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Measuring Nonfinancial Performance for Competitive Superiority

Gary D. Zeune

Analyses of financial statements do not always reveal all the factors that are involved in determining profitability. Many businesses are finding that nonfinancial performance measures, particularly those which address customer satisfaction, can show a direct causal relationship between business procedures and goals.

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, but they're kidding themselves. If you don't think so, look at your watch the next time you get in line and look again when you have that first thought of "Hurry up . . . get your food and sit down."

Have you had to make a call in the last year using a rotary dial phone? How long does that take? As Tom Peters says, we live in a nanosecond society. The United States Postal Service wasn't fast enough or reliable enough, so we have Federal Express. "Absolutely positively overnight" isn't fast enough, so now we use fax machines, and e-mail.

What business are you in? Write it down on a piece of paper.

That's wrong. Whatever you wrote on the piece of paper is what you "do." The business you are "in" is to solve customer problems. It doesn't make any difference what your expertise is or how many bells and whistles your product or service has. If you don't solve the customers' problems, they won't do business with you.

A personal example. Homeowners in central Ohio 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, A-1's owner called, and I told him the grass was growing great, 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 to me, as I figured his back shop simply forgot the weed killer in the mix. But when I still didn't pay, the owner called again. I told him the weeds still were merrily growing along with my grass, and 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 of ridding my lawn of tall weeds.

He was focusing 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 changed dramatically in the last 20 years. Response

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EXECUTIVE SUMMARY

- The competitive weapons in business competition today—response time, quality, and variety—are directly related to level of customer satisfaction.
- In many instances, nonfinancial measures of business performance are the best indicators of customer satisfaction.
- Identifying and measuring business procedures, which can be directly linked to satisfying customers' needs, are found to be valuable competitive tools.
- As a basic formula for competitive success, companies first should identify the factors that influence customer loyalty, and, second, determine the association or correlation between those factors and employee performance and business systems.

time shortened while quality and variety increased exponentially. Time is the new competitive weapon (see Exhibit 1).

Twenty years ago, you could have any two of the three variables of response—time, quality, and variety—but not all three. However, Japanese competitors have shown that it is possible to have all three. In the 1970s, industry leaders were the low cost producers. In the 1980s, quality providers took the lead. In the 1990s, speed to market became paramount, and cost and quality could be traded off as secondary variables.

A 1983 study by McKinsey & Company shows why. Clearly, in our nanosecond economy, a delay in getting the product or service to market is far more detrimental to profits than either a production or development cost overrun (see Exhibit 2). But, we usually don't focus on the damage done by lost profits because that's too difficult to measure.

What will be the basis of competition ten years from now? My bet is on "mass customization," or the ability to customize a standard product on demand. There is growing evidence that simply supplying customers with many choices doesn't earn their loyalty. Customers want it the way they want it. For example, if you want a Motorola pager, a salesperson comes to your office, discusses the various features available, and enters your order on a laptop PC. The order is transmitted by modem to the Florida plant where the unit goes into production in an average of 20 minutes, comes out of production in two hours, and is shipped via overnight service. That's manufacturing on demand. Right now, manufacturing on demand is a competitive advantage. In the next ten years, it will become the minimum capability to play the game of business.

STATE-OF-THE-ART IN PERFORMANCE MEASUREMENT

As financial managers, we're taught to measure corporate performance by the numbers—sales numbers, expense numbers, profit numbers, asset and liability numbers, head count numbers, market share numbers, etc. Unfortunately, this traditional quantitative approach doesn't tell the whole story in today's business environment.

In short, we need some nonfinancial methods to measure business performance that take into account how well the enterprise has satisfied its customers' needs. Only by the implications of poor profit numbers do we measure performance today in meeting customers' needs. But we need a more direct series of measurements that don't depend on accounting reports to tell us that we're meeting our business goals.

By the way, why do we keep inventory? What if I said we keep inventory to compensate for our inefficiencies? Think of the inventory you maintain as the water level in a lake. Your boat (the customer) needs to get from one side of the lake to the other and the water level is low. If it's low enough, the boat will crash on the rocks. Removing the rocks (business inefficiencies) is the key to becoming world-class. Reduce the level of inventory, and the inefficiencies will stick out like the rocks in a shrinking lake.

