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Overview of Operational Reviews

The operational review process is most helpful and beneficial in the following instances:

- Identifying operational areas in need of positive improvement—looking for best practices as part of a program for continuous improvements
- Pinpointing the cause (not the symptom) of the problem—avoiding quick-fix, short-term solutions in favor of longer-term, elegant solutions
- Quantifying the effect of the present situation on operations—identifying the cost of present practices and the benefits to be derived through implementation of best practices
- Developing recommendations as to alternative courses of action to correct the situation—identifying best practices in a program of continuous improvements

This chapter will:

- Introduce operational review concepts and principles.
- Provide an update of the current status of operational reviews.
- Familiarize the reader with commonly used operational review definitions and terms.

- Identify the purposes and components of operational reviews.
- Increase understanding of the benefits of operational reviews.
- Introduce the phases in which a typical operational review is conducted.

***Pinpoint the Cause, Not the Symptom,
of the Problem
to Identify the Best Practice***

STAKEHOLDERS

Operational review processes are directed toward the continuous pursuit of positive improvements, excellence in all activities, and the effective use of best practices. The focal point in achieving these goals is the customer or stakeholder—both internal and external—who establishes performance expectations and is the ultimate judge of resultant quality. A company customer is defined as anyone who has a stake or interest in the ongoing operations of the organization, anyone who is affected by its results (type, quality, and timeliness). Stakeholders include all those who are dependent on the survival of the organization, such as:

- Suppliers/vendors: external
- Owners/shareholders: internal/external
- Management/supervision: internal
- Employees/subcontractors: internal/external
- Customers/end users: external

***Stakeholder Expectations
Are the Key to Evaluating
the Company's Performance***

Reader: Identify the stakeholders in your organization and what you believe each one desires from the organization. List the major players in each stakeholder category (e.g., 20 percent of vendors and customers

who provide approximately 80 percent of total volume). How do these various stakeholders affect the focus of the organization?

WHY BUSINESSES ARE IN EXISTENCE

Before one even thinks about performing an operational review of an organization, it is necessary to determine why the organization is in existence. When clients are asked this question, invariably the answer is to make money. Although this is partly true, there are really only two reasons for a business entity to exist:

1. *The customer service business.* To provide goods and services to satisfy desired customers, so that they will continue to use the business's goods and services and refer it to others. An organizational philosophy that correlates with this goal that has been found to be successful is "To provide the highest quality products and service at the least possible cost."
2. *The cash conversion business.* To create desired goods and services so that the investment in the business is as quickly converted to cash as possible, with the resultant cash-in exceeding the cash-out (net profits or positive return on investment). The correlating philosophy to this goal can be stated as follows: "To achieve desired business results using the most efficient methods so that the organization can optimize the use of limited resources."

This means that we are in business to stay for the long term—to serve our customers and grow and prosper. A starting point for establishing operational review measurement criteria is to decide which businesses the organization is really in (such as the two listed) so that operational efficiencies and effectiveness can be compared to such overall organizational criteria.

***Being in the Customer Service
and Cash Conversion Businesses
Enables the Company to Make Money
and to Survive***

Reader: Document the practices that your organization uses with regard to the customer service and cash conversion businesses. Identify any effective best practices and practices that appear to be counter to effectiveness. Identify any performance gaps that need to be addressed in an operational review.

BUSINESSES A COMPANY IS NOT IN

Once short-term thinking is eliminated, managers realize they are not in the following businesses and decision making becomes simpler:

- *Sales business.* Making sales that cannot be collected profitably (sales are not profits until the cash is received and all the costs of the sale are less than the amount collected) creates only numerical growth.
- *Customer order backlog business.* Logging customer orders is a paperwork process to impress internal management and outside shareholders. Unless this backlog can be converted into a timely sale and collection, there is only a future promise, which may never materialize.
- *Accounts receivable business.* Get the cash as quickly as possible, not the promise to pay. But remember, customers are the company's business; keeping them in business is keeping the company in business. Normally, the company has already put out its cash to vendors and/or into inventory. It may even be desirable to get out of the accounts receivable business all together. This is particularly true for small sales where the amount of the sale is less than the cost of billing and collections or where major customers (e.g., 20 percent of all customers equal 80 percent of total sales) are willing to pay at the time of shipping or receipt as part of price negotiations.
- *Inventory business.* Inventory does not equal sales. Keep inventories to a minimum—zero if possible. Procure raw materials from vendors only as needed, produce for real customer orders based on agreed upon delivery dates, maximize work-in-process throughput, and ship directly from production when the customer needs the product. To accomplish these inventory goals, it is necessary to develop an effective organizational life stream that includes the company's vendors, employees, and customers.

- *Property, plant, and equipment business.* Maintain at a minimum: be efficient. Idle plant/equipment causes anxiety and results in inefficient use. If it is there, it will be used. Plan for the normal (or small valleys) not for the maximum (or large peaks); network to out-source for additional capacity and in-source for times of excess capacity.
- *Employment business.* Get by with the least number of employees as possible. Never hire an additional employee unless absolutely necessary; learn how to cross train and transfer good employees. Not only do people cost ongoing salaries and fringe benefits, but they also need to be paid attention, which results in organization building.
- *Management and administration business.* The more an organization has, the more difficult it becomes to manage its business. It is easier to work with less and be able to control operations than to spend time managing the managers. So much of management becomes getting in the way of those it is supposed to manage and meeting with other managers to discuss how to do this. Management becomes the promotion for doing.

