Part II

Where to focus

In brief . . .

Chapter 3: Cost

- No one sets out to destroy value, but organizations can be complex, hiding the true sources of cost, profit, and value
- Accounting systems were designed for reporting financial statements, not for actively managing the business on a day-to-day basis
- Without a solid understanding of what drives profit, many organizations focus on revenue or sales counts; while targets for these could be achieved, 20 percent of your customers could be destroying up to 400 percent of your profit
- Those you *think* are your best customers could turn out to be your worst
- Cost-cutting using traditional accounting practices can be counterintuitive, leading to greater losses and ultimate failure
- Activity-Based Management translates the figures in an accounting system to provide an understanding of what drives cost at the offering, customer, channel, and transaction levels—highlighting who and what destroys or creates value
- With an understanding of how cost, profit, and value flows, management can more accurately identify areas that would benefit from innovation or improvement, then optimize available resources for maximum value
- Loss-making customers can be made profitable in one of two ways: cross-selling more profitable offerings or charging a fair but profitable price for the services they consume
- As consumer behavior or economic or market conditions change, it is imperative that organizations revisit and update their understanding of what drives cost, profit, and value
- Ultimately, organizations need to focus on lifetime value or return on customer; this focus allows management to make decisions today without risking the future

Chapter 4: Productivity

- The only thing that creates new wealth is everyone becoming more productive than they were before
- Many organizations focus on quality—reducing or freezing variation—ultimately leading to pricing pressure as competitors catch up
- Silicon Valley doubles the capacity of chips every eighteen to twenty-four months; innovation, or unfreezing variation, is what allows them to do this
- Improved productivity frees up time to focus on innovation and differentiation, which can lead to greater revenue and profit
- While innovation can be hit or miss, improving productivity is consistent and something that can be taught easily; expect at least a 300 percent improvement fast
- Productivity improvement explores how to free resources by looking at occupancy, effectiveness, and efficiency
- Experience is key; collectively you may have hundreds or thousands of years' experience within your organization; mining this information reveals "logjams," things that stop us from being productive
- A typical organization will find five to seven categories of "logs"—diagnose them and you will find they started with a bad idea; your employees have the wisdom to re-engineer or replace those ideas with good ones, which increases productivity
- Two-thirds of stress and employee dissatisfaction comes from being unproductive; remove the "logs" and expect a happier, healthier workforce
- Leadership style has a major impact on productivity; there are four basic styles: charismatic, monastic, bully, and bureaucrat; correct the last two and expect productivity to increase by as much as twenty times
- Improving productivity does NOT mean laying off staff; it frees up talent to add more value which in turn strengthens the organization today and in the future
- Improving productivity can affect whole organizations and economies; it delivers greater capacity to serve wherever you may be

Chapter 5: Innovation

- Many look to innovation to create differentiation and higher margins, but the cost has been high historically
- Innovations at the verge can be done fast, at lower cost and risk
- Innovations at the verge are basically where something and something different meet to create new value

Chapter 3

Cost

No one intentionally sets out to destroy value, but organizations can be complex. The true sources of cost, profit, and value can easily be hidden or masked. As a consequence, destruction happens every day. When you were a child, perhaps selling lemonade, things were simple. You had a limited number of ingredients, and it was easy to do the math and calculate how much profit you'd make. If only business were that simple.

Today, many of us have thousands of customers, hundreds of products, and multiple channels. We operate in markets and locations with a diverse set of employee skills, culture, and experience. We abide by regulations and laws—many different from one country to the next. We have multiple definitions of the same thing. We have multiple systems tracking information. We also have gaps—information we'd like, but it isn't available. It's complex.

All of this hides the true cost, profit, and value of how we do business. No single person can piece everything together. They use whatever information is available and rely on intuition to fill the gaps. If you have been in the same line of business for thirty years, that intuition may be fine, but most managers haven't—they move around. They trust that information supplied is accurate. They rely on systems. Even when you have forty years of experience, you may sense there is a problem but perhaps misjudge the magnitude by a factor of ten or more.

The problem is that cost information typically comes from the accounting system, a system designed for reporting financial statements to the satisfaction of government regulators—not for actively managing the business on a day-to-day basis. For a shareholder or regulator, those reports are just fine. Give them to an auditor, same response; they put a value on inventory and assets, report an overall profitability figure, and, most important, they balance. Give the same report to a manager, however, and you can expect a number of unintended consequences.

Peter Turney provides an example. A company with excess production capacity wanted to grow sales. Management understood from business school that as long as they had a positive gross margin on the products they sold, as they expanded sales that marginal revenue would contribute to overhead coverage and generate incremental profit.

