Performance Management: Myth or Reality?

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SAS
About Gary Cokins

B.S. Industrial Engineering & Operations Research (Tau Beta Pi)
Cornell University

M.B.A. Finance & Accounting (Beta Gamma Sigma)
Northwestern University, Kellogg Graduate School of Management

Recipient of CAM-I's 1993 Robert A. Bonsack Award for
Distinguished Contribution to the field of Cost Management

Previous Associations:
  FMC Corporation
  Consultant with: Deloitte & Touche,
    KPMG Peat Marwick, &
    Electronic Data Systems (EDS) Head of Global Cost
  Management Consulting Services
About Gary Cokins

Author of:

Activity-Based Cost Management: An Executive Guide (www.wiley.com)

Activity-Based Cost Management in Government (www.managementconcepts.com)

Performance Management (www.wiley.com)

Additional Affiliations:

Certified in Production and Inventory Management (CPIM) by the American Production and Inventory Control Society (APICS)

Member of many committees of professional societies including CAM-I, APICS, the Supply Chain Council, the Council for Logistics Management (CLM), the American Society for Quality (ASQ), and the Institute of Management Accountants (IMA).

Member of Journal of Cost Management Editorial Advisory Board.

Instructor for the Institute of Industrial Engineers (IIE) and the American Society for Quality (ASQ).
What’s the Problem?

Direction, traction, and speed
What’s the Answer?

Performance Management

PM embraces methodologies, metrics, processes, software tools, and systems that manage an organization’s performance.

PM translates strategic plans into results. It is execution. PM is the process of managing your strategy.

There is no single PM methodology because it spans the complete “closed loop” management planning and control cycle.
What’s the Answer?

Performance Management

PM addresses some major headaches of senior executives:

Most employees do not know their organization’s strategy.

Managers and employee teams are making daily decisions with trade-offs ... and they don’t know the impact --- where and to what extent.
How Do They All Fit Together?

Strategy, Mission

customer satisfaction

ERP, etc.

CRM

Scorecards

Your Organization

Supplier Inputs

ROI

Shareholders

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Introduction to Performance Management

Part I
• Taking Action: The Power of ABC/M Intelligence
  - measuring strategic costs (customer/channel profitability)
  - measuring operational costs
  - predicting expenses (resource planning)

Part II
• Performance Management Process
  - Focus --- Strategy Maps
  - Communication --- Scorecards
  - Collaboration --- Discussions/Dialog

Summary: Leveraging Value with PM
Limitations from Business Systems

In the 1990s you were happy if your business system simply recorded and reported transactional information.

Today this is commonplace … and expected.

Transactional systems are effective at producing data, but not at providing knowledge for decision support.

Companies are deluged with data and wasting resources through misalignment.
Managers and teams are stymied

How do I reduce my budget without sacrificing service levels?

How efficient do I have to become to support my expected future workload volume or “new program” with my current budgeted resources?

How do I get out of this pickle? I’m now a process “owner” and being held accountable --- but I have minimal influence and control!

How do you answer these questions with transactional information?
What matters more is what decisions are made with the data.
The Gap Between Strategy and Transaction Systems

Operational and transaction-based data

Strategy
Performance Management: The Process

- Strategy map
- Balanced scorecard

Focus
Communicate
Collaborate

Managerial Accounting Data

Operational Data
My Belief

Resources must eventually be managed. Either:
- Use less, or
- Do more with the same.
Agenda

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    - Collaboration

- Summary: Leveraging Value with PM
The Need for ABM

Changes in Cost Structure

Cost Components

100%

Overhead
(indirect expenses)

Direct (recurring) Labor

Material

Direct

Stages in the Evolution of Businesses

Old-fashioned

Hierarchical

Integrated

1950s

1990s

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Each Activity has its own Driver

From: General Ledger

<table>
<thead>
<tr>
<th>Claims Processing Department</th>
<th>Actual</th>
<th>Plan</th>
<th>Favorable/ (unfavorable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>$621,400</td>
<td>$600,000</td>
<td>$(21,400)</td>
</tr>
<tr>
<td>Equipment</td>
<td>161,200</td>
<td>150,000</td>
<td>(11,200)</td>
</tr>
<tr>
<td>Travel expense</td>
<td>58,000</td>
<td>60,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>43,900</td>
<td>40,000</td>
<td>(3,900)</td>
</tr>
<tr>
<td>Use and occupancy</td>
<td>30,000</td>
<td>30,000</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$914,500</td>
<td>$880,000</td>
<td>$(34,500)</td>
</tr>
</tbody>
</table>