***Knowing the Businesses Not to Be in
Keeps the Company in the Business
It Should Be in—
and Makes it Grow and Prosper***

Reader: Document the extent that your organization is in the aforementioned businesses. Identify related critical areas in each of these areas that should be addressed in an operational review. Document any immediate recommendations that can effectively reduce or eliminate the extent of being in these business. What are the organization's goals for each of these areas?

SOME BASIC BUSINESS PRINCIPLES

Each company must determine the basic principles that guide its operations. These principles become the foundation on which the

company bases its desirable operational practices. Examples of such business principles include:

- Produce the best quality product at the least possible cost.
- Set selling prices realistically, so as to sell all the product that can be produced within the constraints of the production facilities.
- Build trusting relationships with critical vendors; keeping them in business is keeping the company in business.
- The company is in the customer service and cash conversion businesses.
- Do not spend a dollar that doesn't need to be spent; a dollar not spent is a dollar to the bottom line. Control costs effectively; there is more to be made here than increased sales.
- Manage the company; do not let it manage the managers. Provide guidance and direction, not crises.
- Identify the company's customers and develop marketing and sales plans with the customers in mind. Produce for the company's customers, not for inventory. Serve the customers by providing what they need, not by selling them what the company produces.
- Do not hire employees unless they are absolutely needed; and only when they multiple the company's effectiveness so that the company makes more from them than if they did it themselves without them.
- Keep property, plant, and equipment to the minimum necessary to maintain customer demand.
- Plan for the realistic, but develop contingency plans for the positive unexpected.

***Basic Business Principles
Guide the Company's Operations***

Reader: Which of these basic business principles does your organization embrace—not just philosophically—but in reality? Document other basic business principles that you believe your organization operates under. Which ones increase the organization's effectiveness and which ones are detrimental?

CRITERIA FOR ORGANIZATIONAL GROWTH

There are numerous criteria that the organization may choose to implement in its program of continuous improvements leading toward organizational growth. As part of conducting an operational review, the reviewer must be aware of these criteria to be successful in addressing the company's desired direction—in total or by business segment or function. Some of these criteria include:

- Cost reductions
- Price increases
- Sales volume increases
- New market expansion
- New distribution channels
- Market share increase in existing markets
- Selling or closing a losing operation or location
- Acquire another company, division, operation, or product
- Developing a new product or service
- Efficiency or productivity improvements
- Non-value-added activities eliminated
- Making employees responsible
- Organizational structure revisions

Reader: Document your organization's criteria for organizational growth in each of the listed areas. How do they affect your organization's present and future effectiveness? Are there are other areas for organizational growth in your organization? What are they?

MENTAL MODELS AND BELIEF SYSTEMS

Many organizations operate on the basis of prevalent mental models or belief systems—usually emanating from past and present top management—which have an overriding effect on the conditions with which operations within the company are carried out. They can help to produce a helpful working environment or atmosphere or a hindering one. In effect, such mental models become performance

drivers—those elements within the organization that shape the direction of how employees will perform their functions. Examples of such mental models and belief systems include:

- Hard work and doing what you are told are the keys to success for the individual and the company.
- The obedient child in the company survives and is promoted, while the rebellious child is let go or leaves the company.
- Only managers can make decisions.
- Power rises to the top—and stays there.
- Employees need to be watched to do their jobs.
- Power and control over employees is necessary to get results.
- Managers are responsible; employees are basically irresponsible.
- Those at the top of the organization know what they are doing.
- All functions should be organized in the same manner.
- Higher levels of organization ensure that lower levels do their jobs.
- Policing and control over employees ensure their compliance.
- All employees are interchangeable.
- Doing the job right is more important than doing the right job.
- Control the people, control the results.
- Organizational position is more important than being right.
- Top management has the right to set all policies and procedures.
- Managers create results; employees do the job.
- Organizational hierarchies ensure that things get done.
- Employees cannot be trusted on their own.
- You can not run a business without the proper organization structure.
- Managers know more than employees.
- Managers have a right to be obnoxious.
- Management is the enemy.
- Each function needs its own organization structure.
- The more employees reporting to you (and the larger your budget), the more important you are within the organization.

Reader: Check off those mental models and belief systems from the preceding list that exist in your organization. Are there others that you

can identify? What are they? Document how these mental models and belief systems affect performance within your organization—positively and negatively.

ORGANIZATIONAL CRITERIA EXAMPLE

The first step in successful operational review planning is to define the company's desired criteria for results as related to their reasons for existence, basic business principles, mental models, belief systems, performance drivers, and so on. These organizational criteria typically encompass the company as an entity as well as its major functions. An example of such an organizational results criteria structure is as follows:

Organization-Wide Criteria

- Operate all activities in the most economical, efficient, and effective manner as possible.
- Provide the highest quality products to our customers at the least possible cost.
- Satisfy our customers so that they will continue to use the company's products and refer the company to others.
- Convert the cash invested in the business as quickly as possible so that the resultant cash-in exceeds the cash-out to the greatest extent possible.
- Achieve desired results using the most efficient methods so that the company can optimize the use of limited resources.
- Maximize net profits without sacrificing quality of operations, customer service, or cash requirements.

Sales Function

- Make sales to the right customers that can be collected profitably.
- Develop realistic sales forecasts which result in a present or future real customer order.
- Sell those products as determined by management to the right customers, at the right time, in the right quantities.

- Actual customer sales should directly correlate with management's long- and short-term plans.
- Sales efforts, and corresponding compensation systems, should reinforce the goals of the company.
- Customer sales should be integrated with other functions of the company, such as manufacturing, engineering, accounting, and purchasing.

