uncovering of structural problems and currency volatility



Global outlook

United States

- The economy grew by 1.7% in 2011, but grew by 2.8% in Q4 of 2011.
- Growth prospects for Q1 2012 are around 2 to 2.2% on the back of a gain in consumer confidence's subsequent retail sales and manufacturing.
- Persistently high unemployment and risks of downturns in markets abroad will keep the FED's policy rate at very low levels until even as late as 2014.

Europe

- European economic growth slowed during 2011 to 1.5% and is expected to contract further in 2012 to -0.3%, before a modest recovery in 2013.
- Inflation should remain relatively low and contract to around 2.2% in 2012 from the 2.7% observed in 2011.
- The European debt crises threatened to derail global recovery for the last two years

Japan

- Manufacturing in Japan is already experiencing a v-shaped recovery after the March 2011 earthquake and tsunami.
- GDP is expected to grow at around 1.5% in 2012 on the back of reconstruction activities and a recent upswing in machinery exports and local consumption.

Emerging Markets

- Fears surrounding an economic downturn have lead EM central banks to either cut their interest rates or postpone monetary tightening during 2011.
- Market expectations are that EM countries will outperform developed countries between 2013 - 2016, as interest rate differentials will favour investment into these EM countries over that of the OECD economies.

BRICS

- The BRIC countries are recognised as having very large economies and populations, with unravelled growth potential in foreseeable years.
- The Brazilian economy experienced rapid expansion in the last decade with strong economic growth but is showing signs of slowdown
- Russia experienced strong economic growth over the past few years, but manufacturing and foreign investment slowed down since the global downturn.

The Next 11

- The Next 11 consist of South Korea, Iran, Mexico, Turkey, Philippines, Indonesia, Egypt, Nigeria, Pakistan, Vietnam and Bangladesh.
- These economies are smaller in size than the BRIC countries, but with its large population size and growth rates of above the global average, promises favourable opportunities for future investment and market growth.

India which showed resilience during the last decade is now showing signs of slowdown & tardiness in growth …

High Inflation – Enough to keep Growth on check!	Inflation has shot up to 8.43% in December as against 7.48% in November. Food inflation remains stubbornly high at 16.91%.
Slow Reform Movement – Stalling Growth Prospects!	Though, the pace of reforms was mired by obstructive policies of Left-coalition partners. But repeated disruption of Parliament proceeding and myriads of sudden policy reforms have left economy in shallow waters.
Earnings Slowdown Impacted by higher Operating costs!	The commodity cycle has yet again turned bullish. Manufacturing companies are more susceptible to such impact of rising raw material prices. The tremors of the same shall be felt in next few quarterly performances.
Industrial Growth – A bit too volatile to Digest!	High inflation and weak IIP data are cause of concern. Way to increase Industrial production needs to be discussed about and reforms needs to be introduced.
Global woes – India still not decoupled yet	Neither India, nor China has ever decoupled from global markets. With increasingly globalization, no country can avoid negative impact of trade and business with overseas partners.
Rising Interest Rates – Renders Working Conditions Costly!	Rising interest rate scenario can directly impact the growth prospects of a nation as it sums up to costly working conditions and operating environment.

All these create challenges for industries and especially put pressure on Costs and Pricing

Across industry there needs to be sustained efforts to create more value and mitigate existential risks …

Industry / Sector	Value and Risk Drivers		
	Revenue	**Costs**	**Capital Intensity**
Consumer Business	▪ Consolidation among competitors ▪ Shifting consumer preferences	▪ High input, commodity, and energy costs ▪ Consolidation of retail customers ▪ Volatility in credit markets and effect on pension costs ▪ High transportation costs	▪ Inability to receive financing from debt or equity markets ▪ Reduced liquidity
Manufacturing	▪ Decreasing auto sales ▪ Consumer credit crunch ▪ Pricing pressure ▪ Concerns with key customers	▪ Reduced commodity and energy prices ▪ Weakened financial strength of suppliers ▪ Opportunity to manage down transportation costs	▪ Decreased demand ▪ Increased competition and effect on payables ▪ Inability to receive financing from debt or equity markets
Financial Services	▪ Decreasing confidence in financial system rate cuts ▪ Risk averse investing and issuance of credit ▪ Consolidation	▪ Limited liquidity to cover operations ▪ Volatility in credit markets ▪ Locked up assets	▪ Recessionary pressures on financial instrument value ▪ Collections becoming more problematic
Telecommunications & Technology	▪ Consolidations among competitors ▪ Slowing growth; saturated market ▪ Continued pricing pressure	▪ Cost decreases slowing ▪ Potential supply chain disruptions ▪ Energy costs having larger impact	▪ High capital intensity ▪ High competition, pressure on pricing

