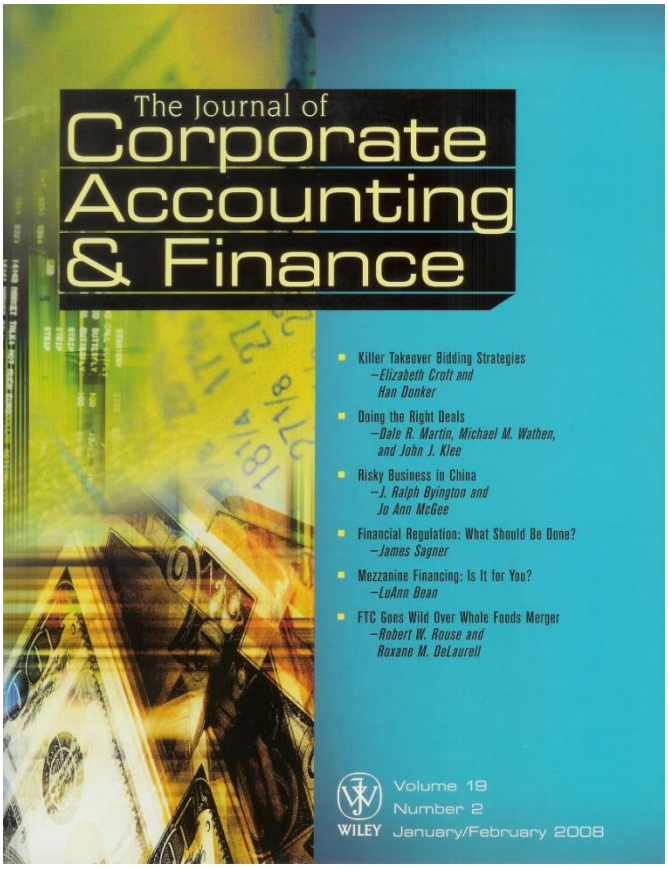
Thirteen Steps to Improve Financial and Operational Performance While Improving Customer and Employee Loyalty

Brian K. Higgins
Principal
Management Resource Technologies, Ltd.
mrtinfo@MRT-Ltd.com

S. Mark Young
KPMG Foundation Professor of Accounting and Professor of Management and Organization
University of Southern California
Marshall School of Business
Los Angeles, California 90089



Thirteen Steps to Improve Financial and Operational Performance While Improving Customer and Employee Loyalty

Brian Higgins and S. Mark Young

Even during times of economic prosperity, organizations strive to improve financial and operational performance to enhance their viability and competitiveness in the marketplace. Given the plethora of methods available today to improve performance, the challenge is to identify the most comprehensive and comprehensible approach that holds the most promise of generating significant improvements. This article outlines a well-tested approach from which 13 steps have been extracted that managers can follow that will result in dramatic improvements in bottom-line performance as well as improved competitiveness, customer loyalty and employee commitment.

UNDERSTAND YOUR COSTS

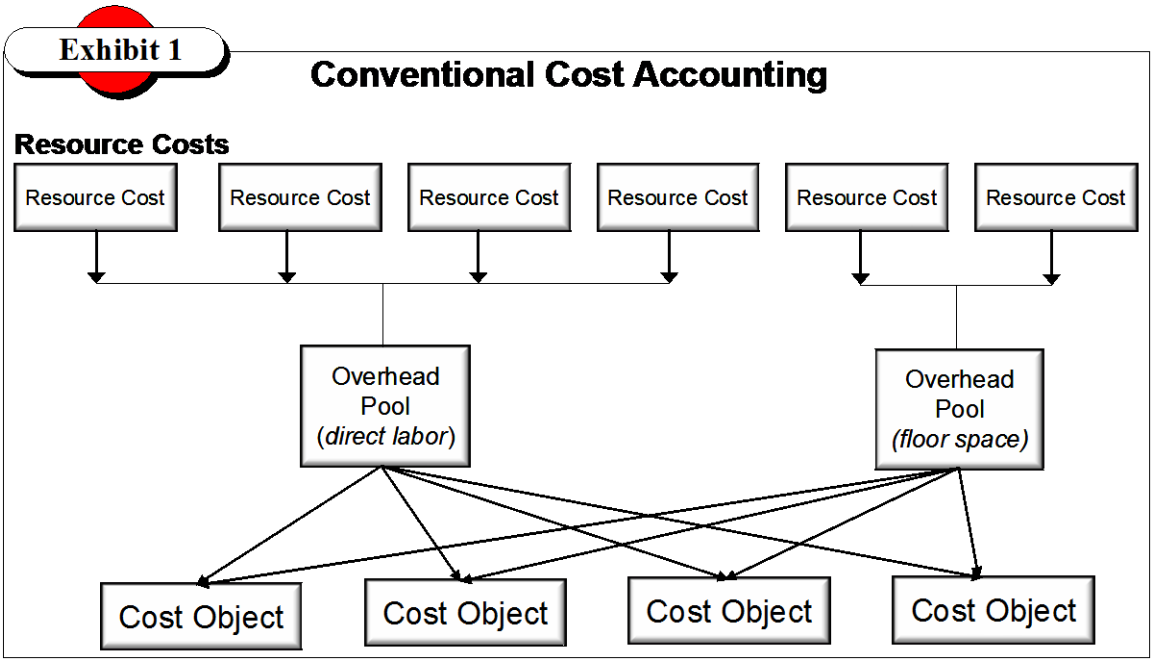
It may be hard to believe, but most organizations do not understand their costs – especially indirect and overhead costs. Ninety percent of companies still adhere to antiquated cost-accounting methods that "allocate" indirect and overhead costs (Exhibit 1).

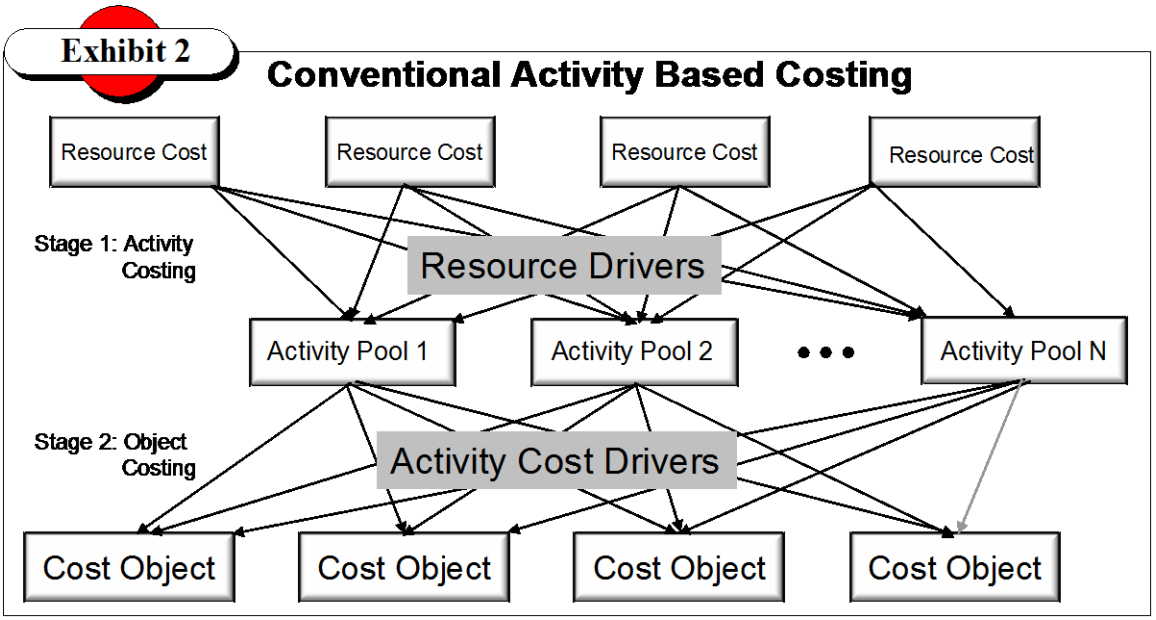
Even more contemporary methods of cost accounting such as activity based costing (ABC) rely on pooling, averaging and allocation of costs to products and services (Exhibit 2). Whereas conventional cost accounting employs large cost pools (especially of overhead and/or shared costs), ABC uses smaller, yet more numerous pools. Both techniques are fairly similar with respect to allocating pooled costs to products and services – such techniques distort product and service costing and make it very difficult to validate financial and operational performance.

