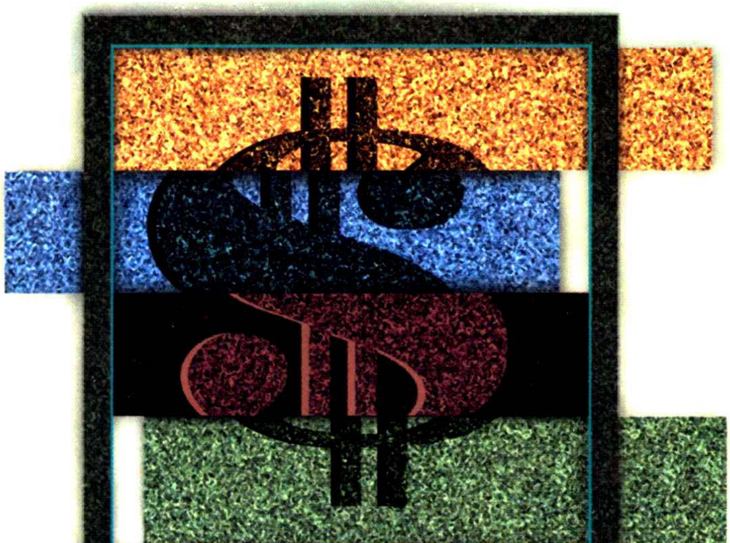
THE PROFIT POTENTIAL

TAKING HIGH PERFORMANCE TO THE BOTTOM LINE



C.J. McNAIR

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To thank each one of those who helped me over the years would be difficult. But you know what you have said and where your ideas appear, blended with the "CJisms" that inevitably pop up. Thanks to each of you for helping me learn to see the world a bit differently.

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Introduction

If we use nothing at all, is not then the waste total?

HENRY FORD
Today and Tomorrow (1926, p. 92)

A sustainable competitive advantage is the result of meeting or exceeding customer requirements. A customer pays for the perceived value of a good or service and not for its "cost." Relying on cost-plus pricing approaches to ensure long-term profits is akin to relying on a fairy godmother to make all your dreams come true. Faith may seem to work in the short run, but in the long run there is no magical way to avoid life's realities: prices are set by the market.

The market price is a hard, unbending cap on the amount of money a company can make by selling a good or a service. Within this constraint, management has the freedom to choose from a wide variety of structures, strategies, and management techniques. The goal pursued by management is clear: minimize total costs and maximize profits by meeting or exceeding customer requirements.

The lessons of the 1980s and 1990s have been hard ones for companies to learn. Focused on improving efficiencies and eliminating inefficiencies, companies have forgotten to ask the one vital question for their future: Are we doing the right things? In trying to solve the profitability puzzle, companies have often failed to examine what they are doing first. Effectiveness, which comes from recognizing and eliminating waste, is the key to sustainable growth.

In reality, there are three pieces to the puzzle management is trying to solve: *cost, waste*, and *profit*. Cost is the economic value of the resources a company uses in creating value for its customers: it is the total of all the activities the customer is willing to pay for. Market price less these *value-adding costs* is a company's profit *potential* on the good or service. Customers are willing to provide management with this potential profit.

The difference between the profit the customer is willing to provide and the actual profitability of a company is where waste has its impact. Waste, which is the economic value of all of the activities that a customer *is not* willing to pay for, comes out of potential profits. Since it is *non-value-adding* in the customer's eyes, waste is not going to be factored into the market price. High levels of waste, combined with a cost-plus pricing approach, can lead to a competitive nightmare as sales plummet, profits disappear, and unpaid bills stack up.

Managing a company out of a decline requires creativity and a focus on eliminating waste. The power of this approach can be seen in company after company. Motorola, Xerox, Harley-Davidson, and Bose Corporation are all known as effective competitors in the global marketplace. Each of these companies pursues the continuous elimination of waste (non-value-added work) from their ongoing operations. Less waste means more profits. By learning to do existing work better and by eliminating activities the customer doesn't value, many American firms are on the road to building a sustainable competitive advantage.

Make Waste Visible

Waste squeezes out the profits of a firm. Only by making waste visible, and by actively working to eliminate it, can a company gain long-term control over its profits. The result of hiding waste, of spreading it over marketable units of product or service, is that it effectively disappears from view. Hiding waste ensues its unbridled growth.

The unbridled growth of waste is almost a natural outcome of success. When a company is in its growth stage, it cannot add resources fast enough to meet demand. Trying to catch up, management adds more and more resources, even as the market begins to mature. The total amount of added cost, spread out over an increasing volume of products, seems unimportant. Only when the company hits maturity does the high cost of unbridled growth hit home. By then, so much waste is hidden in the measurements, management, and processes used to deliver products and services to customers that it is virtually impossible to uncover.