All of the rocks in Exhibit 3 are self-explanatory, except perhaps, Decision Backlog. One of the best nonfinancial performance measures to use is to track how long it takes to get a decision made in your organization. A recent study of high tech companies reported in *California Management Review* found that the most successful companies make decisions in one-third the time that it takes the average company to make decisions.

But how can management make faster decisions? World-class companies use a fundamentally different process—passing smaller but more frequent batches of information to the next function in the chain, and using two-way communication so errors can be corrected early in the decision-making process (see Exhibit 4).

GE recently estimated that each time an error or defect passes one link in the chain, it costs 10 times more to correct than at the previous level. So an error on the receiving dock that costs 3 cents to correct, costs 30 cents to correct if it gets into inventory, $3 if it gets pulled for production, $30 if it gets into production, and $300 if it makes its way to the customer.

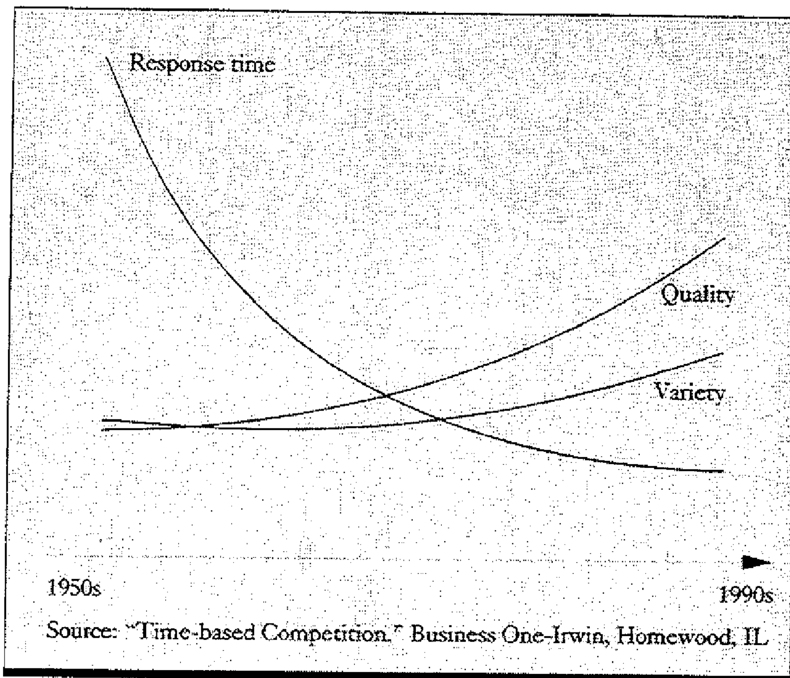
TIE PERFORMANCE MEASUREMENT TO CUSTOMER SATISFACTION

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 wanted to improve customer service to increase its market share. This firm takes most of its orders over the phone. At the time, the order takers answered 85 percent of incoming calls by the third ring, a rate that was considered exemplary. Conventional wisdom was that each year the company could improve that answer rate by one to two percent. Then someone asked, "What if that isn't what our customers are demanding?"

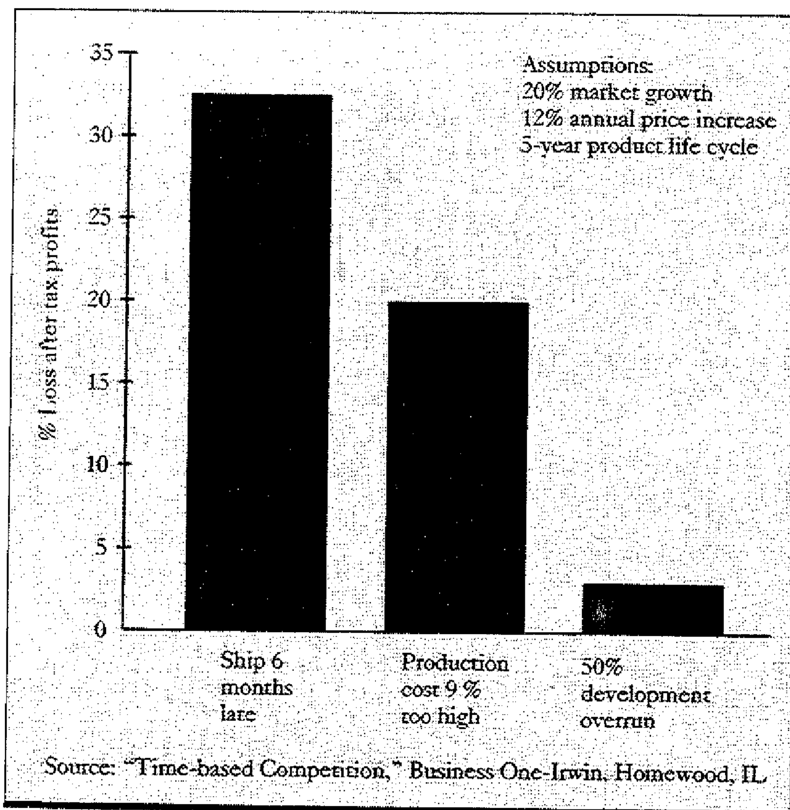
To find out, the company could have conducted market surveys by mail, phone, or face-to-face. But the company