Manufacturing

- Operate in the most efficient manner with the most economical costs.
- Integrate manufacturing processes with sales efforts and customer requirements.
- Manufacture in the most timely manner considering processes such as customer order entry, timely throughput, and customer delivery.
- Increase productivity of all manufacturing operations on an ongoing basis.
- Eliminate, reduce, or improve all facets of the manufacturing operation including activities such as receiving, inventory control, production control, storeroom operations, quality control, supervision and management, packing and shipping, and maintenance.
- Minimize the amount of resources such as personnel, facilities, and equipment that are allocated to the manufacturing process.

Personnel

- Provide only those personnel functions which are absolutely required as value-added activities.
- Maintain the levels of personnel at the minimum required to achieve results in each functional area.
- Provide personnel functions such as hiring, training, evaluation, and firing in the most efficient and economical manner possible.
- Develop an organizational structure that organizes each function in the most efficient manner for their purposes.
- Minimize the hiring of new employees by such methods as cross training and interdepartmental transfers and other best practices.

- Implement compensation systems that provide for effective employee motivation and the achievement of company goals.

Purchasing

- Purchase only those items where economies can be gained through a system of central purchasing.
- Implement direct purchase systems for those items that the purchasing function does not need to process, such as low-dollar purchases and repetitive purchases.
- Simplify systems so that the cost of purchasing is the lowest possible.
- Effectively negotiate with vendors so that the company obtains the right materials at the right time at the right quality at the right price.
- Maintain a vendor analysis system so that vendor performance can be objectively evaluated.
- Develop effective computerized techniques for economic processing, adequate controls, and reliability.

Accounting

- Analyze the necessity of each of the accounting functions and related activities, such as accounts receivable, accounts payable, payroll, budgeting, and general ledger.
- Operate each of the accounting functions in the most economical manner.
- Implement effective procedures that result in the accounting functions becoming more analytical than mechanical.
- Develop computerized procedures that integrate accounting purposes with operating requirements.
- Develop reporting systems that provide management with the necessary operating data and indicators that can be generated from accounting data.
- Eliminate or reduce all unnecessary accounting operations that provide no value-added incentives.

***Organizational Criteria
Focuses the Operational Review Criteria***

Reader: Check off those organizational criteria from the lists preceding that pertain to your organization. For those items not checked off, which ones should be implemented in your organization? Document other organizational criteria that exist or should exist for your organization. What is the effectiveness of existing organizational criteria?

ECONOMY, EFFICIENCY, AND EFFECTIVENESS

Operational review procedures embrace the concept of conducting operations for economy, efficiency, and effectiveness. The following is a brief description of each of the three Es of operational reviews.

1. *Economy (or the cost of operations)*. Is the organization carrying out its responsibilities in the most economical manner—that is, through due conservation of its resources? In appraising the economy of operations and related allocation and use of resources, the reviewer may consider whether the organization is:
 - Following sound purchasing practices
 - Overstaffed as related to performing necessary functions
 - Allowing excess materials to be on hand
 - Using equipment that is more expensive than necessary
 - Avoiding the waste of resources
2. *Efficiency (or methods of operations)*. Is the organization carrying out its responsibilities with the minimum expenditure of effort? Examples of operational inefficiencies to be aware of include:
 - Improper use of manual and computerized procedures
 - Inefficient paperwork flow
 - Inefficient operating systems and procedures.
 - Cumbersome organizational hierarchy and/or communication patterns
 - Duplication of effort
 - Unnecessary work steps
3. *Effectiveness (or results of operations)*. Is the organization achieving results or benefits based on stated goals and objectives or some other measurable criteria? The review of the results of operations includes:

- Appraisal of the organizational planning system as to its development of realistic goals, objectives, and detail plans
- Assessment of the adequacy of management's system for measuring effectiveness
- Determination of the extent to which results are achieved
- Identification of factors inhibiting satisfactory performance of results

Reader: Document areas of economy, efficiency, and effectiveness in your organization. Can these areas be improved upon? Are there critical areas of ineconomy, inefficiency, and ineffectiveness that need to be addressed in an operational review?

SPECIFIC OBJECTIVES

There are many reasons why management might desire to have an operational review of their operations performed. Some of these reasons are given in the following list. Keep in mind that management may be looking for a single objective (e.g., operational efficiency), a combination of objectives (e.g., least cost but most efficient systems—best practices), or their own specific agenda (e.g., achievement of results on the basis of cost versus benefits).

Financial and Accounting

- Adherence to financial policy
- Performance of accounting procedures
- Procedures performed by individuals with no incompatible functions
- Adequateness of existing audit trail
- Observability of right procedures

Adequacy of Internal Controls

Accounting controls

- Safeguarding of assets
- Reliability of financial records
- System of authorizations and approvals

- Separation of duties
- Physical controls over assets

Administrative controls

- Operational efficiency
- Adherence to managerial policies
- Adequacy of management information and reporting
- Employee competency and training
- Quality controls

Procedural Compliance

- Laws and regulations: federal, state, and local
- Adherence to administrative policy
- Performance of authorization and approval
- Evidence of action to achieve stated goals and objectives
- Adherence to long-range/short-term plans
- Achievement of management objectives
- Effective recruiting and training
- Evaluation of organizational policies

Organizational Efficiency

- Clear understanding of responsibilities and authority
- Logical, nonconflicting reporting relationships
- Current job/functional descriptions
- Separation of duties
- Productivity maximization (internal benchmarking)
- Staffing levels compared with those of similar organizations (external benchmarking)
- Elimination of non–value-added functions and activities
- The right number of people to do the right job

Operational Results

- Organizational planning: goals, objectives, and detail plans
- Detail plan development and implementation; considering alternatives, constraints, cost/benefit, and resource allocation

Evaluation of operational results

- Appropriateness of measurement criteria
- Feedback on success or failure
- Adjustment of goals, objectives, strategies

Doing the right job, the right way, at the right time

Reader: What are the specific objectives for performing an operational review in your organization in total or by function as listed above? Are there other objectives for performing the operational review? Why do you think an operational review should be performed?

