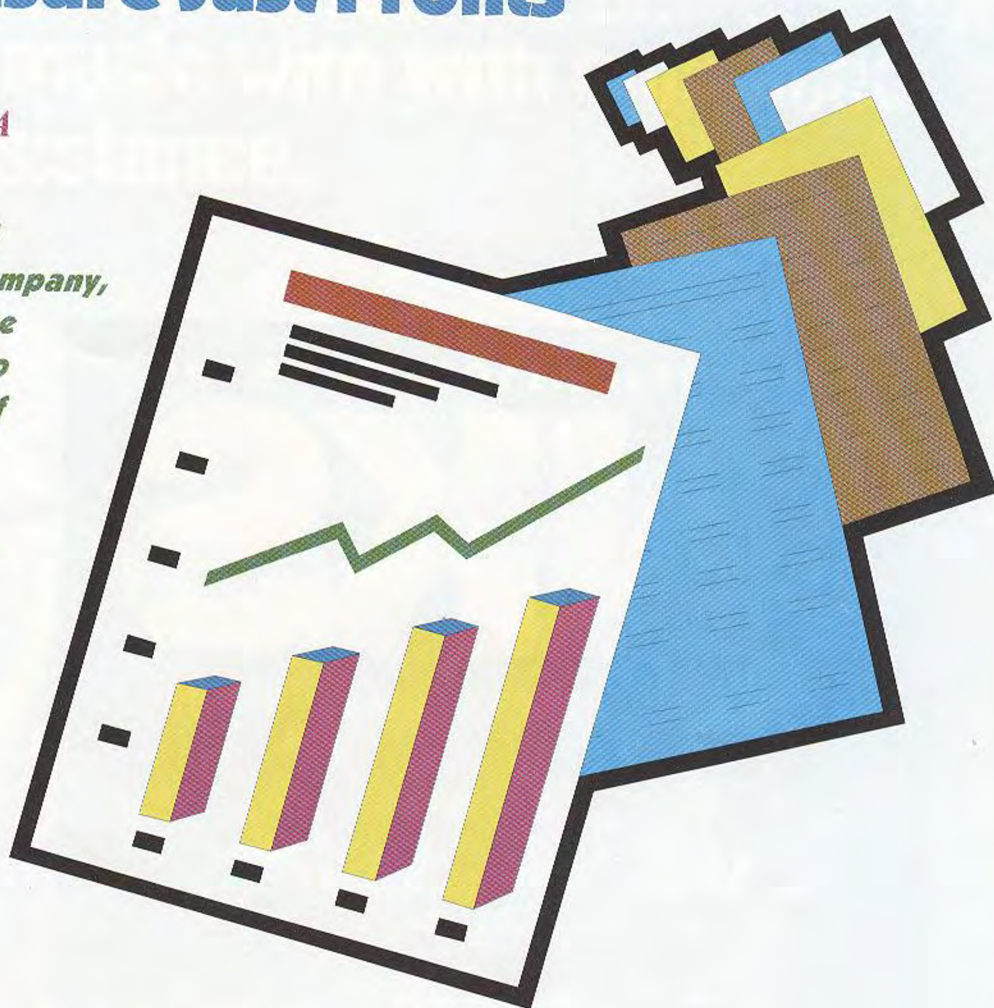
Don't Measure Just Profits

By Gary D. Zeune, CPA

To determine the actual performance of your company, you must get beneath the accounting numbers into the "whys and "hows" of the process. The key to business success is to develop measurements of internal efforts that boost customer satisfaction and loyalty, and hence drive company profitability.



How long do you stand in line at a "fast food" restaurant before you get irritated? Most people would say that they can wait four or five minutes for their food. That's not true. Next time you stop at your favorite fast food restaurant, look at your watch when you get in line and look again when you have that first thought of "Hurry up!" Now think of the last time you made a call using a rotary dial phone. How long does that take? About a year, or so it seems. As Tom Peters says, we live in a nanosecond society. The U.S. Postal Service wasn't fast enough or reliable enough, so we have Federal Express. Fed Ex isn't fast enough, so now we use fax machines and e-mail.

What business are you in? Write it down in this space: ______________________________

That's wrong. Whatever you wrote in the space is what you "do." The business you are "in" is to solve your customers' problems. It doesn't make any difference what your expertise is or how many bells and whistles your product or service has; if it doesn't solve your customers' problems, they won't do business with you.