To: ABC Data Base

<table>
<thead>
<tr>
<th>Activity-Based View</th>
<th>Claims Processing Dept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key/scan claims</td>
<td>$31,500</td>
</tr>
<tr>
<td>Analyze claims</td>
<td>121,000</td>
</tr>
<tr>
<td>Suspend claims</td>
<td>32,500</td>
</tr>
<tr>
<td>Receive provider inquiries</td>
<td>101,500</td>
</tr>
<tr>
<td>Resolve member problems</td>
<td>83,400</td>
</tr>
<tr>
<td>Process batches</td>
<td>45,000</td>
</tr>
<tr>
<td>Determine eligibility</td>
<td>119,000</td>
</tr>
<tr>
<td>Make copies</td>
<td>145,500</td>
</tr>
<tr>
<td>Write correspondence</td>
<td>77,100</td>
</tr>
<tr>
<td>Attend training</td>
<td>158,000</td>
</tr>
<tr>
<td>Total</td>
<td>$914,500</td>
</tr>
</tbody>
</table>

When managers get this kind of report, they are either happy or sad, but they are rarely any smarter!
ABC/M Provides Accurate Picture of Costs

Activity-Based Costing

Traditional Costing (baseline)

% Error

0%

50%

1,000%

0%

Grossly under-costed

Over-costed

Highest volume
Low complexity
Simple / Problem free

Low volume
Diverse and Complex
Specialty /Niche

Over 50% of Reported Product Costs are Wrong!
Profitability Profile using ABC

Unrealized profit revealed by ABC

Specific Products, Services, and/or Customers
(ranked most profitable to least profitable)
$ 30 sales
- $ 28 expenses
= $ 2 profit

Net Revenues Minus ABM costs = profit

Unrealized profit revealed by ABM

Cumulative Profit (Millions)

# of Products

Ranked from highest to lowest
ABC Profit Margin
ABM provides insight for the product’s or service’s cost drivers and driver quantities.

Each activity’s driver quantity \( \times \) unit activity driver cost (eg. # of registrations)
Multi-Stage Cost Flowing

Simple ABM

Expanded ABM
ABC/M Cost Assignment Network

Resources:
- Salary, Fringe Benefits
- Direct Material
- Phone, Travel Supplies
- Depreciation
- Rent, Interest, Tax

Work Activities:
- Support Activities
- Equipment Activities
- "cost-to-serve" paths

Final Cost Objects:
- Suppliers
- Products, Services
- Business Sustaining
- Customers

"Costs Measure the Effects" 
(1) Demands On Work
(2) Costs

People Activities

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The ABM Slogan

It is better to be approximately correct than precisely inaccurate!
Other Below-the-line “Calculated” Costs

Products are not the only thing for which accountants should compute costs.

What about costs for:
• types of orders?
• types of SKUs?
• types of containers?
• types of routes?
• types of trucks?
• types of sales channels?
• types of customers?

The problem with traditional accounting’s gross margin reporting is you don’t see the bottom half of the picture.

# 1- Customer Retention – It is relatively much more expensive to acquire a new customer than to retain an existing one.

# 2 – Source of Competitive Advantage – As products become commodity-like, the shift is towards service-differentiation.

# 3 – A Power Shift – The Internet is shifting power ... irreversibly ... from sellers to buyers.
Profit contribution erosion
# ABC/M Customer Profit & Loss Statement

CUSTOMER: XYZ CORPORATION (CUSTOMER #1270)