SPECIFIC PURPOSES

In conducting an operational review, the reviewer should be aware of the purpose for which the review is being performed. Prior to the start of the operational review, the reviewer should communicate clearly his or her understanding of the purpose(s) to appropriate management personnel. There should be a mutual agreement as to the purpose of the operational review in the beginning. For example, the purpose may be one or more of the following:

- To review and evaluate the adequacy of the accounting system and related internal accounting controls (including both accounting and administrative controls)
- To analyze systems and controls, as related to internal controls, functional operations, and legal compliance
- To analyze the capability to accomplish agreed upon stated goals, objectives, and results in management's approved plan
- To compare actual accomplishments/results with the goals and objectives established in management's plan for the period; and to determine reasons that established goals and objectives were not met
- To analyze and explain cost overruns or high unit costs for each function/activity for which such data can be quantified
- To assess and evaluate compliance with federal, state, and local laws and regulations; ensuring at least minimal compliance
- To identify and report deficiencies and areas for improvement and to provide technical assistance and follow-up where necessary

***The Operation Review
Ensures Doing
the Right Job, the Right Way,
in the Right Time***

Reader: Document the purposes for which an operational review should be performed in your organization. Is there an encompassing purpose for the organization in total and specific purposes for functional areas? What are they?

BENEFITS OF OPERATIONAL REVIEWS

Depending on its scope, an operational review can be of significant benefit to top management and staff, in some or all of the following ways:

- Identifying problem areas, related causes, and alternatives for improvement
- Locating opportunities for eliminating waste and inefficiency (i.e., cost reduction).
- Locating opportunities to increase revenues (i.e., income improvement).
- Identifying undefined organizational goals, objectives, policies, and procedures
- Identifying criteria for measuring the achievement of organizational goals
- Recommending improvement in policies, procedures, and organizational structure
- Providing checks on performance by individuals and by organizational units
- Reviewing compliance with legal requirements and organizational goals, objectives, policies, and procedures
- Testing for existence of unauthorized, fraudulent, or otherwise irregular acts
- Assessing management information and control systems

- Identifying possible trouble spots in future operations
- Providing an additional channel of communication between operating levels and top management
- Providing an independent, objective evaluation of operations

***Operational Review Benefits
Help to Sell the Review***

Reader: Check off the benefits from the preceding list that apply to your organization. Are there other benefits for your organization that can be realized from an operational review? What are they?

OPERATIONAL REVIEW PHASES

Operational reviews consist basically of gathering information, making evaluations, and developing recommendations where appropriate. An operational review is essentially the evaluation of an activity for potential improvement. In addition, the review includes analyzing results and being alert to problems. These also provide insights into the effectiveness of management and the potential for improvements.

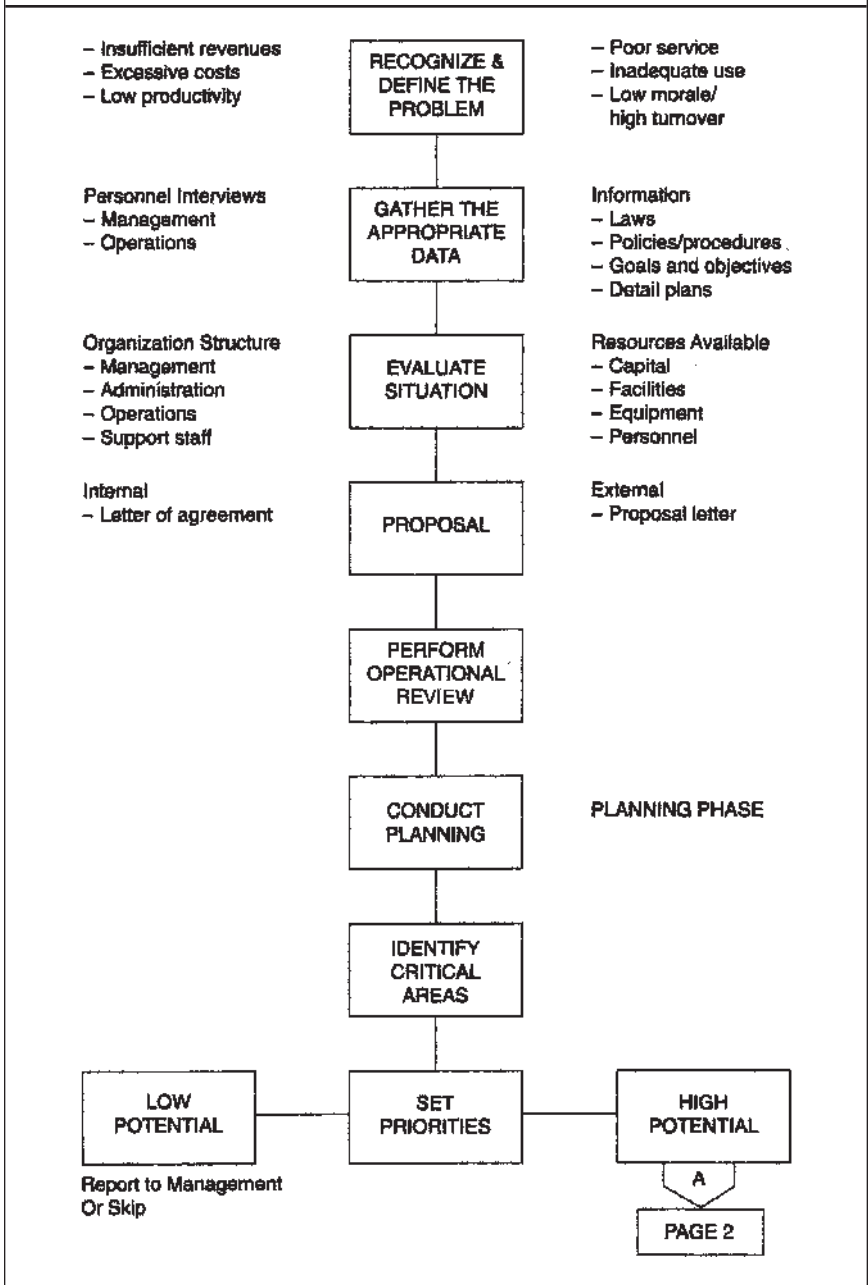
The phases through which an operational review progresses are:

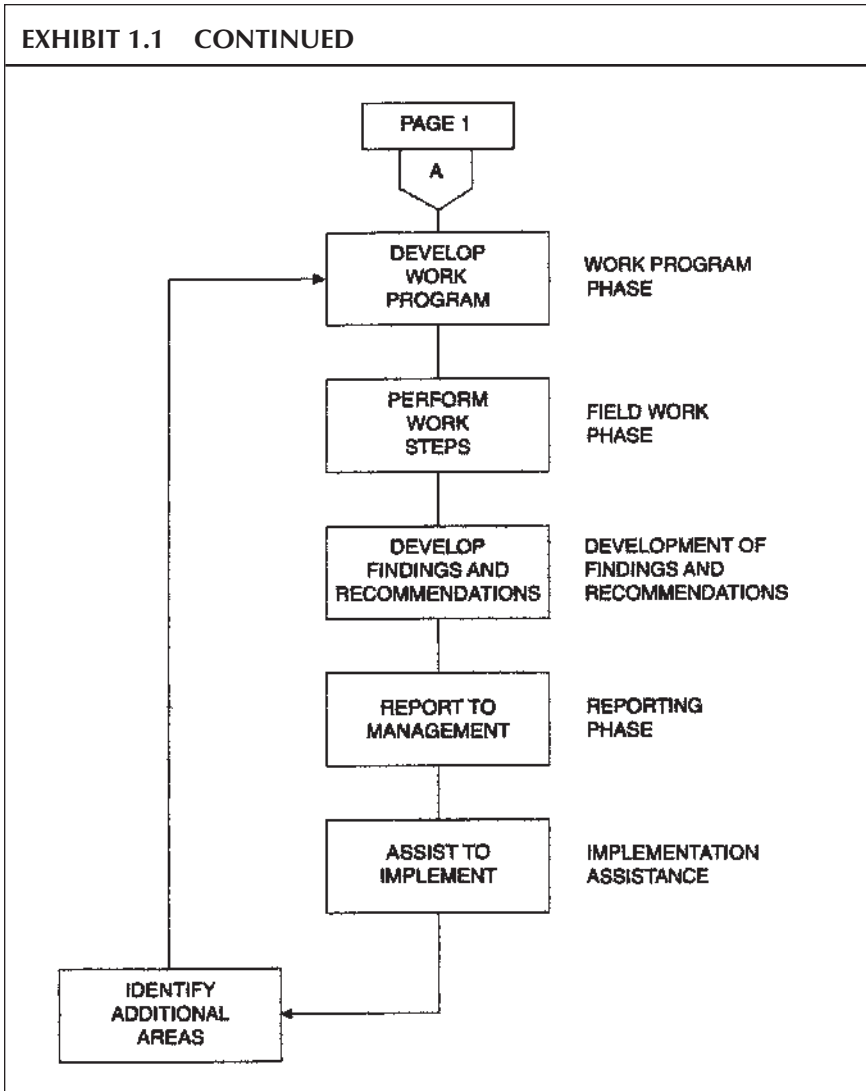
- Planning
- Work programs
- Field work
- Development of findings and recommendations
- Reporting

***Operational Review Phases
Cover All of the Bases***

Reader: Document how you would proceed in conducting your operational review based on the five-phase approach and the engagement development chart (see Exhibit 1.1) for an organization-wide and a specific functional review.

EXHIBIT 1.1 OPERATIONAL REVIEW ENGAGEMENT DEVELOPMENT





WHAT FUNCTIONS TO REVIEW

The most critical question for an organization to answer is what function or functions to include in the operational review. Where shall it review? Does it perform the operational review for all functions of the

organization or for only selected areas? One way to decide which functions to review is to determine how critical each function is to the overall organizational operation. Criteria for determining a company's critical areas include:

- Areas with large numbers in relationship to other functions, such as revenues, costs, percentage of total assets, number of sales, units of production, and personnel.
- Areas where controls are weak; for instance, there may be a lack of an effective manufacturing control system, management reporting system, or organizational planning and control system.
- Areas subject to abuse or laxity; for example, there may be inventory and production controls that allow transactions to go unreported and undetected, uncontrollable time and cost reporting, and ineffective personnel evaluation procedures.
- Areas that are difficult to control; for example, there may be ineffective storeroom, shipping, or time recording procedures.
- Areas where functions are not performed efficiently or economically; for instance, there may be ineffective procedures, duplication of efforts, unnecessary work steps, inefficient use of resources such as computer equipment, overstaffing, and excess purchases.
- Areas indicated by ratio, change, or trend analysis, such as characterized by wide swings up or down when compared over a number of periods. Examples include sales changes by product line, costs by major category, number of personnel, and inventory levels.
- Areas where management has identified specific weaknesses or needs for improvement, such as personnel functions, manufacturing procedures, computer operations, and management reporting.