EXHIBIT 1
The Basis of Competition



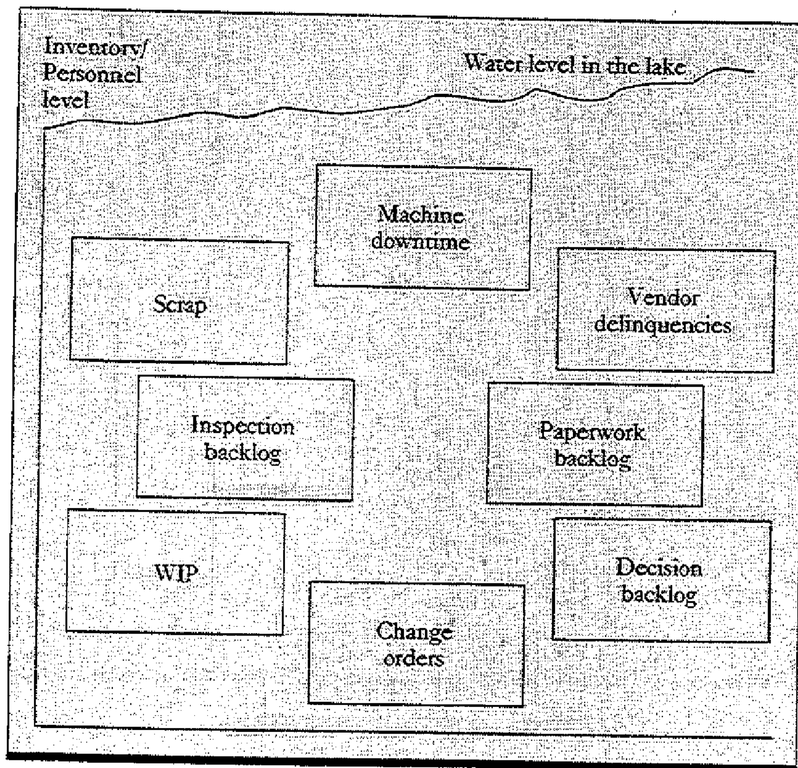
Source: "Time-based Competition," Business One-Irwin, Homewood, IL

EXHIBIT 2
Factors Affecting Profit



Source: "Time-based Competition," Business One-Irwin, Homewood, IL

EXHIBIT 3
Why Do We have Inventory/Personnel?



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.

How often does your phone ring? In most telephone sales 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 now answers over 98 percent of its incoming calls within three rings.

A second part of the international company's study focused on the order rate when an operator didn't know the answer to a customer's question. 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.

In traditional fashion, department supervisors sat in corner offices. Since it took too long to go to the supervisor's office for each answer, order takers would stockpile questions and ask the supervisor at the end of the day. They then would call customers back the following day, converting only 50 percent to sales.