As we discussed in a previous article (Higgins and Young, 2001), the most accurate and reliable method of costing products and services is to *directly* assign resource costs and effort to activities, products and services without using any pooling or averaging of costs. This approach provides the only mechanism to accurately validate costs by creating a bi-directional audit trail between resource costs and products/services that is impossible to achieve if allocation of pooled costs or average driver costing are used.

The process necessary to capture and assign organizational costs – especially useful in shared-service environments – begins by inventorying the processes and activities performed within the organization. An Activity-Logic Diagram is a storyboarding process that enables the identification of organizational processes and activities in a relatively short timeframe. Using an inventory of processes and activities has a number of benefits:

- Activities form the focal point to which costs and efforts are assigned. For example, employees often describe their jobs first by identifying the activities performed followed by the products and services to which those activities apply. For example, a sales person would describe his/her role as "selling products ABC and XYZ." When capturing and assigning costs to products for example, a necessary first step would be to understand how much time is "selling" then what portion of selling is devoted to product ABC and product XYZ.
- Activity cost and effort forms the basis for identifying work that is either mission- or non-mission-related. In addition to understanding the cost of work performed across offerings, activity cost/effort helps identify the contributed value

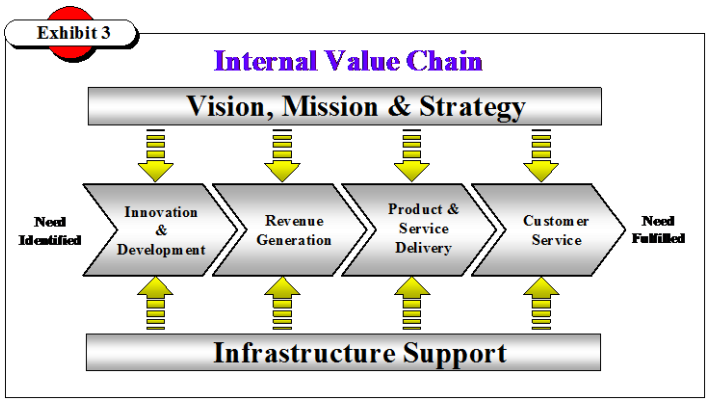




associated with the work performed – which activities align or do not align with the strategic direction of the organization.

- Understanding the cost associated with the work performed across the organization provides the basis to assess opportunities related to changes in organization structure (e.g., centralized, decentralized, matrix or hybrid).
- Measuring the number of employees participating in an activity as compared to the Full-Time-Equivalency (FTE) is a measure of fragmentation. Similar to a computer's hard drive, the more fragmented an activity, the less efficient it operates. Although some activities are designed to be fragmented, many activities can be significantly improved by having fewer employees specialize in the activity, reducing the burden on other employees.

The process of identifying organizational processes and activities begins with the internal value chain – the hierarchical listing of the principal processes performed within the organization (Exhibit 3). After the value-chain activities have been identified, the activities and tasks are grouped by major value-chain



process (Exhibit 4). This activity set forms the basis by which all costs and efforts will be assigned.

The process described, Activity Value Management (AVM), is significantly different from all other costing methods as it does not rely on any "pooled" or allocated costs, but assigns resource costs directly to products and services -- thus, treating all costs as direct. This system provides the basis for the steps that are outlined in this article.

After the activities have been defined, all organizational costs and efforts are *directly* assigned to the products and services without any pooling or allocation of expenses – thus, providing the most accurate costs and profitability that can be determined (Exhibit 5).

Once the data has been collected, the information will be used to analyze organizational performance. The activity cost/effort information will form the basis by which the remaining steps will be implemented.

BECOME MISSION-FOCUSED

Staying focused on the mission means that organizations or departments must concentrate on the activities that represent their primary responsibilities. Having people do more of what they should be doing and less of what they should not be doing is a key to success.

A service organization conducted an activity costing study and was able to filter the data by functional area. One area of concern was flat sales over a number of years. After filtering the information to expose the efforts of the sales department, it was discovered that only about half of the effort was related to their mission of "generating revenue" (Exhibit 6).

This information was used to restructure the sales function by transferring full responsibility for customer support to the customer support department where they have the infrastructure necessary to properly support the customer base. The cost of sales