A list of major organizational functions is as follows:

Board of Directors

- Management
- Organizational
- Departmental
- Reporting and control

Planning Systems

- Organizational
- Departmental
- Detail planning

Personnel

- Hiring procedures
- Evaluation procedures
- Staffing levels
- Payroll procedures

Accounting

- Assets
- Liabilities
- Budget procedures
- Payroll and labor distribution
- Accounts payable
- Accounts receivable
- Billing and collections
- Financial reporting
- Cost accounting procedures
- Borrowing and debt outstanding
- General ledger and journal entry system

Computer Processing

- Systems design and analysis
- Programming and software development
- Equipment and hardware
- Operating procedures
- Data control
- Reporting

Operations

- Purchasing
- Personnel administration
- Plant and/or office operations
- Manufacturing and/or service delivery controls
- Production control
- Inventory control
- Marketing and sales
- Engineering
- Property, plant, and equipment
- Fixed assets
- Insurance and risk management

Reader: A good starting point is to list the organization's major functions, to check off those where operational review would be most helpful, and then to prioritize each function as to its criticalness and/or the desired order of review. Based on the criteria in the preceding list for determining criticalness, check off those functions from the list of organizational functions that should be included in your organization's operational review and document each one's degree of criticalness.

INITIAL SURVEY

A sample operational review initial survey form is shown in Exhibit 1.2. The purpose of the initial survey is to identify areas of major importance in the total organization or specific operations to be reviewed.

Reader: Review the initial survey form in Exhibit 1.2. Make any necessary additions, deletions, and changes to individualize the form for use in your organization.

CASE STUDY—JOE SORRY, INC.

If the basic purposes for being in business as described in this chapter (i.e., customer service and cash conversion) are understood, how

EXHIBIT 1.2 SAMPLE OPERATIONAL REVIEW INITIAL SURVEY FORM***Planning and Budgeting***

1. How does the company plan? Describe the system of planning.
2. Does a long-range plan exist? Attach copy.
3. Do current short-term plans exist? Attach copy.
4. What are plans for expansion or improvement?
5. What are plans for physical plant development?
6. What are plans for future financing?
7. What are personnel plans?
8. How does the organization budget? Describe the budgeting system.
9. Does a current budget exist? Obtain or prepare copy.
10. Do budget versus actual statistics exist for the last five years of operations? Obtain or prepare copy.

Personnel and Staffing

1. Does an organizational chart exist? Obtain or prepare copy.
2. Do functional job descriptions exist for each block on the organization chart? Obtain or prepare copies.
3. Do staffing statistics by functional area exist? Obtain or prepare copy.
4. Is there a system of employee evaluations? Describe procedures.
5. How are employees recruited, hired, evaluated, and fired? Describe procedures.
6. How are new employees oriented and trained? Describe.
7. What are promotional policies? Describe.
8. How are raises and promotions determined? Describe.
9. Is there a grievance mechanism? Describe.
10. What type of personnel records are maintained? Obtain copies.

Management

1. Does a board of directors exist? Attach list of names and credentials.
2. Who is considered top management? Attach list of names and credentials.
3. Who is considered middle management? Attach list of names and credentials.
4. Who is considered lower management? Attach list of names and credentials.

EXHIBIT 1.2 CONTINUED

5. How adequate are existing reports in furnishing information for making management decisions? Describe.
6. Are there tools for internal downward communication to the staff? Attach copies.
7. Is authority effectively delegated to management and lower levels? Describe.

Policies and Procedures

1. Do written policies exist? Obtain copy.
2. Are written policies current?
3. Are systems and procedures documented? Obtain or provide copy.

Accounting System

1. What is the chart of accounts used? Obtain or prepare copy.
2. Is the accounting mechanized? Obtain documentation.
3. What financial reports are produced? Obtain documentation.
4. Is there an internal audit function? By and to whom?
5. Are internal operating reports produced? Obtain copies and determine uses.

Revenues

1. What are the sources of revenue for the last five years? Obtain or prepare statistics.
2. Have there been any substantial changes during this period? Document any that have been made.
3. Are actual versus budgeted data available? Obtain or prepare copy.

Expenses

1. What are the major expense accounts used? Obtain or prepare copy.
2. What are actual expenses for these accounts for the last five years? Obtain or prepare copy.
3. Have there been any substantial changes during this period? Document any that have been made.
4. Are actual versus budgeted data available? Obtain or prepare copy.

EXHIBIT 1.2 CONTINUED***Computer Processing***

1. Where is computer processing presently located in the organization? Obtain or prepare copy of information technology organization.
2. What computer equipment is used? Obtain or prepare copy of equipment list and locations.
3. What is total cost of equipment rental or purchase price?
4. What are the major applications computerized? Obtain or prepare copy of list of applications, with general systems applications.
5. Are management, operational, control, and exception reports provided? Describe.

Purchasing

1. What is purchasing authority? Obtain or prepare copy of policy relative to purchasing authority.
2. Is purchasing centralized or decentralized? Describe operations.
3. How are purchase requisitions initiated? Describe general procedures.
4. Who determines quality and quantity desired?
5. Are purchase orders used? Describe procedure.
6. Are competitive bidding procedures used? Describe procedure.