<table>
<thead>
<tr>
<th>Sales</th>
<th>$$$</th>
<th>Margin $</th>
<th>Margin % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$$$</td>
<td>(Sales - ΣCosts)</td>
<td>% of Sales</td>
</tr>
<tr>
<td>Product-Related</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supplier-Related costs (TCO)</td>
<td>$ xxx</td>
<td>$ xxx</td>
<td>98%</td>
</tr>
<tr>
<td>Direct Material</td>
<td>xxx</td>
<td>xxx</td>
<td>50%</td>
</tr>
<tr>
<td>Brand Sustaining</td>
<td>xxx</td>
<td>xxx</td>
<td>48%</td>
</tr>
<tr>
<td>Product Sustaining</td>
<td>xxx</td>
<td>xxx</td>
<td>46%</td>
</tr>
<tr>
<td>Unit, Batch*</td>
<td>xxx</td>
<td>xxx</td>
<td>30%</td>
</tr>
<tr>
<td>Distribution-Related</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outbound Freight Type*</td>
<td>xxx</td>
<td>xxx</td>
<td>28%</td>
</tr>
<tr>
<td>Order Type*</td>
<td>xxx</td>
<td>xxx</td>
<td>26%</td>
</tr>
<tr>
<td>Channel Type*</td>
<td>xxx</td>
<td>xxx</td>
<td>24%</td>
</tr>
<tr>
<td>Customer-Related</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Customer-Sustaining</td>
<td>xxx</td>
<td>xxx</td>
<td>22%</td>
</tr>
<tr>
<td>Unit-Batch*</td>
<td>xxx</td>
<td>xxx</td>
<td>10%</td>
</tr>
<tr>
<td>Business Sustaining</td>
<td>xxx</td>
<td>xxx</td>
<td>8%</td>
</tr>
<tr>
<td><strong>Operating Profit</strong></td>
<td>xxx</td>
<td>8%</td>
<td></td>
</tr>
</tbody>
</table>

* Activity Cost Driver Assignments use measurable quantity volume of Activity Output
(Other ActivityAssignments traced based on informed (subjective) %s)
Migrating Customers to Higher Profitability

Knowing where channels or customers are located requires knowing their true costs via ABC/M.

Types of Customers

- Very Profitable
  - High (Creamy)
- Product Mix Margin
  - Low (Low Fat)
- Cost-to-Serve
  - Low
  - High

Profitable

Unprofitable

Very unprofitable
Customer Equity (CE) and CLV Management

Who is more important to pursue with the scarce resources of our marketing spend budget?

Our most profitable customers?
Or our most valuable customers?

What is the difference?

The “customer lifetime value” measure is intended to answer this question.
Current vs. Long-Term Potential Value

If you could measure past-period customer profitability but also future potential customer economic value, then …

- **High current profit contribution (static)**
- **Low future potential (long-term)**