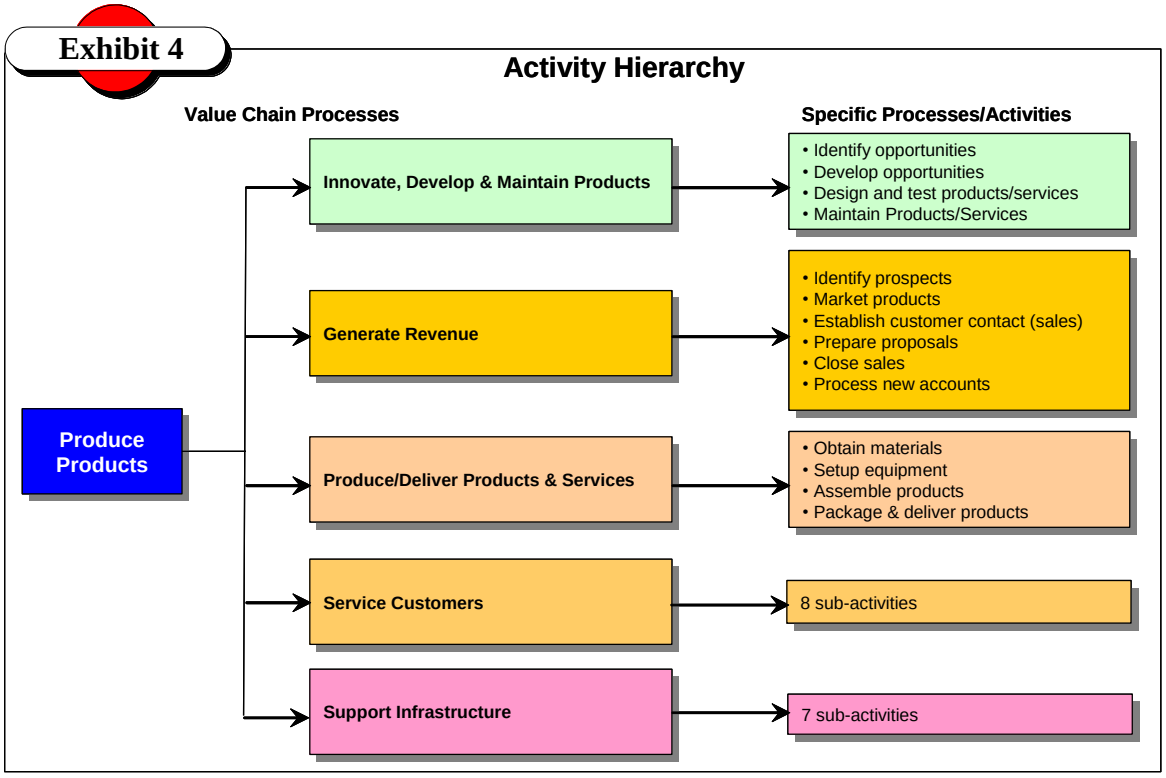


Exhibit 5

Profitability Analysis

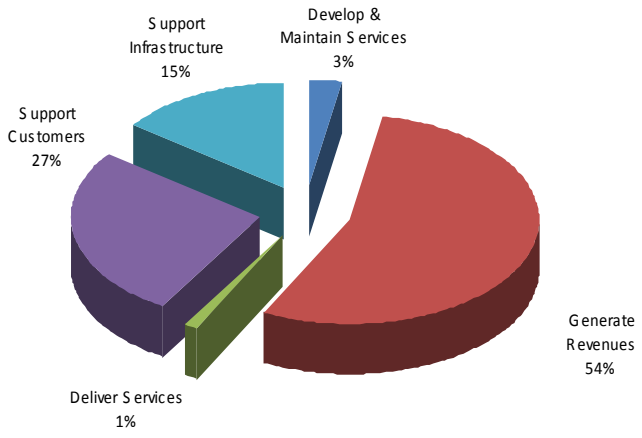
ACME MANUFACTURING COMPANY
LOB Profitability Analysis

ACTIVITY NUMBER	DESCRIPTION	OVERALL	A - WHATITS	B - DINGBATS	C - WIDGETS	ACTIVITY NUMBER
1	*Develop/Maintain Products	$245,506	$40,285	$13,490	$76,286	1
11	*Research Market	$39,279	$17,548	$15,280	$6,451	11
111	Analyze Competitors	$26,730	$12,655	$9,862	$4,213	111
112	Determine Market Profile	$12,549	$4,893	$5,418	$2,238	112
12	*Plan Products	$26,349	$8,245	$11,544	$6,560	12
121	Contact Customer	$10,654	$2,455	$5,411	$2,788	121
122	Prepare Plans	$12,305	$4,501	$5,238	$2,566	122
123	Approve Plans	$3,390	$1,289	$895	$1,206	123
13	*Develop Products	$116,197	$2,244	$1,897	$4,720	13
131	*Design Products	$67,851	$1,135	$788	$758	131
•	•	•	•	•	•	•
•	•	•	•	•	•	•
•	•	•	•	•	•	•
2	*Generate Revenue	$990,622	$480,822	$250,524	$259,276	2
21	*Define Market	$27,095	$13,767	$6,584	$6,743	21
211	Analyze Market	$11,789	$5,639	$3,040	$3,111	211
212	Analyze Competition	$10,146	$6,426	$1,842	$1,878	212
213	Develop Marketing Plans	$5,159	$1,703	$1,703	$1,754	213
22	*Market Products	$501,624	$289,802	$92,662	$119,160	22
221	Develop Marketing/Advertising Material	$189,244	$111,731	$26,575	$50,939	221
222	Distribute Marketing Material	$7,392	$2,701	$2,773	$1,918	222
•	•	•	•	•	•	•
•	•	•	•	•	•	•
•	•	•	•	•	•	•
9	*Support Infrastructure	$1,716,186	$129,843	$109,304	$129,778	9
91	*Administer Operations -- General	$113,215	$14,696	$16,728	$16,867	91
911	*Plan Operations	$64,290	$14,538	$16,571	$16,705	911
9111	Develop Strategies	$20,171	$1,968	$1,968	$2,027	9111
9112	Review Operating Performance	$44,119	$12,570	$14,603	$14,678	9112
912	Audit Operations	$2,134	$157	$157	$162	912
913	Provide Legal Assurance	$33,950				913
•	•	•	•	•	•	•
•	•	•	•	•	•	•
•	•	•	•	•	•	•
	TOTAL COST	$5,793,003	$1,519,313	$1,044,236	$1,718,815	

REVENUE:	$6,000,000	$3,300,000	$1,200,000	$1,500,000
PERSONNEL:	$3,084,048	$693,728	$536,186	$777,630
NON-PERSONNEL:	$2,708,955	$825,585	$508,050	$941,186
SUB-TOTAL	$5,793,003	$1,519,313	$1,044,236	$1,718,815
GENERAL COSTS		$830,851	$302,127	$377,659
TOTAL COSTS	$5,793,003	$2,350,164	$1,346,364	$2,096,475
OPER. MARGIN($)	$206,998	$949,836	-$146,364	-$596,475
OPER. MARGIN(%)	3.45%	28.78%	-12.20%	-39.76%

Exhibit 6

Sales Effort



declined through attrition, revenues jumped by 15 percent within 6 months by having more concentrated effort devoted to obtaining profitable contracts, and customer churn (due to inadequate customer support) declined — a win-win situation for the company, its employees and customers.

EXAMINE YOUR ORGANIZATION STRUCTURE

All businesses typically are organized around a *centralized* or *decentralized* structure. There are primary advantages and disadvantages of each form of structure.

CENTRALIZED STRUCTURE

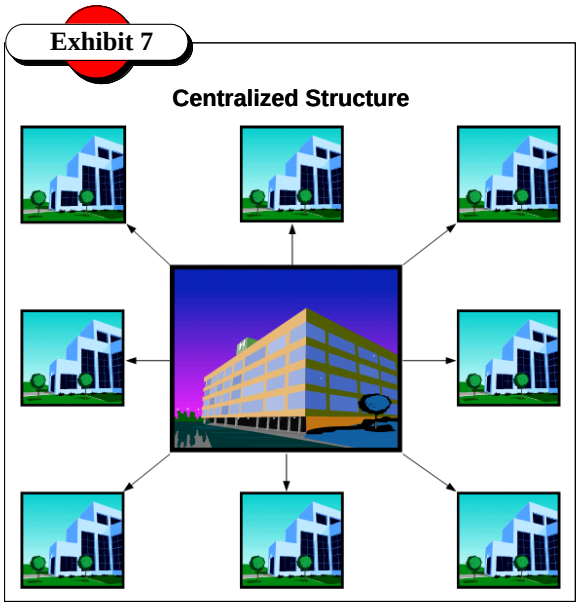
A centralized organization structure is characterized by a strong central staff that performs most of the management and/or administrative functions within the organization. Typically, there are strong lines of authority between the centralized functions to the rest of the organization (Exhibit 7). Centralization allows for economies of scale by utilizing common resources, or shared services, necessary to provide services to the business units across the organization. Often, decisions are made centrally and carried out throughout the business in the form of edicts or management directives — there is little, if any, autonomy at the division or business unit levels.

Another advantage is the consistency of work and the control over work output. Instead of duplicating functional responsibilities and interpretations of policies at the business unit level, a centralized or shared-services environment offers significant improvements in process control – changes in processes, policies and procedures only need to occur in the centralized function rather than interpreted across numerous strategic business units (SBUs) and/or physical locations where misinterpretations can lead to declines in performance and additional remedial work.