Manufacturing Systems

1. Is a computerized manufacturing control system being used? Describe operation.
2. What type of manufacturing processes are being used? Describe processes.
3. How are jobs controlled in manufacturing? Describe procedures.
4. Is a manufacturing cost system used by job? Describe system.
5. Are operational and management reports provided to control manufacturing operations? Obtain or prepare copies.

Production Control

1. Is a manufacturing control system being used? Is it computerized? Obtain or prepare copy of general procedures.
2. What types of manufacturing processes are being used? Describe.
3. What is location(s) of manufacturing facilities? Document.

EXHIBIT 1.2 CONTINUED

4. Are production control cost centers used to control the routing of manufacturing orders? Obtain or prepare copy of cost centers.
5. Is a manufacturing cost system used? Obtain or prepare copy of cost accounting procedures.
6. Are operational and management reports provided to control manufacturing operations? Obtain copies.

Inventory Control

1. Is an inventory control system being used? Is it computerized? Obtain or prepare copy of general procedures.
2. What types of inventory control procedures are being used? Describe.
3. Where are inventory storeroom locations? Obtain or prepare copy of locations and describe storeroom procedures.
4. How are inventory records maintained? Describe procedures.
5. Are inventory statistics and data maintained? Obtain data as to items in inventory, dollar value, usage, on-hand balances, etc.
6. What is basis for reordering inventory items, and how are reorder quantities determined? Describe procedures.

Responsibility and Authority

1. Are responsibilities clearly defined and understood by managers and staff personnel? Describe procedures.
2. Has authority been delegated effectively to managers and lower levels within the organization? Describe process.

have so many businesses gone astray? To illustrate some of these principles and the application of operational review concepts, let me share the story of one of my consulting clients whom we'll call Joe Sorry. Joe was a professional friend of mine working for a large national electronics organization as a top middle manager, but who wanted to have his own business. He knew he could run a business better than his present employers. He decided he was ready and hired me to assist him in putting his business together.

Joe had been employed by ACE Electronics for nearly 20 years, serving in a number of engineering and manufacturing positions at various locations. Presently, Joe was assigned as plant engineer to a small division manufacturing specialty printed circuit boards for a select number of customers. The company had always looked at this division as a sharer of overhead, not as a growth profit center. In fact, the division shared manufacturing space with a larger division and was considered a divisional “stepchild.” The company had recently been purchased in a leveraged buyout, and the new owners were going through a program of divestiture and selling off of various divisions and facilities, as well as a program of cost cutting and employee downsizing.

Joe’s division was one that the new owners decided to put up for sale. Joe was eager to buy it, because he felt very strongly that with the sale of his division he would be let go. He also believed that he could do a better job of managing and running the division on a full time basis than was presently being done by the parent company on a “stepchild”-type basis. Joe saw good potential for additional sales as the present company mainly treated this division as a specialty house for their existing customers. He also foresaw numerous possibilities for cost savings through production efficiencies as presently production was accomplished by inefficiently sharing space and manufacturing processes with the main division. In addition, by breaking away from the company, he believed this division could be operated at much less administrative cost and would not have to share the inequitable share of overhead burden allocated to them. Joe had no doubt that he could improve operations dramatically within the first year, and growth possibilities were extremely attractive.

Fortunately, Joe chose to purchase and start a business in which he knew something about: He had been the plant engineer for his previous employers’ electronics business. While he did not know everything there was to know about running a business—such as finance and accounting, sales and marketing, production and inventory control, and purchasing—he knew that in this business (at that time) it was fairly easy to produce a quality product for less than customers were willing to pay for it. He had seen his previous employer making bundles of money (in his terms) from this division in spite of themselves and their gross inefficiencies. He was certain that their internal reporting and allocation systems had made this division look worse

than it was and a prime candidate for sale. Joe knew he could do better.

Financing the Business

Joe had acquired some financial backing (other than his and his wife's savings, and his children's college fund) from his in-laws. Although Joe had some basic accounting knowledge, he did not have strong financial and accounting skills, but he knew he had to present some kind of projected numbers to acquire the additional financial backing he needed from others. For this purpose, Joe developed the following income statement projection, comparing the last year of ACE Electronics operations (in millions of dollars) with the projected future goals of Joe Sorry Company's operations:

	ACE Electronics		Joe Sorry Company	
	12-31-X1 Actual		12-31-X2 Projected	
Sales	\$4,200	100.0%	\$6,300	100.0%
Cost of Goods Sold	<u>2,940</u>	<u>70.0</u>	<u>3,900</u>	<u>61.9</u>
Manufacturing Profit	1,260	30.0	2,400	38.1
Selling, General & Administrative Expenses	<u>950</u>	<u>22.6</u>	<u>825</u>	<u>13.1</u>
Operating Profit	310	7.4	1,575	25.0
Taxes	<u>113</u>	<u>2.7</u>	<u>315</u>	<u>5.0</u>
Net Income	<u>\$ 197</u>	<u>4.7%</u>	<u>\$1,260</u>	<u>20.0%</u>

Based on the above projection, which Joe believed was relatively realistic, Joe performed no further financial studies, and his financial backers requested no additional data. Joe believed that through his efforts he would be able to easily meet the targeted increase in sales, decreases in costs of manufacturing and selling and administration, and resultant improvements in profitability. The combination of these factors should be enough to avoid any financial difficulties.