Sounds simple, but traditional financial reporting ignores the crucial product- or customer-level detail, detail that can make or break such a business decision. In this example, in order to fill that excess production capacity, the company added new customers, new designs, and new products. There was a lot of engineering work. Order sizes got smaller, and they expended more time and energy on the sales and marketing end. It seemed to pay off as revenues went through the roof, but to their disbelief, profitability fell.

Convinced the growth strategy was right, they doubled their previous development and marketing efforts only to find that profits declined even faster. The situation became so severe that they almost had to close the business. What went wrong? In short, their behavior, activities, and thus drivers of cost changed. Generally accepted accounting principles look at the organization as a whole; they don't account for the actual resources being consumed for each transaction or activity. They spread or allocate costs (for the whole organization) using relatively simplistic methods. Again, fine for regulatory reporting, but not sufficient for helping managers make the right decisions.

In Peter's book *Common Cents*[1] he talks about a company that used standard costing techniques to arrive at a cost of $2 per unit produced. They sold it for $4. Sales volumes, however, were low, and when you specifically accounted for all resources consumed (machinery, raw materials, shipping, marketing, sales, etc.) through the use of an appropriate activity-based costing methodology, the true cost per unit was $500. That's a 25,000 percent product costing error!

All of these companies had information, but it wasn't quality information. It came from a source never intended to support business decisions at the activity, process, product, and customer levels. The unintended consequence was poor, even disastrous, business decisions, even though the statutory financial data suggested the decisions were good. The irony is that these types of errors only tend to surface during tough times. When everything is booming, other parts of the business overcompensate for the losses. They are invisible on the enterprise-level financial reports, so no one pays much attention. When conditions are bad, however, everything comes under the microscope.

As you adapt during radical times, ask yourself the question, “How confident am I in the relevance and accuracy of my costing data?”

False assumptions

Another challenge compounds the problem. Many organizations chase revenue or product volume. They “assume” that each sale brings a profit. Correction: The majority of people don’t care; they have revenue targets and will do whatever they can to achieve them. That’s how they get a bonus, right? Even if it is at the expense of another department. Remember, we get what we measure. Beware the unintended consequences!

One of the banks that fell victim to the crisis of 2008 realized this too late. Their historical mantra was to focus on fee income; employees were compensated based upon it. Unfortunately, no one paid much attention to the type of fee income. When they eventually saw the writing on the wall, they dug deep and asked many questions about what was driving cost and profitability. Breaking their fee income down by business process, they realized a large portion was from bounced check fees—a perfect leading indicator of trouble ahead—but few questioned it, as their own personal income depended on it.

No doubt you will have read many articles prescribing advice for cutting costs, preserving cash flow, and the like. I asked Peter if there were any counterintuitive things people should be on guard for. That led to a discussion on exploding some of the myths around cost behavior and its relationship to profitability.

A foundational belief is that you have variable costs and fixed costs. With regard to those fixed costs, the assumption is that as you increase volume, adding new products, new customers, and so on, the additional contribution margin will flow automatically to the bottom line. Many articles follow this sort of traditional cost, volume, profit, or break-even model that accountants have been using for many years. The problem is that these models are, at base, wrong. Overhead is not fixed; it is variable within the scope or diversity of things the company does.

When you make changes, you have to understand the mix, the diversity of things, and how that contributes to the profitability of a business. If you don't do that you will make mistakes. Let's look at a few examples.

A company uses standard costing techniques to determine product margin. It has two important customers, both generating the same revenue: customer A has a margin of 40 percent; customer B, 18 percent. If you want to impress one of these companies to secure additional future business, perhaps through more personal service, more attention, or simply through greater marketing and sales activity, which would you pick? Customer A, of course. The one making 40 percent, right?

But what the costing system failed to do was account for the differences between the customers. It assumed that marketing, engineering, and sales efforts were equal for both. However, when you properly take those activities into account, the net margin for customer A fell to 14 percent. Customer B on the other hand was far less demanding. Orders were e-mailed and never changed. They didn't rely on the call center or engineering for help. The true net margin for customer B was 16 percent. Customer B was the most profitable. Both were good customers, but their behavioral profile was very different. Knowing this changes everything: the way you allocate resources, prioritize orders, and so on. Once they understood the differences, the company created two price lists. One included a list of basic support functions that would be provided; the other listed a menu of optional services, at additional cost. On presenting these to the customers, customer A smiled. Many of the items on the optional list were just that—optional. As long as they were included or "free," they'd use them, but none made them any more or less likely to do business. In some cases, they were prepared to pay; for others, they stopped using those services. By changing the pricing structure and, therefore, customer behavior, margins among all customers became more predictable and even. It all started by getting more analytical about the data.