… you’d view existing customers in different categories.

```
<table>
<thead>
<tr>
<th></th>
<th>substantial</th>
<th>limited</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Future potential</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

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Current vs. Long-Term Potential Value

There appear to be obvious customer strategies for each category.

<table>
<thead>
<tr>
<th>Current Profit Contribution (Static)</th>
<th>Future Potential (Long-term)</th>
</tr>
</thead>
<tbody>
<tr>
<td>high</td>
<td>most favored status</td>
</tr>
<tr>
<td>current</td>
<td>defend &amp; retain</td>
</tr>
<tr>
<td>profit</td>
<td>maximize</td>
</tr>
<tr>
<td>contribution</td>
<td>manage up or out</td>
</tr>
<tr>
<td>(static)</td>
<td>limited</td>
</tr>
</tbody>
</table>
After CLV (or CP) is calculated and rank-ordered, then ...
Also, be prudent attracting new customers.

Source: Customer Equity Marketing; European Mgmt. Journal; Vol 20, No. 3; June, 2002
Activity Analysis for Process Improvement

Activity analysis judges work based on need, efficiency, and value.

Is activity required by a customer?

Yes

Does activity contain low-value added tasks?

Yes

Eliminate the activity to reduce cost

No

Can activity be eliminated?

Yes

Reduce the activity frequency to reduce cost

No

Can the driver frequency be reduced?

Yes

Eliminate low-value added work to reduce cost

No

Does activity contain low-value added tasks?

Yes

All cost reduction opportunities identified

No

Target an activity for improvement
Historic Reporting vs. Predictive Costing

- **Activity-Based Costing**
  - Historical & Descriptive
  - Starts with known:
    - spending
    - driver measures
    - output quantities
  - Calculates “costs”

- **Activity-Based Planning**
  - Predictive
  - Requires capacity analysis
  - Starts with estimated outputs
  - Applies ABC/M rates
  - Solves for Resource “expenses”
Resource expenses can be calculated with “backwards ABC”
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Goal Non-congruency, Conflict, and Mis-alignment

Mission Strategy

Maximize Shareholder Value

- high quality
- speedy
- low cost
- great service
- flexible

“Wall of Disconnects”

Sub-optimization of work

Strategies

Measures

Accountability
Performance Management: The Process

- Strategy map
- Balanced scorecard
- Focus
- Communicate
- Collaborate

Managerial Accounting Data

Operational Data
Vision and Mission Statements

A Vision statement answers “where do we want to go?”

Examples:
USA President Kennedy, “We will put a man on the moon.”
Microsoft, “A computer on every desktop.”

A Mission statement answers “Why are we here?”

Examples:
US Navy Ordnance: “We save ships.”
Strategy Maps and Scorecards

Strategy maps and scorecards solve this by answering, “How will we get there?”
Maximize Shareholder Value

Financial

Customer

Internal Processes

Learning

Realized Value

Potential Value
(intangible assets)
### Who Does What?

<table>
<thead>
<tr>
<th>1st Quarter</th>
<th>Strategic Objective</th>
<th>Identify Projects, Initiatives, or Processes</th>
<th>Measure</th>
<th>KPI Target</th>
<th>KPI Actual</th>
<th>comments / explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Team</td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managers and Employees</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
<td>their score</td>
<td>X</td>
</tr>
</tbody>
</table>

A scorecard is more of a social tool than a technical tool.
The Key to Strategy Maps and Scorecards

How does everyone answer this single question:

“How am I doing on what is important?”

Strategy maps and Scorecards provide this answer.

The overriding purpose of a scorecard system is to make vision, mission, and strategy everyone’s job.
Accountability, Responsibility, and Ownership

Scorecard

or

Report Card?

(used for punishment or remedy?)
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Value is Ambiguous -- Whose Value?

Strategy, Mission

Customer satisfaction

ERP, etc.

CRM

Scorecards

Your Organization

Supplier Inputs

Shareholders

ROI

Value is Ambiguous -- Whose Value?

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How Do They All Fit Together?

- **Strategy, Mission**
- **Senior Management**
- **Adjusted Strategy**
- **Products, Services, Missions**
- **KPIs**
- **Customer Satisfaction**
- **Order Management (front office)**
- **ERP, etc.**
- **Process planning & execution (back office)**
- **Scorecards**
- **Employees**
  
  “How am I doing on what is important?”
- **Assets**
- **Employee behavior**
- **Your Organization**
- **Supplier Inputs**
- **ROI**
- **Shareholders**
ABM and SPM add key components to the Performance Management solution.

SAS SPM

Data Storage
- Financial
- Sales / Marketing
- Operations / Manufacturing
- Procurement / Inventory
- Human Resources
- Product / Design Technology
- ABC / ABM

SAS ABM
- ABC Model Output
- Financial Consolidations
- Cost and Driver Data

SAS FMS
- Financial Allocations

OLAP
- Paper Reports
- Electronic/ Web Reports

SAS SPM components:
- Financial
- Customer
- Operations
- Growth

SAS Warehouse Administrator

G/L
- Sales & Marketing
- Customer DB
- Spreadsheets
- Inventory
- Production
The Intelligence Hierarchy

Power of Information

- Raw Data
- Standard Reports
- Ad hoc Reports & OLAP
- Descriptive Modeling
- Predictive Modeling & Optimization

$\text{Put into Action}

Data ➔ Information ➔ Knowledge ➔ Intelligence

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Traction, Direction, and Speed …
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Or feel free to contact:

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Join us at SAS Forum International Lisbon 21-23 June 2005
The Obligatory Forces of Pressure

Issues and rules are many, but principles are few.
Key Principles (a one minute MBA)

- Managing always involves making choices.
  - Your job is easy.
  - Your managers’ jobs have daily trade-off decisions involving the natural tension from conflicting objectives, constraints, and competing measures.

- All employees need to know:
  - Where they are supposed to go and how they are performing.
  - What is the probable impacts of their decisions.

- Accountability for results is rising.

- Governance is rising too.