… As the economy continues to falter, companies need to look at innovative ways to address this downturn, tardiness and continue to create value for its stakeholders ...

…Competiveness in Cost and pricing pressures will be one of the key determinant in answering the existential question; and in this the role of the Cost & Management Accountant becomes crucial

There are four stages of distress and it is imperative that organizations look for distress specific signals

Underperforming

- Underperforming stock price
- Declining market shares
- Lagging sales growth
- Deteriorating margins

Troubled

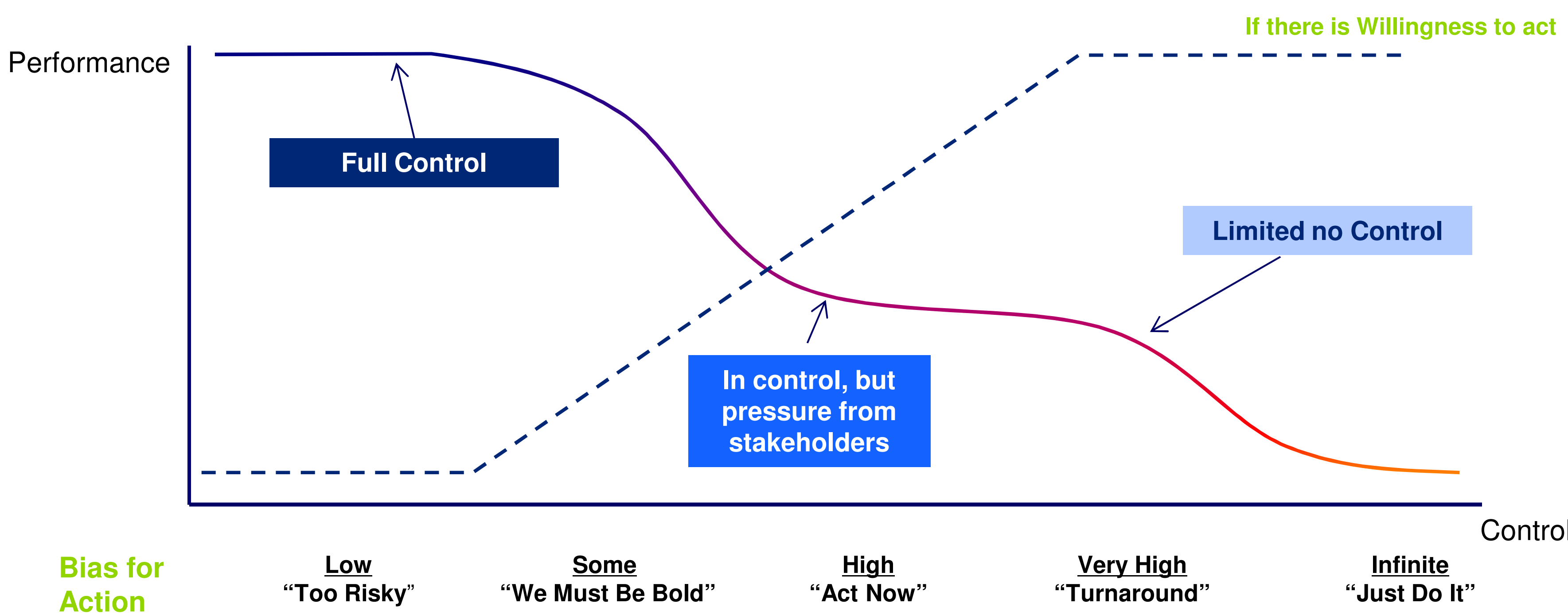
- Technically in default
- Insufficient cash flows from operations
- Declining W/C
- Increasing debt
- High management turnover