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

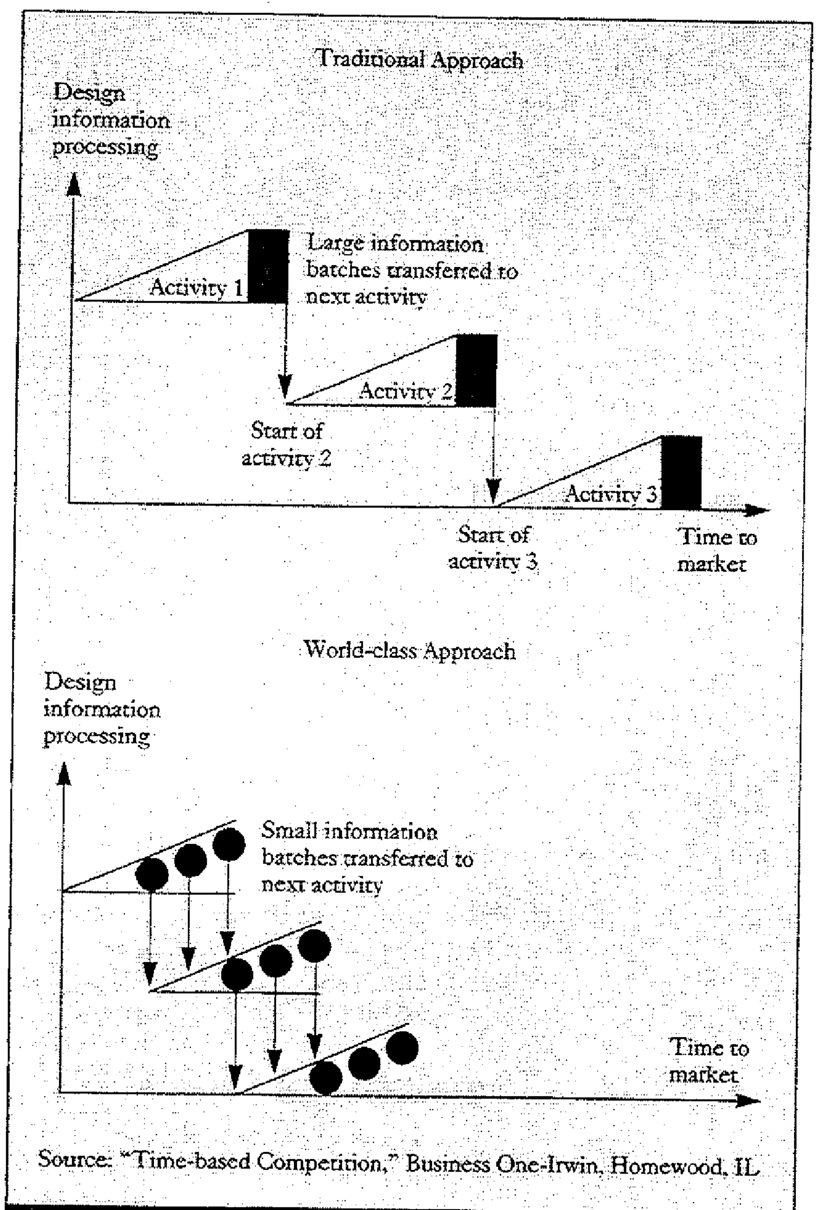
MEASURE CUSTOMER SATISFACTION THROUGH PERFORMANCE

The problem with financial statements is that they are lagging indicators of performance, not leading indicators; and they are results oriented, not process oriented. Nonfinancial performance measures evaluate the key success factors that drive the financial results. Think of business as a ball game. If you want to know who won the game, look at the scoreboard, but if you want to know how they won the game, watch what happens. 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—get better at the processes of playing the game.

I had a client once 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 in order to compete in the poor economy he lowered prices. When I asked him how he knew that, he replied that he has

been in business for 25 years and knew his customers' minds. Besides, he added, that was how his competitors competed against him.

EXHIBIT 4
Speeding Up Processes to Increase Profits



Source: "Time-based Competition," Business One-Irwin, Homewood, IL

We surveyed boat repair shops, including customers and noncustomers, and found that the element of cost was way down on the list of competitive factors. Speedy 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 and from the holding lot.