A personal example: Homeowners in central Ohio, where I live, are fastidious about their lawns. Many of us have our lawns treated with a fertilizer/weed killer combination. I'll call my lawn care company A-1 Lawn Service. Last spring, A-1 completed the first treatment of my lawn in early April. When I didn't pay the bill, George, the owner, called. I told him the grass was growing fine, but the weeds were growing better. He replied that he guaranteed his work and would treat my yard a second time free of charge. That was acceptable, since I figured his shop simply forgot the weed killer in the mix. But when I didn't pay after the repeat – free – treatment, the owner called again. I told him the weeds still were merrily growing along with my grass. He replied, "But I fulfilled my guarantee. I sprayed your lawn a second time at no charge." He never understood that his job was to solve my problem – I wanted green grass and no weeds.

It's like a salesperson telling a homeowner how great his grass seed is. Does the owner care about the grass seed? No. The homeowner only cares about how the lawn will look. Most salespeople never get it. Tell the customer about how

good the lawn will look; not about the grass seed. Talking about how good the lawn will look is an external focus – the customer's. Talking about the grass seed is an internal focus, and the customer doesn't care.

In the lawn service example, George focused on his effort; I focused on the results. I didn't care how much effort it took. His was an internal view, of what he did and the effort expended. Mine was an external view, of the results.

The Nature of Modern Competition

The basis of competition has changed dramatically in the last 20 years. Response time has shortened, while quality and variety have increased exponentially. Response time is the competitive weapon of the next 10 years.

Twenty years ago, you could have any two of the three variables of response time, quality, and variety, but not all three. But Japanese competitors have shown that it is possible to have all three. In the 1970s, world-class companies were the low-cost producers. In the 1980s, they were leaders in quality. In the 1990s, speed to market became paramount, and cost and quality could be traded off as secondary variables.

What will be the basis of competition 10 years from now? My bet is on "mass customization," or the ability to customize a standard product on demand. Mass customization solves the paradox of business. Remember your college marketing class? Your professors talked about giving customers many choices. But customers don't want a lot of choices anymore. Customers want it the way they want it. For example, in its Personal Pairs program, Levi's can make custom-made jeans in more than 10,000 configurations of size, material and style, Fed Ex'd to your door in less than two weeks from the Mountain City, TN, plant. When customers need additional jeans, no need to go to the store. Just call Levi's and read the bar code number sewn into the waistband. That's manufacturing on demand. Right now, manufacturing on demand is a competitive advantage. In the next 10 years, it will become the minimum capability to play the game of business.

State-of-the-Art in Performance Measurement

Financial managers are taught to measure corporate performance by the numbers: sales numbers, expense numbers, profit numbers, asset and liability numbers, headcount numbers, market share

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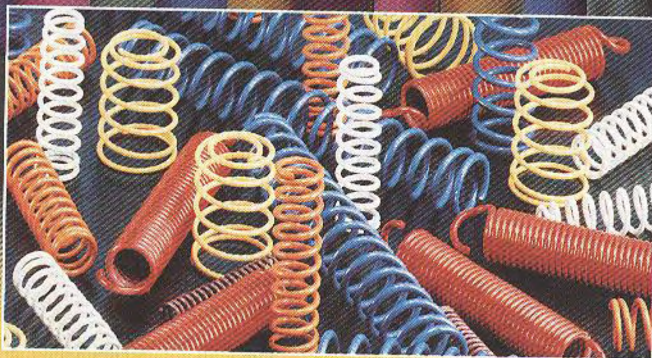
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"Giving your competitors your most unprofitable customers is one of your most potent competitive weapons"

numbers, and on and on. But this traditional quantitative approach doesn't tell the whole story in today's business environment. When the company makes the product only when the customer orders, the real value isn't in the bricks and mortar or finished goods inventory (because there isn't any). The value of today's business is in the ability of the employees to do the job right, the first time, with no defects. In a world-class company, there is no such thing as an acceptable level of scrap. In mass customization, finished goods inventory is a liability. Why? Because you make the product, then send salespeople out to sell it, even if the product isn't what customers want.