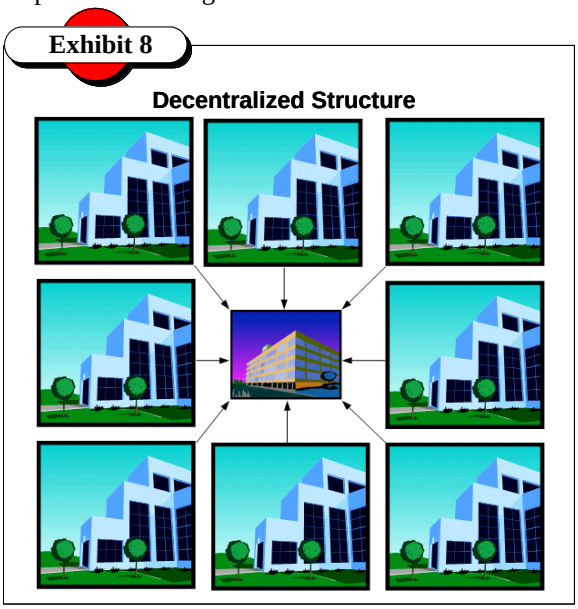
A major drawback to this type of structure is the bureaucracy that accompanies it. Although more cost effective, centralized structures typically take longer to make decisions and often times are less responsive to external changes (e.g., changes in the marketplace or competition).

DECENTRALIZED STRUCTURE

In contrast to a centralized structure, a decentralized organization structure has the services provided at the business unit level with reporting requirements to a centralized corporate function



(Exhibit 8). The functions are located at the business units that use those services. This type of structure has less bureaucracy and, therefore, is more responsive to changes in the business climate.



However, this comes at a price of duplicating common services across many locations which drives the costs upwards. With this style of organization, each business unit is more independent, allowing for less control and expense from a central function. The business units operate more as profit centers rather than cost centers as is typical in centralized structures. One advantage of decentralization is that business units can decide the level of assistance and spending for common services, as opposed to service costs mandated by a centralized corporate structure.

Although there are significant cost-related advantages associated with a shared-services environment, a major drawback is cost and/or performance visibility. It is common practice to "pool" such shared services and "allocate" these costs using drivers or other means as described earlier in this article that are based on average cost per transaction, revenues and so on. These methods do not often take into consideration differences in execution as related to the constituents. For example, similar work outputs may require considerably more time and expense for one business segment than others. The accounting or cost-accounting system must accommodate such differences if performance is to be accurately measured. If not reasonably measured, cost and performance information may lead to uninformed business decisions that have a detrimental impact on overall performance. The costing system used must be capable of capturing the nuances of the organizational structure (e.g., proper assignment of shared-service costs to lines of business and/or business segments).

There is a general rule of thumb that when decentralized organizations experience difficulties (typically bottom-line issues), it often helps to consolidate efforts and expense and gain improvements through economies of scale and specialization. On the other hand, highly-centralized organizations tend to have challenges related competitive encroachments or other marketplace factors which require quick and decisive responses. Centralized organizations often find relief by decentralizing the tasks necessary to meet those challenges. The bottom line is to look at the organizational structure to determine if any changes would improve the performance of the enterprise.

With any general rule, there are exceptions. One of the authors worked with a team of consultants whose client was a Midwestern electronics firm that had government as well as civilian products and services. Government requirements imposed stringent financial controls and reporting responsibilities. Since the financial function was centralized, they operated to the more stringent government requirements across both business segments. Millions of dollars per year were saved by decentralizing the organization into governmental and civilian components permitting less costly financial services to be performed within their civilian business.

Often, the best structure may be a hybrid — decentralizing some functions where nimbleness and responsiveness are required while centralizing other services where cost efficiency and control are critical and responsiveness is less important. To overcome issues in centralized functions, related to

responsiveness, expertise within the centralized service function related to business segments can be established to facilitate awareness.

ENGAGE THE STAKEHOLDERS

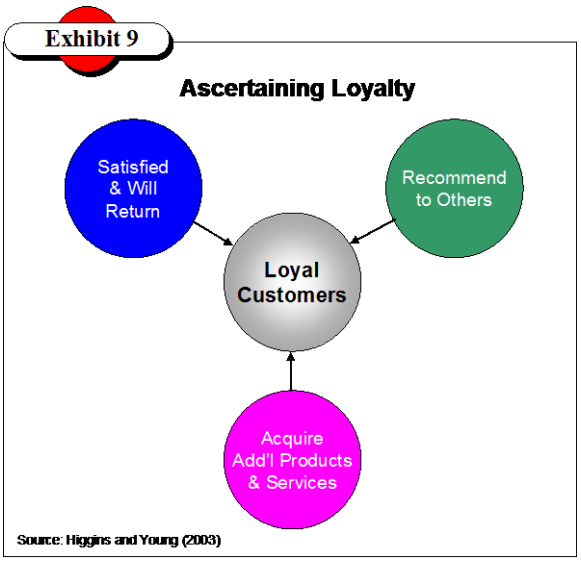
Improving organizational performance cannot occur in a vacuum. Changes made to processes, activities, staffing and the like can have both positive and negative effects on the stakeholders (employee, customers, vendors, etc.). Engaging the stakeholders in the improvement process will help to ensure that any changes in the organization will not have unexpected negative consequences.

The stakeholders are often an excellent source of ideas regarding what needs to be changed in the organization. There are a number of ways to obtain stakeholder input:

- *Surveys* – a good method to cover a large number of stakeholders. Responses may be limited by the number of questions in the survey and, other than verbatim statements, input beyond question responses is limited. However, one good way of discerning the importance of survey responses is to measure the respondent's loyalty to the organization. Many surveys use questions to ascertain loyalty such as: (1) Are you satisfied and will return as a customer, (2) Would you recommend the company to others? and (3) Will you acquire additional products and services (Exhibit 9; see Higgins & Young, 2003). Those respondents that answer these questions with the highest score are considered loyal customers. Survey responses are correlated to whether the respondent is considered a loyal customer. Areas of concern for loyal customers should be addressed, or at least considered, when examining ways to improve organizational performance.
- *Interviews* – an excellent method to capture stakeholder concerns and opportunities. Considerably more expensive to conduct than surveys, interviews provide the opportunity for discussion and follow-up questions that allow for greater drilling down to core issues.

In many situations, surveys can be used to identify the major issues facing the organization, followed by interviews to capture more texture around those issues. Capturing information from current, former and competitors' customers will provide invaluable insights as to where opportunities exist.

Linking survey verbatim statements and interview comments to costed activities is a powerful tool to identify the financial impact of stakeholder concerns, as well as identify specific processes and activities



that must be modified. For example, a medium-sized manufacturer of computer components ($100 million in revenues with about 500 employees) captured nearly 850 stakeholder comments which were correlated to organizational activities and cost. This information was then used to identity nearly $8 million in improvements while improving stakeholder satisfaction.

The importance of obtaining stakeholder involvement when organizations are striving to improve financial and operational performance cannot be overemphasized.

LOWER THE COST OF POOR QUALITY

Everything can be improved! With the resurgence of quality programs over the last 15 years – the latest incarnation being several variants of Six Sigma – organizations are seeking profit improvement opportunities by doing things right and routing out the poor quality. Nevertheless, one of the major challenges in any quality program is the identification of quality improvement opportunities. Just how does an organization identify the most opportune areas which will provide the greatest return on investment?