Distressed

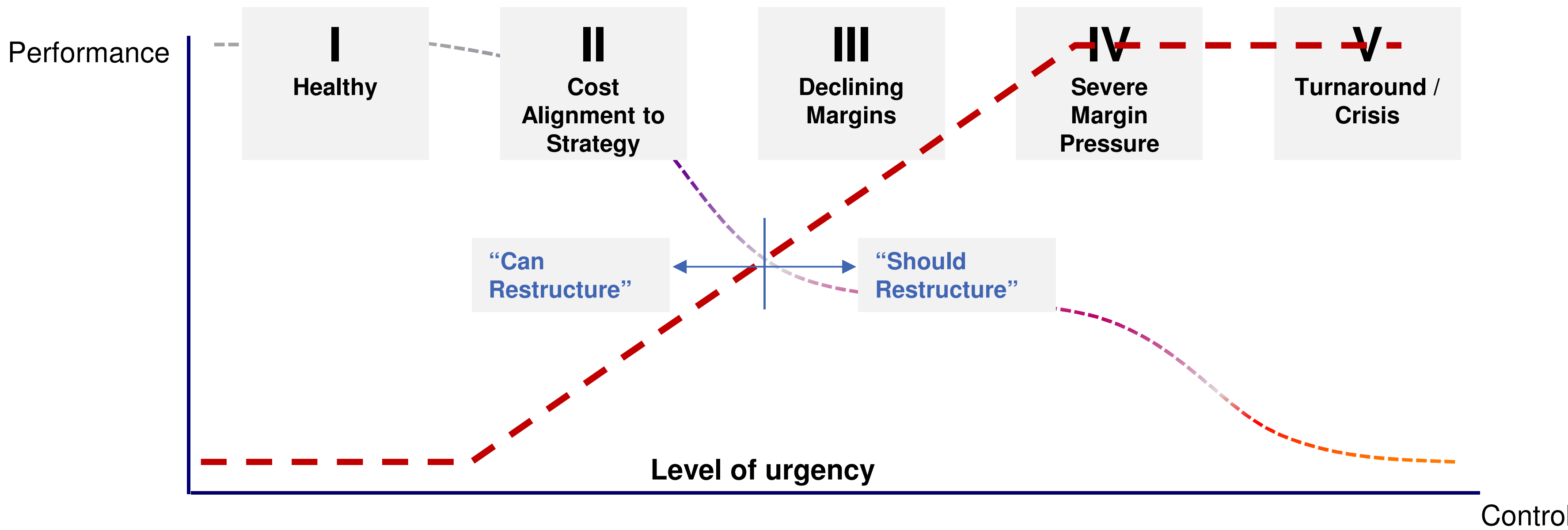
- Technically insolvent
- High interest coverage ratio
- Full asset leverage
- Financing non-income generating assets with debt

Bankrupt

- No access to capital
- Requirements for prepayment
- Creditors stop supplying due to non-payment



There are four stages of distress and it is imperative that organizations look for distress specific signals … (cont'd)



Low — **Imperative to Restructure Enterprise** — **High**

Bias for Action	**<u>Low</u>** **"Too Risky"**	**<u>Some</u>** **"We Must Be Bold"**	**<u>High</u>** **"Act Now"**	**<u>Very High</u>** **"Turnaround"**	**<u>Infinite</u>** **"Just Do It"**
Levers to Engage	▪ Revenue enhancement ▪ Process-focused continuous improvement	▪ SG&A functions ▪ Indirect spend ▪ Enterprise Cost Reduction ▪ Strategic initiatives	▪ SG&A functions ▪ Indirect spend ▪ Direct spend ▪ COGS	▪ SG&A functions ▪ Indirect spend ▪ Direct spend ▪ COGS functions ▪ Infrastructure ▪ Balance sheet	▪ SG&A functions ▪ Indirect spend ▪ Direct spend ▪ COGS functions ▪ Infrastructure ▪ Balance sheet ▪ Cash flow ▪ Financial restructuring