In short, we need non-financial methods to measure business performance that take into account how well the enterprise has satisfied its customers' needs. Today, we measure performance in meeting customer's needs only by the implications of poor profit numbers. By the time the poor customer satisfaction shows up in the bottom line, it's too late. The customer is lost. Probably forever. Thus, we need a more direct series of measurements that don't depend on accounting reports to tell us whether we're meeting our business goals.

Tie Performance Measurement to Consumer Satisfaction

The key is to develop measurements of internal efforts that drive customer satisfaction, and increase customer loyalty and company profitability. Several years ago, a large international company that takes most of its orders over the phone wanted to improve customer service to increase its market share. At the time, the order takers answered 85 percent of incoming calls by the third ring, a rate that was considered exemplary. The conventional wisdom was that the answer rate could be increased by one to two percent annually. Then someone asked, "What if that isn't good enough?"

To find out, the company could have conducted mail, phone or face-to-face market surveys, which measure attitude Instead, the company decided to measure customer behavior rather than attitude, because behavior and attitudes frequently are not the same. A "black box" was installed on the company's phone system. The company found that 10 percent of the callers were hanging up if the phone wasn't answered by the third ring! What's it called when a customer hangs up and gives up the attempt to do business with you? LOST REVENUE. Financial managers are very good at measuring what's there but terrible at measuring what should be there but isn't — a sale gone forever.

Now, a test: How often does the phone ring? In most telephone systems, it rings about every three or four seconds. How would you like to have the opportunity to increase revenues 10 percent by reacting 10 seconds faster? The company tracked the flow of phone calls by time of day, day of week, week of month and month of year. Using the data, the company was able to staff for the flow of phone calls. Now the company answers over 98 percent of its incoming calls in three rings.

A second part of the international company's study was focused on the order rate when an order-taker didn't know the answer to a customer's question about a product. The company found that the order rate declined 50 percent each time an operator had to find the answer and call the customer back. So, if the customer had to be called twice with answers, there was only a 25 percent chance of getting the order. Why? By that time, 75 percent of the customers already had called a competitor and placed the order, many times at a higher price for a lower quality product. In other words, it was more important for the customer to cross that item off the "to do" list than to wait a day for a call-back with the answer.

To capture orders on the first call, the company reconfigured the layout of its order processing department: The supervisors were put in the middle of their respective areas, and the order takers were placed around the supervisors' desks like the spokes on a wagon wheel. Now, the order takers get immediate answers to their questions and capture virtually 100 percent of customers' orders.

Measuring Customer Satisfaction through Performance

The problem with financial statements is that they are lagging indicators of performance, not leading indicators. Financial statements are results-oriented, not process-oriented. Nonfinancial performance measures evaluate the key success factors that drive the financial results.

Think of business as a baseball game. If you want to know *who* won the game, look at the scoreboard. However, if you want to know *how* they won the game, you have to have watched it happen. If you're the losing team and want to win the next time, you can't succeed by watching the scoreboard. You have to learn how to hit, catch, field and pitch better. In other words, you must get better at the processes of playing the game.

Several years ago, I had a client that supplied marine paint to boat repair shops. In the early 1990s, the economy was weak, and the owner was fighting for a larger slice of a shrinking pie. The owner told me that, because of the poor economy, he had to compete based on low price. When I asked him how he knew that, he replied that he had been in business for 25 years and knew his customers' minds; and besides, that was how his competitors competed against him. Having locked him into his answer, we commissioned a small survey of boat repair shops, including customers and noncustomers, and found that the element of cost was way down on the list of important competitive factors. Speedy

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delivery was, by far, the most important element; when a shop pulled a boat in for repairs and found it didn't have the paint to do the job, a couple of extra dollars a gallon for paint paled in comparison to the money wasted waiting for the paint to be delivered or to tow the boat to the holding lot and bring it back later.

The next step was to analyze the client's sales pattern. The client carried about 150 colors of paint. We found that 20 percent of the colors, about 30, accounted for 80 percent of the sales. Knowing those two facts allowed us to put together a winning strategy. The owner bought two additional delivery vans, stocked each one with two gallons of each of the 30 flavors, installed cellular phones, raised prices, guaranteed delivery within 30 minutes (or the first two gallons were free), mailed out flyers to all the repair shops in his market territory, and laughed all the way to the bank.

The key to profitability is to measure the right information, which many times is not readily apparent. Finance and accounting professionals are very good at measuring what's evident and exactly quantifiable, even if it's not very relevant. However, it's much better to be approximately right than exactly wrong.