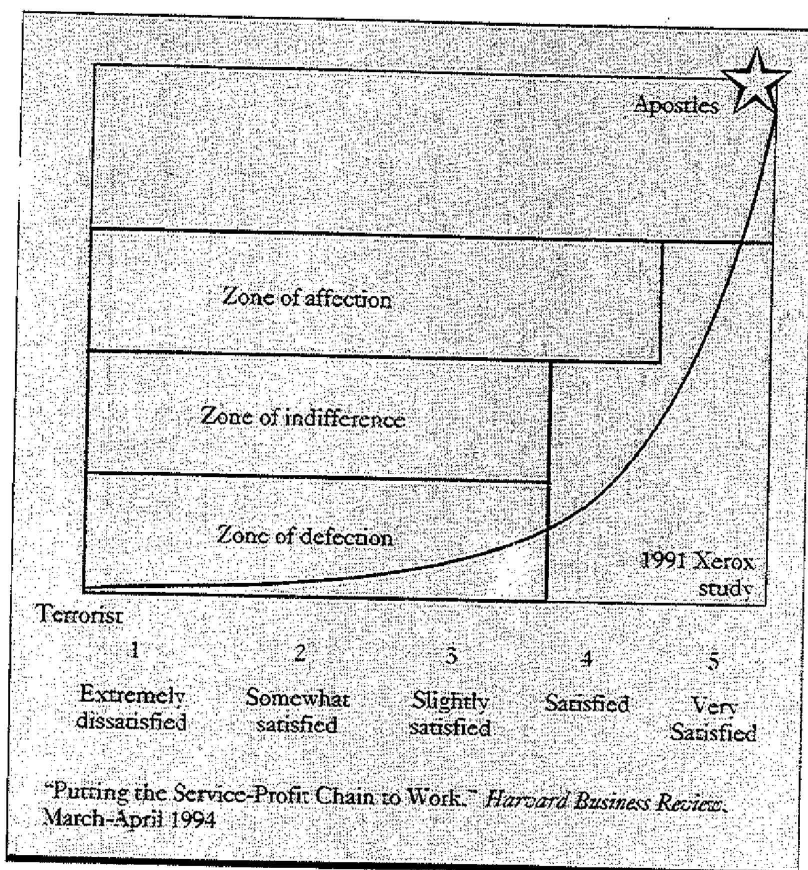
The next step was to analyze the client's sales pattern. The client carried about 150 colors of paint. We found that 20 percent, or about 30, of the colors accounted for 80 percent of sales. Those two facts allowed us to put together a winning strategy. The owner bought two additional delivery vans,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

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

Financial managers today challenge conventional wisdom. In 1988, Xerox began monthly surveys to learn what customers really wanted (see Exhibit 5). 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 level 4 or 5 by 1993.

In 1991, after surveying 480,000 customers per year, Xerox analyzed the results. Conventional wisdom held that the relationship between customer satisfaction and revenue was one-to-one; that 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 (5 rating) were six times more likely to buy more Xerox equipment than merely satisfied customers (4 rating). As a result, Xerox focused its efforts on creating "apostles"—customers that were so satisfied they become virtually part of the sales force, touting their satisfaction to others.

EXHIBIT 5
Customer Satisfaction Drives Loyalty Drives Profit



"Putting the Service-Profit Chain to Work." *Harvard Business Review*, March-April 1994

What kind of nonfinancial performance measures might Xerox track? If you are in a service business, the "call back" rate is a nonfinancial performance measure. Let's assume, for example, 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 the cause. Only when you analyze work orders will the reasons for this dismal performance be apparent.

Repair persons spent, on average, 15 minutes more than planned on each call, making them late for the next call. This resulted in decreased customer satisfaction, and declining customer retention as clients sought out third-party repair alternatives. Digging deeper, they found that 80 percent of the overruns on repair time were committed by 20 percent of the repair staff. Further they learned that 90 percent of the overruns were by repair staff who had been with the company less than 12 months and who had attended a new training methodology adopted at the Xerox training school 18 months ago.

Xerox also wanted to avoid "terrorists"—customers who were so unhappy that they complained to anyone who would listen. What was the answer? Fire your customers. Retain only those customers that generate profitable returns.

How do you identify those to be fired and those to be retained? 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; rather, 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 will likely find that 20 percent of your customers provide 80 percent of your profits. The middle 60 percent provide 30 to 40 percent, and you lose your shirt on the bottom 20 percent of your customers.

Your most unprofitable customers are very price-sensitive and are willing to endure long waiting times. Meanwhile, such customers demand a disproportionate amount of support services and staff time, which, in most companies, isn't tracked to specific customers. Exhibit 6 depicts this relationship.