Focus should be on resurgence / revival / survival and it begins with seven steps …

1	**Decide the extent of cost improvement needed**	The main variables are: • Breadth of change needed • Time available to take action and capture value
2	**Start with the obvious**	• Streamline General and Administrative functions (G&A) • Aggressively tackle external spend (the materials and services a company buys)
3	**Take an enterprise view**	• Company should look beyond organizational silos to include cost reduction opportunities across the entire enterprise • A quick but comprehensive analysis of actionable spend (i.e., costs that are within the company's control over the next 12 months) can help identify the biggest opportunities and set priorities
4	**Balance short-term and long-term improvements**	• Most effective cost management programs apply a tiered approach that includes a mix of short-, medium-, and long-term opportunities
5	**Choose the right business model**	• Main trade-off is between "operational independence" and "cost efficiency"
6	**Protect strategic investments**	• Continue to provide the required funding to R&D, marketing, and advertising
7	**Actively manage change**	• 60% of the respondents to the Deloitte Fortune 500 survey reported that lack of understanding and acceptance by key stakeholders was a barrier to achieving the desired cost savings

Important to take an enterprise view and not just localized improvements

Issues and Functional Strategies / Levers to address them

Business excellence

	Client Issues	Levers/Strategies	Benefit
COST	**Misaligned cost structures that have "ratcheted-up" during the preceding period of growth**	**Lean Out Operations** ▪ Optimize manufacturing and supply chain networks globally ▪ Leverage scale to improve service delivery of "back office" **Shift Fixed Costs to Variable** ▪ Increase variable pay component in compensation models ▪ "Variabilize" cost structure through tolling and outsourcing **Simplify Business Model** ▪ Calibrate SG&A cost burden to Business Unit gross margin potential ▪ Challenge value contribution of each business unit and divest accordingly	▪ Variable cost structure that can flex with demand ▪ Position the company for profitable growth when the economy rebounds
GROWTH	**Sudden decline in growth trajectories or contraction in demand**	**Grow Smart** ▪ Revise pricing strategies based on less price elastic products and services ▪ Emphasize growth in geographies that offer counter cyclical demand **Proactively manage talent** ▪ Identify top talent to be retained through downturn ▪ Re-balance mix of monetary and non-monetary incentives **Bolster Planning Disciplines** ▪ Develop early warning systems and contingency planning capabilities ▪ Tighten alignment between strategy, operating plans, and management rewards	▪ Sustain top-line performance through the down cycle ▪ Retain key customers by enhancing the customer experience
CAPITAL & LIQUIDITY	**The Downturn will strain vendor/ supplier relationships. The credit crunch will make access to short-term capital a challenge**	**Generate & Conserve Cash** ▪ Manage for Cash vs. EPS ▪ Aggressively liquidate underutilized assets ▪ Manage / forecast cash on weekly basis ▪ Suggested Strategies and Levers **Optimize Working Capital** ▪ Leverage bargaining power to extend payables and contract receivables ▪ Rationalize underperforming products and unprofitable customers ▪ Ensure supply chain "life lines" **Balance Sheet Flexibility** ▪ Identify contingent lines of credit ▪ Execute sale / leasebacks ▪ Draw down revolving loans	▪ Keeping the company liquid and poised to "weather" the downturn ▪ Foster a cost-conscious culture that remains beyond the Downturn