What's the definition of a world-class manager? Someone who can make crystal clear decisions based on highly ambiguous information. Nobody cares about computing depreciation on a 5-year-old asset, CEOs want insight, not just information. CEOs want to know the value of keeping an "A list" customer for 10 years

Financial managers today challenge conventional wisdom. In 1988, Xerox began monthly surveys to find out what customers really wanted. Customers were asked to rate Xerox on a scale of 1 (very dissatisfied) to 5 (very satisfied). The goal was to have all customers rating Xerox at the 4 or 5 level by 1993. In 1991, after surveying nearly 400,000 customers, Xerox analyzed the results. Conventional wisdom held that the relationship between customer satisfaction and revenue was one-to-one: Customers giving a 5 rating would buy 25 percent more Xerox equipment than a customer giving a 4 rating. However, Xerox found that very satisfied customers (5s) were six times more likely to buy more Xerox equipment than merely satisfied customers (4s). As a result, Xerox focused its efforts on creating "apostles" – customers that are so satisfied that they virtually become part of the sales force, touting to others how satisfied they are.

What kind of non-financial performance measures might Xerox track? Let's assume that the copier repair unit's revenue declined 10 percent, and costs were up 15 percent in the last quarter. No amount of analyzing the financial statements will reveal why. Only when the work orders are analyzed will the reasons for this dismal performance become apparent. For example, repair persons spent, on average, 15 minutes more than planned on each call, making them late for the next call, resulting in a decrease in customer satisfaction. Customer retention then declined as they sought out third-party repair services. Digging deeper, you find that 80 percent of the overruns on repair time were committed by 20 percent of the repair people, 90 percent of whom had been with the company less than 12 months and had attended XYZ training school, which adopted a new training methodology 18 months ago. . . If you are in a service business, measure the "call-back" rate. Then, do "root-cause" analysis to get to the bottom of the problem.

At the same time, Xerox wanted to avoid terrorists – customers that are so unhappy that they complain to anyone who will listen. What's the answer? Fire your customers! Retain only those customers that generate high returns. How do you identify those to be fired and those to be retained? Answer: Treat each customer as an investment center and compute Return on Customer (ROC). Stop focusing only on sales revenue; not all customers are equally profitable. You aren't in business to generate revenue; you're in business to generate profits. With ROC, you can reduce revenue and increase profits by analyzing each customer's total profitability. That means tracking the below-the-line cost of serving each customer. If yours is a typical American company, you are likely to find that 20 percent of your customers provide 80 percent of your profits, the middle 60 percent provide 30 to 40 percent of your profits, and you lose your shirt on the bottom 20 percent of your customers. Your most unprofitable customers are very price-sensitive, willing to endure long waiting times, and demand a disproportionate amount of support services and staff time, which, in most companies, isn't tracked to specific customers. Determining exactly where profits come from uncovers this relationship.

But how do you fire your customers? Raise prices. Then one of two things will happen – either they will pay the increased prices, making them profitable customers or, more likely, they will refuse and become someone else's profit drain. Either way, you're happy. Think about it: Giving your competitors your most unprofitable customers is one of your most potent competitive weapons.

Don't Automate – Obliterate

In addition to using them as a competitive weapon, non-financial performance measures can be used to streamline the finance and accounting functions. In a joint project, the American Institute of CPAs and The Hackett Group, a Cleveland-based consulting firm, have benchmarked the best practices in finance and accounting departments. They have found that the differences between the best and the average are amazingly large. But the real key to these measures is

The Hackett Group Benchmarking Study, Selected Summary Results

Payroll: Digital Equipment Corp.

	DEC	Average
Labor/check	$1.04	$2.56
No. of paychecks/FTE	108,000	17,436
Paycheck volume	3,294,000	708,695
Cost/revenue	.044%	.068%
Staff/$1 billion sales	3.9	18.5

Features of System:

- Single location of payroll processing.
- Standard weekly pay cycle.
- Remote on-line time entry.
- Automatic transfer to A/P.
- Employee phone system for earnings and direct-deposit enrollment.
- Automatic bank prenotification of direct deposits.

Accounts Receivable Processing: Eastman Kodak Inc.