Once organizational activities have been identified and costed, it becomes an elemental process of assigning the activities and their costs to the cost of quality (COQ) categories of prevention, appraisal, internal failure and external failure (Exhibit 10).

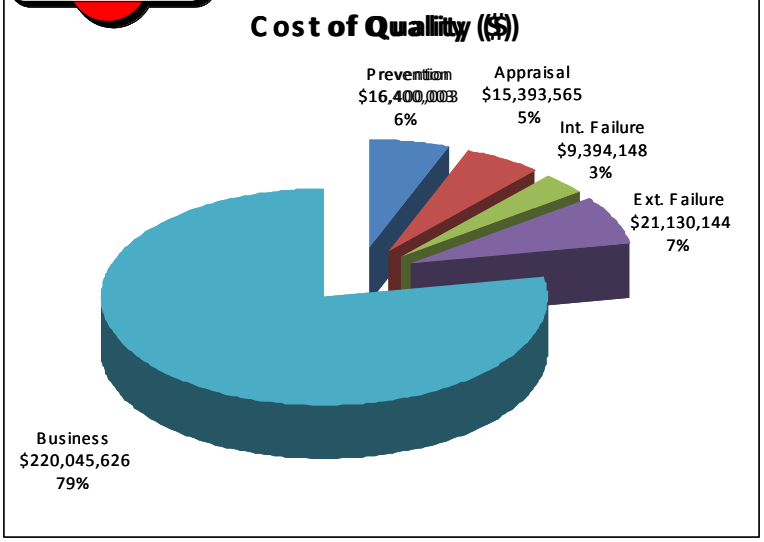
A financial services company undertook an activity costing study where they costed all organizational activities. Once the activities were

Exhibit 10

Cost of Quality Chart

NUMBER	ACTIVITY	PREVENTION	APPRAISAL	INT. FAILURE	EXT. FAILURE	BUSINESS
42	***SUPPORT CUSTOMERS**	N/A	N/A	N/A	N/A	N/A
421	***RESOLVE CUSTOMER ISSUES**	N/A	N/A	N/A	N/A	N/A
4211	Receive/Document Customer Issues				75	25
4212	Transfer Customer Issues				75	25
4213	Research/Resolve Customer Issues				75	25
4214	Document Customer Issue Resolution				75	25
4215	Follow-up Customer Issue Resolution	100				
4216	Process Warranty Status Inquiries					100
4217	***PROCESS NCFS**	N/A	N/A	N/A	N/A	N/A
42171	Research NCfs		100			
42172	***PAY NCFS**	N/A	N/A	N/A	N/A	N/A
421721	Pay NCfs - Goodwill				100	
421722	Pay NCfs - Re-Add (Credits)				100	
4218	Process Customer Cancellations				100	
422	***PROVIDE CUSTOMER SUPPLIES (NON-POS)**	N/A	N/A	N/A	N/A	N/A
4221	Place Customer Supply Requests					100
4222	Deliver Customer Supplies					100
4223	Manage Customer Supply Inventory	100				
423	***SUPPORT CUSTOMER POS NEEDS**	N/A	N/A	N/A	N/A	N/A
4231	Receive Customer POS Issue Notification				100	
4232	***REPLACE EQUIPMENT**	N/A	N/A	N/A	N/A	N/A
42321	Request Customer POS Replacement				100	
42322	Deploy Replacement Customer POS Equipment				100	
4233	Provide Customer POS Training - Update Training	100				
4234	Update Customer POS Software					100
4235	Track Customer Equipment	100				
4236	Move Equipment					100
4237	Return Defective Units				100	
4238	Manage Equipment Inventory	100				
424	Re-Train Customers (Non-POS)	100				
425	***ADMINISTER PAYMENT AT STORE (PAS)**	N/A	N/A	N/A	N/A	N/A
4251	Process Paids					100
4252	Reverse Paids				100	
426	***MAINTAIN CUSTOMER ACCOUNTS**	N/A	N/A	N/A	N/A	N/A
4261	Maintain ID Information					100
4262	Maintain/Validate Banking Information (ACH)					100
427	***BILL CUSTOMERS**	N/A	N/A	N/A	N/A	N/A
4271	Maintain Billing Information (Adjustments)					100
4272	***PRODUCE REGIONAL BILLING**	N/A	N/A	N/A	N/A	N/A
42721	Compile Regional Billing Information					100
42722	Print Regional Invoices					100
42723	Validate Regional Billing					100
42724	Distribute Regional Billing (Mail Services)					100
4273	***PRODUCE NATIONAL ACCOUNT BILLING**	N/A	N/A	N/A	N/A	N/A
42731	Capture National Account Billing Information					100
42732	Apply National Account Pricing/Rules					100
42733	Input/Print National Account Invoices					100
42734	Prepare National Account Billing Detail Reports					100
42735	Assemble/Mail National Account Invoices				100	

Exhibit 11



identified, it was a simple task (refer to Exhibit 10) to assign activity costs to the COQ categories.

In terms of expenses, the cost of quality was $62 million or 22 percent of total spending (Exhibit 11). Although considered very good, note that over $30 million (11 percent of spending) or 481 Full-Time Equivalents (FTEs) (21 percent of effort) was involved in failure costs (Exhibit 12). Given that the cost of quality can be traced back to specific activities, departments and even individual resource costs, numerous specific opportunities for improvement can be identified by concentrating on the high-cost activities that contribute to failures.

IDENTIFY AND REDUCE NON-WORKING MANAGERS

Organizations can no longer afford to engage managers that do not directly contribute to the tangible output of the workgroup – especially at the mid-management and below levels. Nonworking managers often review the work of others but do not directly participate in the creation of work outputs. Managers who delegate all work output to subordinates but do not actively participate in producing output themselves have a detrimental effect on performance. During times of staff contractions, these managers often contribute to declining performance as:

- They that do not play an active role in creating workgroup output or deliverables and cannot adequately empathize with their subordinates as they face increased workloads that may no longer match declines in staffing.
- They are not actively participating in producing work output and cannot effectively evaluate the adequacy of the work processes, tools, and procedures as their information is often secondhand.
- They are often viewed with scorn by employees whose workloads have dramatically increased while that of the manager remains unchanged.

Exhibit 13 is produced from the same system that captured activity costs. Filtering the database elements provides insights related to the activities in which there may not be enough manager participation (circled). As an extension of Step 2, Exhibit 13 identifies the type of employees involved in each activity. This information can be used to identify which types of employees should or should not perform specific activities. For example, when an engineering company faced increased workloads, additional engineers were hired even though about one-third of