Issues and Functional Strategies / Levers to address them

Finance

	Client Issues	Levers/Strategies	Benefit
COST	**Finance organizations are being asked to deliver more value, while continuing to manage and/or reduce costs**	**Rationalize operating model and align the Finance organization roadmap to support business strategy** ▪ Re-organize Finance service delivery model (distributed, centralized, off-shored, outsourced) to drive optimal balance between cost and service ▪ Develop a vision for how Finance will drive value for the organization and identify necessary infrastructure; build and execute roadmap to transition between current and future state ▪ Consolidate financial systems instances to improve processing efficiency and reduce costs	▪ Reduced costs ▪ Increased alignment of Finance function with organization value drivers ▪ Improved timeliness of information and reduce risk of error
GROWTH	**Difficult times require a focus on value-creation, and Finance organizations need to promote a structured, fact-based approach to decision making to ensure resources are focused on the high- potential profitability areas**	**Shift management focus to profitability and sustainability** ▪ Adopt Integrated Performance Management leading practices to better assess and understand performance and profitability ▪ Implement standardized tools, templates and processes for conducting financial analysis and developing business cases	▪ Improved data for management decision-making
CAPITAL & LIQUIDITY	**Market dynamics have increased the need for Finance organizations to develop sophisticated capabilities to best position the business, maximize shareholder value, and manage as well as mitigate risk**	**Develop methodology and tools for cash management:** ▪ Identify opportunities to generate cash, quantify opportunity and impact to financial statements, systemize prioritization of opportunities ▪ Implement Treasury workstation to effectively manage cash and reduce costs ▪ Improve Receivables and Payables Efficiency-Evaluate metrics against best in class and optimize Order-to-Cash and Procure-to-Pay processes **Advise on M&A activity, Evaluate Capital Structure, Optimize Asset Management** ▪ Develop formal robust target screening process to support acquisition strategy and framework for evaluation and rationalization of low value generating assets ▪ Ensure disciplined approach to capital management; optimize the sourcing and allocation of capital	▪ Improved information to support merger, acquisition, divestiture and other investment opportunities ▪ Improved allocation of capital ▪ Improved market valuation

Issues and Functional Strategies / Levers to address them

M&A

	Client Issues	Levers/Strategies	Benefit
COST	**Recent acquisitions should be reviewed to ensure that synergy capture has been realized and go-forward cost structures are in place** **For divestitures, use the carve-out as a catalyst to right-size cost structures and position the organization for flexibility and efficiency**	**Periods of economic Downturn will be intensified by functional redundancies** ▪ Examine workforce requirements to execute the current strategy ▪ Ensure the supplier base has been rationalized and contract terms have been favorably renegotiated ▪ Rationalize the finance and IT function to reflect the consolidated business **Go to a Parity-plus model** ▪ Strive for additional cost savings beyond the base numbers of the carved-out entity ▪ Use the divestiture as a launch point for a leaner Downturn-ready organization	▪ Lean organization with a flexible business model ▪ Improved terms, conditions and position through Downturn opportunity and scale realization
GROWTH	**Position the enterprise as a consolidator during the Downturn and capture market share**	**Take a long-term view** ▪ Position the enterprise for the rebound be entering new markets or adding to the product/service portfolio **Diversify Revenue Streams through strategic acquisitions** ▪ Ensure the business has a revenue mix that mitigates risk through diverse product offerings and geographic reach	▪ Sustainability by increasing market share and positioning for growth
CAPITAL & LIQUIDITY	**Be opportunistic during the Downturn and identify cash-strapped targets for strategic acquisitions**	**Take advantage of the reduced multiple** ▪ For companies with cash, the downturn is a great time to acquire ▪ Acquire to enter new markets or accelerate growth strategies **Use treasury stock as an advantage during the credit crunch** ▪ Less competition for the same deals as leveraged buy-out activity wanes	▪ Lower multiples could accelerate pay back and expand ROI ▪ Access to deals that were previously “too rich”

The role of CMA becomes important in ensuring that the organization is well equipped to deal with the challenges …

- Many a times there is ambiguity and misconception on what role a Cost & Management is expected to play in an organization
- Cost and Management accounting system had often become of little importance to managers. Many regarded them as minor routine belonging to the accountants, used to evaluate stocks and prepare monthly results speedily
- Cost & Management accounts still continue to do the obvious things such as Statutory and Financial accounting, Taxation compliance, Funding, Management reporting and so on. But the main value that a CMA is expected to bring is to bridge the gap between managers and accountants and focus on looking towards the future – at where business is going and what is going to happen.
- It is perceived that very few conceptual modifications have been brought in, in the cost and management accounting in the last 40 years
- Cost is too important to be left to the cost and management accountant alone