The only way to turn around this downward spiral of increasing waste and evaporating profits is to measure, and then eliminate, waste throughout the organization. But few companies actually do measure waste. Why? Because waste is what we have done wrong. Measurements seldom focus on what we do wrong, and when they do, it is in a piecemeal fashion.

The only reliable way to affect behavior is to measure it, and to use these measures to reward individuals for their efforts. If the key to long-term sustainable growth is the continuous elimination of waste, the entire measurement process has to focus on waste. Waste has to be weighed, labeled, displayed, and managed to be permanently eliminated. Total quality management (TQM) provides a company with many of the metrics needed to track waste on the plant floor, but the key yardstick used to measure company performance is not as supportive. The accounting system provides no information on waste. It records "cost," a number that blends the good (value-adding work) with the bad (non-value-adding activities).

Undoing the damage done by allocations and poor knowledge of the underlying dynamics of value creation will require a sustained effort by companies to honestly record, monitor, and eliminate waste. This change starts with recognizing that every resource has the capability to create value. Value-creating potential—not historical cost—is the baseline measurement for the economic worth of an asset. It is this basic value-creating potential that needs to be managed and optimized. While most managers would agree with this statement, the mechanics of creating a value-focused accounting process are not as easily agreed upon.

The current move to "reengineer" corporations is one way companies are trying to drive value creation into every process and activity they undertake. But reengineering is a "re." "Re's," as described in the pages that follow, are the actions taken to correct previous mistakes. To avoid being merely a "re," reengineering efforts need to highlight the amount of waste that is embedded in an organization—in its assumptions and in its practices. Are the activities being performed the ones the customer is willing to pay for? If downsizing takes place, will the company lose a core competency? Do top-down cost-reduction drives, under whatever name, really ensure that waste is eliminated and long-term sustainable profits are guaranteed?

Management will get the type of behavior it measures and rewards. If management believes that it has to eliminate fat and waste from the organization, it needs new measurements that accurately track existing waste levels and pinpoint areas where improvement will result in increased long-term profitability. These measures are not an option; they are the key to gaining a sustainable competitive advantage in the global market.

Waste-based measurement systems don't look, act, or feel like traditional accounting measures. Instead, they reflect the realities of organizational life. If $1 million in resources is needed to process customer complaints, then $1 million of waste needs to be recorded and discussed. The merging of these non-value-adding costs with other resource costs hides the true profit potential of a company. Measuring these non-value-adding costs, thereby making them visible, is the key to eliminating them.

This is Japan's secret. Simply, they have a deep respect for the learning that comes from recognizing, studying, and fixing mistakes. Mistakes are waste. Waste robs a company of its profit-creating potential if and only if it is not learned from. To learn from mistakes, a company needs a way to discuss them and see their effects in terms of dollars of wasted resources. This lesson must be learned by Western companies and their managers if a sustainable competitive advantage is to be gained.

A Personal Note

The role of waste in defining a company's profitability and the need to measure this vital area of company performance became clear to me as I studied the differences between old and new methods of managing factories and offices. What separated these new techniques from their older cousins was the way they directed everyone's attention to the waste embedded in the way an organization did its work. The common denominator in all of these continuous-improvement models was waste.

The troubling issue, though, was the lack of measurements for recording current levels of waste or for preventing new waste in the future. The accounting numbers I had learned so well in earlier parts of my life did not provide any insight into waste. They were driven by a concern to balance the ledger. Accounting relied on average costs, and I knew that "average" simply wasn't good enough for the future.

Understanding waste and its impact on a company's health became a passion for me. Everywhere I went, I saw good companies assuming that large levels of waste were inevitable. I saw good people doing work they knew was non-value-adding but having no recourse but to keep on doing the work they were told to do. I saw company after company struggling to implement the newest management fad to bandage hemorrhages of waste that were bleeding them dry. Unable to see, or accurately measure, the root cause of their declining profitability—waste—these good companies continued to struggle. Some were successful, but all too many were unsuccessful in their battle against the weight of waste that was dragging them down.

Once the role of waste became clear to me, I knew it had to be measured. The profit bandits had to be made visible so that people could act on the sources of waste. I had to find a way to show people that waste was all around them—to focus their attention on eliminating waste from their organizations. That goal led to this book and to the ideas and measures that follow. Making waste visible is a journey that has just begun for me. It is one that will take a lifetime to complete.

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