Exhibit 12

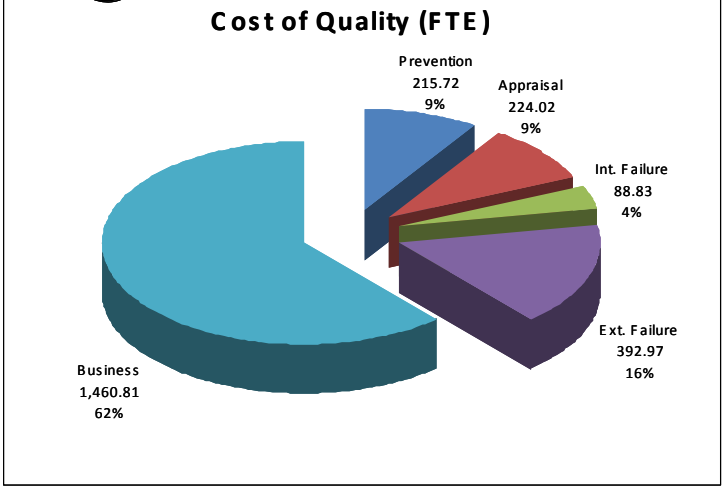


Exhibit 13

Manager Participation

NUMBER	ACTIVITY DESCRIPTION	MGR	IC	SUP	CLK	TOT
4211	Receive/Document Customer Issues	40	353	4		397
4212	Transfer Customer Issues	12	210	2		224
4213	Research/Resolve Customer Issues	70	432	4	6	512
4214	Document Customer Issue Resolution	24	175	2	5	206
4215	Follow-up Customer Issue Resolution	31	190		4	225
4216	Process Warranty Status Inquiries	10	136			146
42171	Research NCI's	16	63		3	82
421721	Pay NCI's - Goodwill	3	73		1	77
421722	Pay NCI's - Re-Add (Credits)	2	74		1	77
4218	Process Customer Cancellations	1	9	1		11
4221	Place Customer Supply Requests	2	64	2	3	71
4222	Deliver Customer Supplies		13		1	14
4223	Manage Customer Supply Inventory	5	12	12	4	33
4231	Receive Customer POS Issue Notification	3	123			126
42321	Request Customer POS Replacement	1	62			63
42322	Deploy Replacement Customer POS Equipment		94			94
4233	Provide Customer POS Training - Update Training	1	69			70
4234	Update Customer POS Software	7	111			118
4235	Track Customer Equipment	6	19	16		41
4236	Move Equipment	2	14			16
4237	Return Defective Units	2	20	6		28
4238	Manage Equipment Inventory	5	15	9		29
424	Re-Train Customers (Non-POS)	1	41			42
4251	Process Paids	4	68	1	13	86
4252	Reverse Paids	5	28	1		34
4261	Maintain ID Information	2	42	2		46
4262	Maintain/Validate Banking Information (ACH)	4	52	13		69
4271	Maintain Billing Information (Adjustments)	9	57	2		68
42721	Compile Regional Billing Information	2	8			10
42722	Print Regional Invoices	2	10			12
42723	Validate Regional Billing	4	9			13
42724	Distribute Regional Billing (Mail Services)	1	9		1	11
42731	Capture National Account Billing Information		10	1		11
42732	Apply National Account Pricing/Rules		1	1		2
42733	Input/Print National Account Invoices		11	1		12
42734	Prepare National Account Billing Detail Reports		20			20
42735	Assemble/Mail National Account Invoices		10	1		11
42741	Print TRS Invoices		1			1
42742	Review TRS Billing		10			10
42743	Produce TRS Checks		10			10
42744	Mail TRS Invoices/Checks		10			10

engineers' time was spent on clerical/administrative activities. A more cost-effective approach would have been to hire less-costly administrative support personnel to supplement the work of more costly engineers.

Sometimes, reduced staffing forces managers to become more directly involved in the work output of the department. If this does not occur, then they must be identified and weeded out or given more tangible work assignments.

REDUCE THE WORK, THEN THE RESOURCES — PERFORM THE RIGHT ACTIVITIES

When faced with an immediate need to reduce costs, many organizations react by implementing quick reductions in personnel resources, leaving the evaluation of the work content and workload to a later time. More often than not, the lack of staff either does not allow for an adequate evaluation of the workload or it doesn't happen at all. As a result, the remaining staff is often saddled with performing the same amount of work that was demanded earlier when the organization had a greater complement of resources. If management was effective when original staffing requirements were determined, performing the same amount of work with less staff often produces undesirable results:

- The quality of work output declines as time to perform each task is reduced in accordance with the reduced staffing levels. Often, these declines in execution frequently manifest themselves in lower organizational performance. In turn, lower organizational performance is often addressed with further reductions in staff creating a downward-spiraling effect on performance. It is commonly observed that organizations that cut resources without an appropriate reduction in work content will reduce staff again within six to nine months. This response will continue until the organization discovers that such cuts have severely hampered the organization's ability to effectively compete.
- The remaining employees, in an effort to protect their jobs from further cuts, will attempt desperately to keep up with the additional demands on their time. Making this even more difficult is that employees may not be adequately trained to take on new responsibilities resulting from vacated staff positions. A natural outcome is to increase the work day from 8-10 hours to 10-12 hours, further

demoralizing the staff, as these longer hours become the expected norm. As employees become "burnt out," they seek opportunities elsewhere often to the detriment of the organization if, under revised hiring policies, replacement employees cannot be hired.

Under the pressure of compressed work schedules and perhaps under the threat, either imagined or real, of further job cuts, employees tend to guard their "turf." Teamwork – at a time when teamwork is most important – suffers as employees become more protective of their jobs as survival becomes paramount.

There are numerous negative outcomes that can occur when resources are cut before the work is reduced. The key question is how does one determine what work should be reduced or eliminated? There are a number of tools and techniques that will help identify the work that can be reduced or eliminated to match the desired staffing levels. These techniques preserve the quality of output for the important work that must be performed by the workgroup.

Exhibit 15

Financial Service Organization's Relevance Report

NUMBER	ACTIVITY	RELEVANCE
42	***SUPPORT CUSTOMERS**	**N/A**
421	***RESOLVE CUSTOMER ISSUES**	**N/A**
4211	Receive/Document Customer Issues	3
4212	Transfer Customer Issues	3
4213	Research/Resolve Customer Issues	8
4214	Document Customer Issue Resolution	6
4215	Follow-up Customer Issue Resolution	6
4216	Process Warranty Status Inquiries	4
4217	***PROCESS NCI'S**	**N/A**
42171	Research NCI's	7
42172	***PAY NCI'S**	**N/A**
421721	Pay NCI's - Goodwill	3
421722	Pay NCI's - Re-Add (Credits)	2
4218	Process Customer Cancellations	4
422	***PROVIDE CUSTOMER SUPPLIES (NON-POS)**	**N/A**
4221	Place Customer Supply Requests	10
4222	Deliver Customer Supplies	10
4223	Manage Customer Supply Inventory	8
423	***SUPPORT CUSTOMER POS NEEDS**	**N/A**
4231	Receive Customer POS Issue Notification	8
4232	***REPLACE EQUIPMENT**	**N/A**
42321	Request Customer POS Replacement	8
42322	Deploy Replacement Customer POS Equipment	10
4233	Provide Customer POS Training - Update Training	4
4234	Update Customer POS Software	10
4235	Track Customer Equipment	8
4236	Move Equipment	8
4237	Return Defective Units	10
4238	Manage Equipment Inventory	8

Activity Scoring

A simple, yet very powerful, tool is to score the activities in terms of relevance to the organization. When examining the activities on a companywide basis, it is useful to think about the relevance that the activity contributes to the success and strategy of the business (Exhibit 14; see Higgins & Young, 2003). Each activity can be scored in terms of their relevance.

Exhibit 14

Measures of Relevance — Organization-Wide

10 – Contributes to Market Dominance
8 – Significantly Relevant
6 – Moderately Relevant
4 – Maintains Status Quo
2 – Marginally Relevant
0 – Non-Productive

Each activity is assessed and a score assigned to help segment the activities into categories that might draw attention to those activities that do not align with the goals and objectives of the business. Those activities that do not align with what the business should be doing are identified for reduction or elimination.