Here is a similar example from the telecommunications industry. Everyone assumed that customers subscribing to a telecommunications company's $100-a-month plan were golden. This assumption affected marketing practices and a whole host of other services. As in the previous example, some of those customers were more demanding than others, perhaps switching features or contacting the call center regularly. The reality was that 25 percent of customers on this plan were actually costing $200 per month to service. One option would be to "fire" this kind of customer—something Martha Rogers would caution be done judiciously, with an eye to the customer's future as well as current value, and also be done "in a warm and loving way," as she puts it, to avoid public relations fallout. Another option would be to just get smarter and figure out how you can transform the relationship into a profitable one. Using statistics, this company identified the probability of an unprofitable customer to take on additional services that would bring them back to profit. They weren't able to convert everyone, but they reduced unprofitable business by half—a substantial sum of money.

When you think about it, these examples seem obvious. Our gut tells us this is the case, yet we go along with the information reported and assume someone else has done her homework and figured things out at the detailed level. Think again.

Sticking with differences between customers, I want to share a fact Peter has witnessed through countless implementations of Activity-Based Management. Twenty percent of your customers could be destroying 400 percent of profit. That's right: 20 percent destroying 400 percent. If you made a profit of $1 billion last year that means you could have destroyed $4 billion without realizing it. The irony of this statistic is worse. Many of those customers (within the 20 percent) are probably considered your best customers. Think of the telecommunications story earlier. A regional bank I talked to in the last quarter of 2008 told me that a mere five customers, customers who had historically generated massive fee income, wiped out 100 percent of the previous year's profit as they defaulted on loans (not 5 percent, but five customers!).

It all comes back to following that false god called revenue, assuming without further question that margins are positive for everyone and that returns have been adjusted for risk. Hopefully you will have begun to question those assumptions by now.

In part IV we will look at "marketing your way out." History has proven that those who maintain or increase marketing during a recession come out with greater market share for lower cost. But what if you target those customers with profiles matching the 20 percent that destroy 400 percent? You'd be shooting yourself in the foot, creating a spiral of doom. As stated earlier, once you know the facts, you can do something about it.

Now 400 percent destruction from only 20 percent of your customers is a lot of money, but Peter is also concerned with the 60 percent who merely break even. That's a lot of customers, a lot of revenue, and a lot of potential. How can you make them profitable? Same idea as before: cross-sell profitable offerings or charge a fair but profitable price for services consumed. Sometimes you need the volume to demonstrate market share. That may be as important as delivering profit. That's okay. But don't forget about these customers. Think lifetime value, think return on customer. Constantly evaluate your options, a topic we will address in chapter 10.

Now let's switch to the remaining 20 percent that deliver 500 percent of profit—the good ones. Are there some unintended consequences here? Three come to mind. The first is that you don't realize they are your best customers. Without this knowledge, two second-order implications could be:

a. You don't pay enough attention to them and they leave, or
b. You fail to capitalize on understanding their profile to attract and grow others exhibiting similar behaviors.

Either way, you are suboptimizing the value of the information you already own.

Back to counterintuitive actions. Here is another story of a company using standard costing techniques: a manufacturer with large operations and about 10,000 employees. Their sourcing department used standard costing information to compare costs to bids they received on a regular basis. One day they got a bid from Taiwan. The costs were dramatically lower, so they decided to capitalize on the savings and outsource that part of the business. The problem for the manufacturing plant was it took away volume, resulting in excess capacity. Accounting systems deal with this excess by fully absorbing all costs, then allocating them to the inventory and parts that are left—effectively pushing up unit cost for those that remain. Some of the costs associated with the business going to Taiwan never went away—they were "fixed" (buildings, machinery, etc.). Others weren't visible enough under the traditional accounting system, so they were difficult to manage away. So guess what? Another bid lands in the sourcing department. With internal costs rising, they had another candidate for outsourcing and excess capacity increased further.

Peter calls this the "spiral of doom." By the time the company realized what was going on, they had outsourced 50 percent of their products and laid off several thousand employees—jobs that were gone forever.

But there is another twist to outsourcing and another example of how traditional accounting practices encourage good managers to make bad decisions. A company in Minnesota compared labor rates to those found in Mexico. There was a dramatic difference. The gap was so large that it seemed like a no-brainer to relocate a subassembly plant to Mexico. The relocation created a number of challenges and unintended consequences. The first hit agility: they now had an additional six-week lead time. Also, they now had additional costs not present in the previous set-up—receiving, inventory, handling, and coordination costs. But the real issue was quality. These were hi-tech products. They now needed highly skilled, highly paid employees in Minnesota to check the quality—time taken away from other productive work. Add this to the increase in scrap costs and the cost of the Mexican subassembly quickly surpassed the previous benchmark cost in Minnesota. The good news was the company learned from its mistake and brought the work back to Minnesota to save money.