In future most of us will be doing the job, which we have never learnt and not been doing so far …

The role of CMA can become important and pivotal if they reorient their capabilities …

FUTURE BELONGS TO KNOWLEDGE

- Future will be “knowledge era”. So obsolesce of knowledge will be very fast and more visible among accounting professionals.
- There will be continuous cycle of “Learning, Un-learning and re-learning”, and more frequently.
- Make extensive use of the vast IT system and BI applications in organization; be in forefront for use of technology for data capture and analysis

REINVENT, REORIENT CAPABILITIES & REPOSITION

- Management Accountant must re-orient THEIR capabilities, else other professionals will replace them.
- They have to be ‘futuristic’ in their outlook instead of provider of historic or current information. They should ask “how better” and help management in decision-making level and for performance improvement.
- The responsibility of the management accountant will be less on forecasting the future and more on contributing to its creation.

In future most of us will be doing the job, which we have never learnt and not been doing so far … (cont'd)

The role of CMA can become important and pivotal if they reorient their capabilities …

MORE OF A LEADER THAN A MANAGER

- Quality of "leadership" will be more in demand than that of a "manager" or an accountant.
- They will have to Shift from "informational" role to an "influential" role.
- Management accountant needs to lead the effort in training other managers in using accounting information along with balancing it with other key data sources

TEAM PLAYER AND NOT JUST AN INDIVIDUAL

- Management Accountant will HAVE TO play the role of a catalyst / changing agent rather than an accountant in the future organization.
- They will have to corroborate, collaborate and develop alliance with the major functions of the organization - Finance, MIS, Industrial engineering, Corporate planning & Sales & marketing
- And actively participate along with other managers in decision making and strategy implementation.

Transaction Cost Theory - Forms of Governance

- Oliver Williamson (1975, 1981) identified three fundamental forms of transaction governance and the conditions when they're likely to occur:
- Market: Autonomous parties' exchanges are governed by prices in supply-demand equilibrium
- Hierarchy: (Formal org) Transactions among parties occur under a unified owner, who settles disputes by administrative fiat
- Hybrid: "Long-term contractual relations that preserve [parties'] autonomy, but provide added transaction-specific safeguards as compared with the market."

Three Transaction Dimensions

- Transactions have three key dimensions that determine how their costs affect governance choice
- **Uncertainty** about environments, other actors

  e.g., Floods delay, factory supplier's just-in-time deliveries
- **Frequency** of exchanges; one-off or recurrent?
- **Asset specificity:** investments lacking alternative uses except at loss of productive value; asset specificities can be human skills, geographical sites, brand names, dedicated machinery

  e.g., Chip supplier builds factory to Principal's computer specs

Transaction Economizing → Governance

- Williamson's key claim: Variations in exchange governance forms result from efforts to economize on transaction costs
- His three transaction costs dimensions align efficiently with transactors' choices among the three ideal forms of governance:

	Market	**Hybrid**	**Hierarchy**
Uncertainty	LOW	MIDDLE	HIGH
Frequency	LOW	MIDDLE	HIGH
Asset Specificity	LOW	MIDDLE	HIGH

Make-or-Buy?

- Transaction cost theory examines the conditions under which organizations chose to internalize some functions (hierarchy) or to purchase them on the market (e.g., relational subcontracting)

e.g., When should a firm or agency train its own employees, hire external vendor (college or commercial), or create a jointly staffed program?

- Are employee job skill requirements changing rapidly & unpredictably?
- How often must newly hired or promoted workers be (re)trained?
- Would org's own training staff have to invest heavily in asset-specific facilities, such as simulation labs?

- Is org's own training staff more knowledgeable than external trainers about firm-specific and tacit skills needed by employees?
- Are external vendors competent, reliable & cost efficient?