When scoring activities, it is often helpful to obtain cross-functional inputs to gain a consensus regarding which activities can be earmarked for reduction or elimination. Exhibit 15 is an excerpt from a financial services organization as they assessed the relevance of the activities associated with providing customer support.

Receiving and transferring customer issues has been given a low score by the management team as efforts in these areas are not to be expanded – in essence, it goes without saying that the organization does not wish to do more of these types of activities. Conversely, providing replacement point-of-sales (POS) equipment to the customer base is rated very high as the goals of this organization were to be the leaders in their market with respect to driving customer loyalty.

Exhibit 14 is a useful tool for evaluating organization-wide activities. The same principle, however, can be applied at the functional or department level (Exhibit 16; see Higgins & Young, 2003).

In this case, departmental activities should be scored in terms of the contribution or relevance to the goals and objectives of the department. In times where staff reductions may be mandated, such an evaluation is a logical first step to reduce and/or eliminate those activities that simply do not contribute to the success of the department.

Exhibit 16

Measures of Relevance — Department Level

10 – Essential to Goals & Objectives Attainment
8 – Highly Relevant to Goal Attainment
6 – Moderately Related to Goal Attainment
4 – Maintains Status Quo
2 – Insignificant Contribution to Objectives
0 – Non-Productive

Exhibit 17

Measures of Performance

10 – Performed Perfectly (Rare Score)
8 – Performed Well
6 – Performed With Few Problems
4 – Known Problems Exist
2 – Unreliable
0 – Awful

- Identify high-cost activities that have a low relevance scores. No matter how well the activity is performed, it adds little value to the success of the organization or department and should be a target for reduction or elimination. Once the activity has been reduced or eliminated, then reduce the resources that were required to perform the activity.
- Identify the highly relevant activities that are not performed adequately. These activities must be modified to improve performance if the organization is to prosper. Employ process improvement techniques to improve performance. In many cases, liberated resources from low-relevance activities can be re-deployed to enhance the performance of more relevant activities. Performing the right activities right is often the most cost-effective manner in which to operate.

PERFORMING THE RIGHT THINGS RIGHT

It is not only essential to perform the right things, but to perform the right things right. A natural extension to the previous step is to assess how well the department performs the necessary activities. Adding the dimension of performance to activity scoring provides the means by which underperforming activities are identified (Exhibit 17; see Higgins & Young, 2003). Unfortunate reductions in staff are not permission to carry out the responsibilities of the department in an unacceptable manner. Clearly, to avoid any future reductions in staffing, all required activities must be carried out with the highest quality.

A provision in the activity costing system described earlier allows for relevance and performance scoring. Exhibit 18 shows that although there are a number of highly relevant activities – requirements for success – they are not performed in an adequate fashion. Unless the execution of these activities is improved, performance may continue to decline, accompanied by additional staff reductions as an unfortunate and misguided solution.

Once activities have been costed and scored in terms of relevance and performance, the information can be segregated to identify areas of opportunity in terms of cost management as well as performance improvement.

Exhibit 18

Relevance and Performance Scoring

NUMBER	ACTIVITY	RELEVANCE	PERFORMANCE
42	***SUPPORT CUSTOMERS**	**N/A**	**N/A**
421	***RESOLVE CUSTOMER ISSUES**	**N/A**	**N/A**
4211	Receive/Document Customer Issues	3	6
4212	Transfer Customer Issues	3	8
4213	Research/Resolve Customer Issues	8	3
4214	Document Customer Issue Resolution	6	5
4215	Follow-up Customer Issue Resolution	6	4
4216	Process Warranty Status Inquiries	4	4
4217	***PROCESS NCI'S**	**N/A**	**N/A**
42171	Research NCI's	7	6
42172	***PAY NCI'S**	**N/A**	**N/A**
421721	Pay NCI's - Goodwill	3	8
421722	Pay NCI's - Re-Add (Credits)	2	8
4218	Process Customer Cancellations	4	8
422	***PROVIDE CUSTOMER SUPPLIES (NON-POS)**	**N/A**	**N/A**
4221	Place Customer Supply Requests	10	6
4222	Deliver Customer Supplies	10	3
4223	Manage Customer Supply Inventory	8	6
423	***SUPPORT CUSTOMER POS NEEDS**	**N/A**	**N/A**
4231	Receive Customer POS Issue Notification	8	6
4232	***REPLACE EQUIPMENT**	**N/A**	**N/A**
42321	Request Customer POS Replacement	8	7
42322	Deploy Replacement Customer POS Equipment	10	5
4233	Provide Customer POS Training - Update Training	4	6
4234	Update Customer POS Software	10	6
4235	Track Customer Equipment	8	5
4236	Move Equipment	8	6
4237	Return Defective Units	10	4
4238	Manage Equipment Inventory	8	6

A case in point: a financial services company discovered that nearly $10 million per year can be saved and/or redeployed to more relevant activities after discovering that customer service activities were performed within the sales function. Through this type of analysis, it was discovered that such activities were not pertinent to their mission of "generating revenue," as such activities were duplicated in other parts of the organization. As a result, revenues jumped (15 percent in the first six months), customer churn was reduced, and the sales force was more energetic, as they were compensated on

revenues/profits obtained rather than on customer service provided.

ELIMINATE ACTIVITY FRAGMENTATION

Fragmentation of activities has the same effect as fragmentation of the hard drive on a computer – neither operates at peak performance. But what is fragmentation? Organizational fragmentation occurs when significantly more employees are involved in an activity as compared with the effort expended. Although there are some activities designed to be fragmented — such as managerial or supervisory tasks — fragmentation can be a drain on organizational performance, driving costs upwards while performance slips.

Another aspect of fragmentation that often goes unnoticed is the inability to realize savings from process improvements. That is, if many employees only spend a small fraction of their time performing a process or activity, process improvements may only affect a very small portion of a significant number of employees' time. Although reductions in those small portions of employee's time might make slight improvements in the capacity within the organization, staffing levels cannot be affected and bottom-line savings will not be realized. More concentrated efforts by fewer people who specialize in the performance of an activity provides more ownership, greater efficiency, and process improvements will have a more demonstrable impact on bottom-line performance.

For example, after an evaluation of the activities, a large service company discovered some interesting opportunities associated with fragmentation (Exhibit 19).

Exhibit 19

Activity Fragmentation

NUMBER	ACTIVITY DESCRIPTION	TOTAL	FTE
2315212	Determine Pricing	313	13.05
2312	Qualify Merchants	308	16.27
231511	Create/Complete Standard Contracts	301	8.16
231522	Construct Custom Contracts	25	1.75

Of concern was the number of unprofitable contracts that were entered into with customers. It was thought that pricing was centralized so pricing could be controlled. It was discovered that over 300 of the sales force personnel were directly involved in setting prices. Not only was this activity highly fragmented, but it was misplaced and a major cause of a number of unprofitable deals. Upon learning of this situation, the pricing activity was restructured, centralized, and operated under strict policies and controls. As expected, pricing and profitability improved as was demonstrated by a significant bottom-line impact.

REDUCE NEGATIVE DRIVERS

Work drivers are the circumstances such as decisions, transactions, policies, procedures, plans, organization structure, outside influences or dependencies, system measurements or any other circumstances that causes people to do work and expend funds. Some work drivers are positive (sales orders, etc.) or negative (rework, etc.).