Cost and strategy

In terms of false assumptions, here is a personal favorite. Many years ago I used to work in the head office of a bank in the United Kingdom. An executive would ask a question and a whole army of staff would try to figure out an answer—regardless of how important or strategic the question was. Hey, the boss asked for it! Probably happens in your organization as well. The assumption was there was no cost to this activity—everyone received a salary, their time was paid for. Salaries were considered a fixed cost. Wrong.

When you look at this with an Activity-Based Management lens (the approach for unearthing all the issues we have discussed thus far) you examine the activity and the cost of resources consumed. For a bank, that's mainly time. If ten people each spent three hours researching, you look at their salaries and calculate how much was used. Let's assume their hourly rate was $75, for a total of $2,250. If the executive knew this cost, do you think it would influence his and the group's behavior? Okay, some couldn't care less, but anyone seeking to maximize the return of their group would probably think twice.

Strategically, it's not the cost of the work, but the lost opportunity of doing something more valuable, more strategic. We'd see this in department after department. I worked in an internal consulting group tasked with improving the profitability of each department. We'd start by asking the senior management team to explain their strategy, to highlight what was important and what they were doing to execute against it. We'd then talk to employees and quantify how much time they were spending on various activities. Without exception, the costs were not in alignment with strategy.

While everyone could state what was important, their actions, the time they spent on strategic initiatives, did not stack up. Stick a financial number on this, and it focuses the mind. You can then have a conversation about change. What can you do to maximize your value? We'd find things people had always done without question. We called these "Spanish customs"—things handed down from one generation to the next. They may have been important when first introduced, but over time they became unnecessary. So why do them? Time is money! Another easy target was to look at administrative tasks. There were lots of forms and processes that had no value. They weren't required by legal, no one used the information, so again: why do them? Eliminating these activities freed up time, time that could be spent on value-added activities—sales, innovation, differentiation, and growth.

Another angle to look at was benchmarking. If multiple teams performed similar tasks, was the activity cost similar? In many cases we found the answer was no. We then began to look at a number of attributes to explain the differences. Two recurring themes explained the variance.

The first was skills and experience. Highly skilled and experienced people get the job done faster with fewer errors. What we'd find in the underperforming groups were employees without the right skills or experience performing the task—the wrong person in the wrong place or someone with a desperate need for training. In that situation, no one wins. Cost to the company goes up, and the employee rarely excels, becoming bored and frustrated, and perhaps leaves.

The second dealt with preference and promotions. If a person did a great job, they were promoted to a managerial role with a pay raise to boot. The new role required a different set of activities, skills, and competencies—things the person didn't necessarily have or even like. Because they loved their previous role, they kept some of those activities. The problem here was twofold: First, the cost of that activity now went up. The employee performed some of her previous tasks for a higher salary. Second, the new manager was depriving a more junior person (on a lower salary) from building experience doing those tasks.

As you are reading this, you may make another false assumption: All of these cost savings could help justify the elimination of jobs, right? Wrong.

In every instance, once we understood what drove value, we realized we had insufficient resources to achieve stated goals or market potential. Headcount went up. There are no guarantees you will find the same in your organization, but even if you discovered a surplus, those resources could be repurposed to create additional value, additional separation from your competitors. I'll talk about this more in chapter 4, which focuses on productivity.

The key point is simple. Once you start to measure things, assigning accurate costs, understanding what truly drives cost and variation, you can have intelligent conversations. You identify areas for improvement, then optimize resources for maximum value.

Maximum value does not equal achievement of stated goals. It's about maximizing market potential. If you are in a typical organization, targets could have been set in stone when the economy was very different. They could be too aggressive, or too weak. Get them wrong or fail to adapt and you unleash a whole series of unintended consequences. Look outside and constantly re-assess. We'll talk more about this in part III, "Creating sustainable advantage."

Martin H. Fischer said, "Knowledge is a process of piling up facts; wisdom lies in their simplification." This is the realm of performance management—connecting all the dots so that you can optimize and improve your lot. It relies on understanding the complex rules of behavior so that you can focus, communicate effectively, and do the right things.

The 2007 *BusinessWeek* survey mentioned earlier revealed that fewer than 50 percent of the "C" suite understood what drove cost, profit, or value in their organization—a scary thought. As you are probably beginning to realize, that figure could be optimistic. Whenever consumer behavior or economic and market conditions change, it is imperative that organizations revisit and update their understanding of what drives cost, profit, and value.

Act without this knowledge, and it is caveat emptor (let the buyer beware) or, perhaps I should say, let the shareholders or taxpayers beware!

Note

1. Peter Turney, *Common Cents: How to Succeed with Activity-Based Costing and Activity-Based Management* (New York: McGraw-Hill, 2005).