But how do you fire your customers? Once you find out how much it's costing to support these customers, don't hesitate to 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. 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 nonfinancial performance measures as a competitive weapon, you can use them to streamline the finance and accounting functions. In a joint project, the American Institute of CPAs (AICPA) and The Hackett Group, a Cleveland-based consulting firm, benchmarked the best practices in finance and accounting departments. They found that the differences between the best and the average are large.

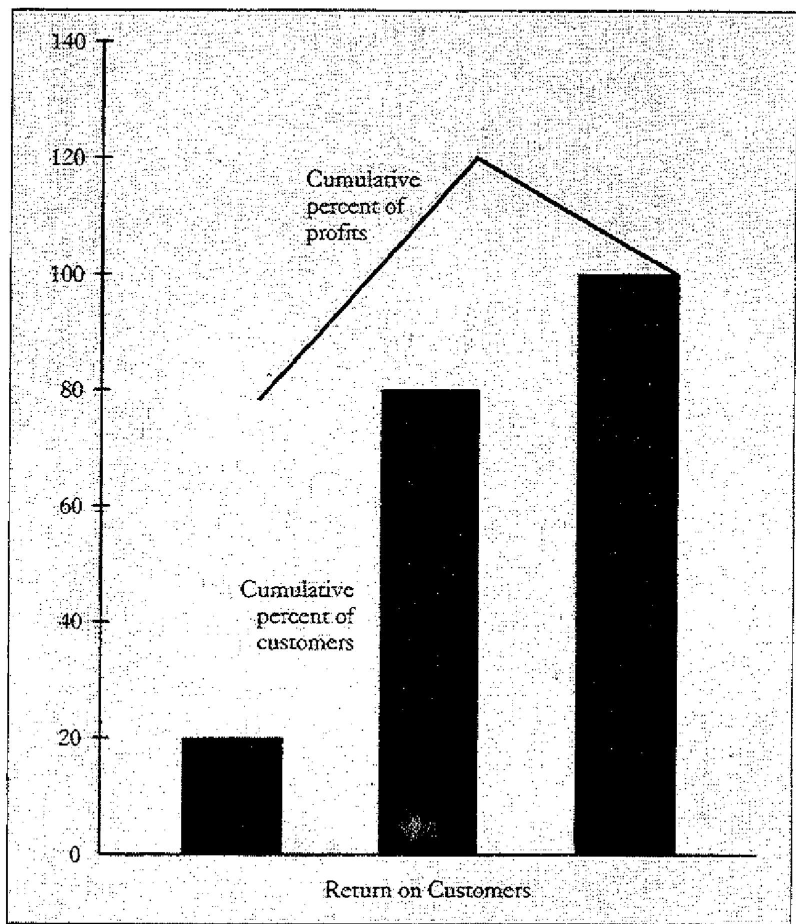
The real key to these measures is how the work is done. World-class companies don't simply automate the work and do it faster; they do it completely differently by analyzing every step of each process and by eliminating steps that don't add value.

Consider how a customer pays vendor invoices. The customer mails a purchase order to a vendor. When the goods arrive, the customer generates a receiving report and sends it to accounts payable. When the vendor's invoice arrives, the accounts payable staff matches the invoice, purchase order, and receiving report.

If the purchase order contains all the requisite detail and a receiving report matches the purchase, why is the vendor's invoice needed? World-class companies such as Ford Motor Company no longer use vendor invoices. As a result, Ford reduced head count in its accounts payable department by more than 75 percent, and has more reliable information to boot.

Rather than matching purchase orders and receiving reports weeks after the goods have been received, Ford enters receiving information into its computer tracking system upon arrival (usually through scanning bar codes and the use of EDI for advance ship notices) and it is automatically matched to the purchase order. Any discrepancies between the purchase order and receiving document are handled immediately while the materials are still on the dock.

EXHIBIT 6
Where Do Profits Come From?



The payoff in efficiency is enormous, but to achieve this kind of system, management must be willing to undertake fundamental change and not settle for doing things "the way we've always done it."

CONCLUSION

The accounting numbers seldom tell the full and necessary story. Financial managers must discover the "whys" and "hows" of the processes in order to measure the actual performance of a company. By evaluating the processes that generate the results in customer satisfaction, the financial manager will have a much clearer and more reliable set of tools with which to measure corporate performance. ■