There are two types of work drivers micro and macro. For example, an insurance claims processing center receives a number of claims per day and must respond within a contractual specification of 24 hours. In this case, the workgroup is subject to two work drivers, (a) the receipt of claims and (b) the processing of those claims must be made within a specified period of time, which may cause additional staffing and/or overtime. Such work drivers are often referred to as micro-drivers as they cause work to be performed only within a specified department.

On the other hand, macro drivers are greater issues or larger causes of work and cost. Additional probing regarding the micro-drivers may reveal the macro-drivers that pose a greater opportunity for improvement. In the previous example regarding the claim processing company, each insurance client was allowed to specify its turnaround or response time. The macro-driver was a policy, or lack of policy, that allowed each client to independently specify their desired turnaround time period. If the turnaround time was individually negotiated with consideration given to available staffing levels, a more uniform flow of work could have been established — reducing overtime expense while still meeting customer expectations.

Another driver of cost is the organization structure itself. A large merchant service company that grew by acquisition learned that they had numerous sales offices with overlapping territories. Additionally, each office had slightly different interpretation of policies and procedures with respect to order completion and processing. Dramatic improvements in performance and costs were achieved by restructuring dozens of smaller offices into only a few "super sales centers" that had clearly defined territories.

The steps to reduce or eliminate negative cost drivers are straightforward:

1. Identify the work drivers that contribute to unnecessary and/or avoidable costs and effort.

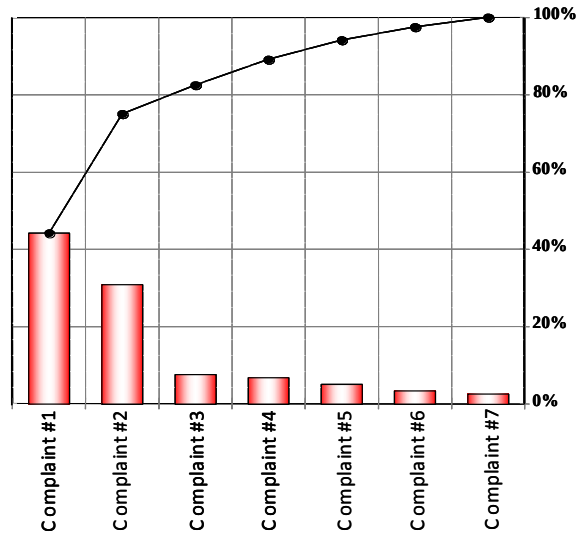
Once the drivers have been identified, estimate the impact that those drivers would have on expenses and effort expended. Also, identify the organization's ability to modify and/or reduce those work drivers to affect an improvement in financial and/or operational performance.

2. Identify those work drivers that would have the greatest impact on the organization and, if controlled, the most potential for affecting the performance of the organization. If such drivers can be changed and contain opportunity for significant improvements in performance, they should be earmarked for corrective action.

For example, if customer complaints are both causing customer churn and driving effort and expense throughout the organization to mitigate those complaints, the cause or type of complaints should be identified (Exhibit 20). Once identified, a Pareto analysis should be performed to identify the most significant complaints. Then identify the remedial action required to reduce those complaints starting with the most prevalent complaint. Don't expect to remove 100 percent of any complaint category, but closer to 75 percent to 80 percent — then work on the next most prevalent complaint. Once the top 80 percent of the complaints (work drivers) have been addressed, then recycle back to work on the next 80 percent of the work drivers.

Exhibit 20

Pareto Analysis



Keep in mind in this example that the customer complaints may not represent the root cause or root driver of expense, and further research and discovery may be required to uncover the underlying cause, which is the ultimate solution to the problem.

SET THE RIGHT PRICE

Often overlooked when organizations seek to improve financial performance is the pricing of their products and services. Unfortunately, too many companies unknowing price their products and services sub-optimally or at a loss. Therefore, the quickest often easiest way to improve the bottom-line may be to simply modify prices. Often pricing is established in the absence of accurate cost information and resulting market acceptance. Costing and pricing are tightly integrated and each must be carefully computed to ensure profitable growth. There are typically three outcomes associated with the relationship between costing and pricing:

- Over-priced products and/or services may lower revenues as the market gravitates towards more price-competitive alternatives (e.g., in-house, outsourced or competition).
- Under-priced products may generate additional revenues with lower margins.
- Optimum pricing correctly balances costs, revenues and profitability — creating the "sweet spot" that optimizes financial performance.

When pricing a product or service, it must be done right. Optimum pricing is a concept based on the precept that products and services should be priced and differentiated on the basis of the value or worth to the consumer. The value or worth to the consumer is determined by considering a number of factors that together constitute perceived value. Once perceived value is determined, pricing can be optimized. Exhibit 21 illustrates this concept

As the example in Exhibit 21 illustrates, of the four options analyzed, the third option produces a 17 percent improvement in revenue along with a 14 percent reduction in volume, thus increasing capacity as well as profitability. It must be noted that the optimum price may be lower than the current price, so careful analysis is required to determine the best price point. Additionally, when organizations are facing capacity constraints, raising prices, which may result in lower volume, may be a more profitable alternative than investing the capital necessary to increase capacity.

Exhibit 21

Pricing Analysis

Factor	Present	Option 1	Option 2	Option 3	Option 4
Price Options	$27	$31	$35	**$37**	$39
Estimated Volumes	140,000	139,000	128,500	120,000	98,500
Total Variable Costs	$2,800,000	$2,780,000	$2,570,000	$2,400,000	$1,970,000
Collected Revenues	$3,780,000	$4,309,000	$4,497,500	$4,440,000	$3,841,500
Contribution Margin ($)	$980,000	$1,529,000	$1,927,500	$2,040,000	$1,871,500
Contribution Margin (%)	26%	35%	43%	46%	49%

DO IT AGAIN!

As with any improvement initiative, the process must be reviewed and repeated at least on a yearly basis. Business conditions change, costs change, and other factors affecting performance change. Unfortunately, as companies prosper, they often become lax with regard to keeping the improvement momentum going. We have all read articles about companies that have been recognized for their success but later succumb to disappointing failures. Continuous improvement is not easy and becomes more difficult when times are good, but it is an unrelenting battle to achieve and maintain success.

GIVE 20 PERCENT MORE

As companies and departments improve their efficiency and effectiveness, strive to achieve 20 percent more on all fronts – 20 percent more in value-creating output, customer satisfaction, revenues, cost savings, and so on. The effort will be well worth it.

Based on the application of these 13 steps, users of these principles have averaged over $6 million per 1,000 employees in financial improvements which is equivalent of 5-10 percent of revenues in annualized repeatable improvements. These results can be achieved while improving customer loyalty and employee satisfaction.

REFERENCES

Higgins, B. K. & Young, S. M. (2001). Improving Operations: Not as Simple as ABC. The Journal of Corporate Accounting & Finance, 12(3), 15-34.

Higgins, B. K., & Young, S. M. (2003). Performance Excellence Through Activity Value Management. The Journal of Corporate Accounting & Finance, 14(3), 23-36.

Brian Higgins is president of Management Resource Technologies, Ltd., in Aurora, Colorado. He can be contacted via e-mail at mrtinfo@MRT-Ltd.com. **S. Mark Young** is Professor of Accounting at the Marshall School of Business, University of Southern California, Los Angeles, California. He can be reached via e-mail at mark.young@marshall.usc.edu.