	Kodak	Average
Labor remittance	$.94	$2.35
No. of remittances/FTE	46,950	28,499
Remittance volume	1,770,000	1,293,670
Cost/revenue	.029%	.094%
Staff/$1 billion sales	6.5	34.2

Features of System:

- Electronic transfer of bank remittances to accounts receivable system.
- Electronic posting of 80% of remittances.
- Automatic write-off of short pays within established tolerances.
- Automatic matching of credit memos to invoices.

Accounts Payable: Electronic Data Systems

	Before Re-engineering	After Re-engineering	EDS	Projected Average
Labor remittance	$4.96	$2.68	$1.20	$3.00
No. of invoices/FTE	9,610	14,800	25,000	12,541
Invoice volume	2,100,000	2,100,000	2,000,000	650,663
Cost/revenue	.16%	.09%	.04%	.095%
Staff/$1 billion sales	48.1	22.1	11.0	30.4

Features of System:

- 77 percent cost reduction since 1991.
- Single, centralized system for processing all US payables.
- Electronic notification of receipt of materials.
- On-line sundry invoice systems for remote data entry.
- Automatic payment of recurring transactions.
- Pay on receipt for material purchases with POs, no invoice needed.
- Automatic routing for notification and approval of sundry invoices.
- Electronic setup,expense distribution and payment for large vendors.

Travel and Expense: Allied Signal, Inc.

	Before Re-engineering	After Re-engineering	Average
Labor/remittance	N/A	N/A	$6.84
No. of remittances/FTE	4,389	19,170	7,704
Invoice volume	130,359	130,359	62,897
Cost/revenue	N/A	N/A	.019%
Staff/$1 billion sales	4.5	1.0	5.4

Features of System:

- Consolidated T&E processing at single site.
- Eliminated traditional expense report for credit card purchases.
- Replaced approvals with statistical audits.
- Replaced manual on-site cash advances with credit cards.
- Corporate sponsored employee liability credit card.
- Direct payment of validated credit card expenses.

Source: The New Blueprint for Finance, CFO: The Magazine for Senior Financial Executives, June 1993

how the work is done. World-class companies don't simply automate the work and do it faster. They do it in a completely different way by analyzing every step of every process and eliminating steps that don't add value. World-class companies resist the temptation to automate inefficient work. World-class companies:

1. understand (the processes and what's important to customers)
2. simplify (the work to become more efficient) and only then
3. automate

Consider the payment of vendor invoices. The customer mails a purchase order to a vendor. When the goods arrive, a receiving report is generated and sent to accounts payable; and when the vendor's invoice arrives, the accounts payable staff matches the invoice, PO, and receiving report.

Question: If the PO contains all the requisite detail, and a receiving report matches the PO, why is the vendor's invoice needed? World-class companies such as Ford Motor Company no longer use vendor invoices for materials purchases. As a result, Ford has been able to reduce head count in its accounts payable department by more than 75 percent, and has more reliable information to boot. Rather than matching POs and receiving reports in the accounts payable department two or three or four weeks after the goods have been received, the receiving information is entered into the computer tracking system upon arrival (usually through scanning bar codes and the use of EDI for advance ship notices) and automatically matched. Any discrepancies between the purchase order and receiving document are handled immediately while the materials are still on the dock. The payoff in efficiency is enormous. To achieve this kind of system, management must be willing to undertake fundamental change and not be blinded because, "That's the way we've always done it."

Some results from the Hackett/AICPA benchmarking study, along with the techniques the companies use to achieve them are shown in the box nearby.

Conclusion

There you have it: The accounting numbers seldom tell the full and necessary story. Financial managers must get beneath the accounting numbers into the "whys" and "hows" of the processes in order to measure the actual performance of the company. By evaluating the processes that generate the results, the financial manager will have a much clearer and more reliable set of metrics with which to measure corporate performance. Many financial managers fear losing their value by measuring non-financial performance measures. However, just the opposite is true. By learning how to measure the processes that "drive" the financial statements, the financial manager becomes a more valuable member of the management team.

Gary D. Zeune, CPA, is a Columbus, Ohio-based consultant who specializes in strategic and financial consulting. This article was adapted from Zeune's training course on Nonfinancial Performance Measures, which was presented at the Spring Manufacturers Institute Spring Meeting in Hilton Head, SC, in April 1998. Zeune may be contacted via e-mail at gzfraud@bigfoot.com or by phone at (614) 885-0262. ❖