Background of Situation

Unfortunately, Joe's projections proved inadequate. He had not taken into consideration three significant factors:

1. Investment of over \$2 million in plant and equipment to gain all of his projected manufacturing efficiencies. Remember, the previous owners operated on a shared plant basis and Joe had to start from scratch.
2. Increase in sales to achieve his sales target from present customers and adding new customers would require increased sales efforts, possible lowering of prices, and more favorable credit terms. The previous owner did not actively look to increase this part of their business, as they saw it as a specialty service to their present customers.
3. It would take time (probably at least three years) to achieve the projected sales volume of over \$500,000 monthly sales to attain the \$6.3 million annual target.

ACE Electronics had enjoyed a unique position in its specialty circuit board division as demand for its products by existing customers exceeded its ability to supply the products. The division was able to sell all of its monthly allocated production quota of about \$300,000 on a continuing basis with no real effort. Due to the nature of the specialty of the product to its customers, ACE could require in most cases cash payment at the time of delivery. ACE was also able to dictate delivery schedules, which allowed them to intersperse their specialty board manufacturing into idle production slots of the main division. This was basically the concept and philosophy of the specialty board division; to fill in production gaps and assume some of the overhead of the main division.

When Joe took over the specialty board division, the division had reached a plateau of about \$300,00 in monthly sales, with operating profits in the 7 to 8 percent range. Joe set up an expansion program with a goal of increasing sales by at least 50 percent with an operating profit margin in the 20 to 25 percent range. Although Joe didn't achieve these goals the first year, by the third year his program was proving successful. His current monthly financial report showed that sales had increased to over \$500,000 with over \$100,000 in net income as shown below:

	Prior Month		Current Month		Next Month (Projected)	
Sales	\$416,000	100%	\$503,000	100%	\$515,000	100%
Cost of Goods Sold	<u>284,000</u>	<u>68%</u>	<u>335,000</u>	<u>67%</u>	<u>342,000</u>	<u>66%</u>
Manufacturing Profit	132,000	32%	168,000	33%	173,000	34%
Other Expenses	<u>58,000</u>	<u>14%</u>	<u>67,000</u>	<u>13%</u>	<u>70,000</u>	<u>14%</u>
Operating Profit	<u>\$ 74,000</u>	<u>18%</u>	<u>\$101,000</u>	<u>20%</u>	<u>\$103,000</u>	<u>20%</u>

Despite finally reaching his sales and profitability goals, Joe now found himself with an \$85,000 cash flow deficit by the end of the current month. Joe had always assumed that a profitable operation would automatically provide for enough cash. Had Joe understood operations, financial reporting, and related cash flow management better, he would have been able to predict what was happening. His present cash flow situation looked like this:

Beginning Cash	\$ 51,217
Collections	620,140
Inventory purchases	(248,386)
Payroll	(262,243)
Manufacturing Expenses	(86,667)
Selling General and Administrative	(112,834)
Equipment Purchases	<u>(46,571)</u>
Ending Cash	<u><u>(\$ 85,344)</u></u>

As Joe learned, even with the most successful businesses in terms of sales and net income, resources always have their limitations. Since Joe believed he understood the product side of the business, Joe hired us to conduct an operational review of his business to help put the business side together.

Educating the Client

The first thing Joe wanted explained to him was if he was making so much money, why didn't the business have any cash. Obviously, Joe's cash deficit wasn't due to anything magical, but developed predictably

from his normal business operations. I explained a number of things to Joe about accrual accounting versus operational data, mainly:

- Sales are recorded when made (goods shipped to the customer) and set up as accounts receivable, with cash being received at the time of payment.
- Expenses are made on a different timing schedule from cash receipts. For example, payroll is paid when due, although you may not receive payback via customer sales until some time in the future (typically over 30 days hence). This is also true of manufacturing costs such as materials and supplies.
- Profits shown on the income statement are based on accrual accounting; that is, sales are recorded when made not when accounts receivable are collected, and expenses are recorded as incurred not when they are paid from accounts payable.
- Some expenses are handled via accounting entries such as depreciation and amortization, while prepaid items are recorded currently but they represent prior cash disbursements.
- Expenditures for fixed assets, inventory, and other deferred expenses are paid for currently but do not immediately appear on the income statement.
- Financial statements do not provide all of the necessary data needed to manage and operate effectively; for example, they do not provide the costs and profits generated for each manufacturing order, the number of on-time deliveries, the amount of returned merchandise, or the amount and cost of rework.

Based on the preceding items, Joe's profit for the current month of \$101,000 turned into a cash deficit of \$85,344. This exemplifies the difference between profitability and liquidity, and accrual versus operational reporting. Had Joe understood these principles, he could have avoided such operational problems. We agreed that we would look at the major aspects of Joe's operations during the course of our operational review.

Preliminary Survey

As part of the operational audit process, it is good practice to meet with the client initially and perform a preliminary review of their operations

prior to submitting a proposal letter (or internal letter of understanding) as to the scope of the review and related fees. This preliminary review is normally performed at no cost to the client and takes from a half to a full day. It is your means to learn about the client and develop a proposal that incorporates the client's major critical operational areas into the operational review—so that you can provide the greatest benefit to their operations.

I started with Joe by explaining what I considered some basic business principles, such as:

- Produce the best quality product at the least possible cost.
- Set your selling prices realistically, so as to sell all the product that you can produce within the constraints of your production facilities (cost, pricing, volume analysis).
- Build trusting relationships with your critical vendors; keeping them in business is keeping you in business.
- You are in the customer service and cash conversion businesses.
- Don't spend a dollar you don't have to; a dollar not spent is a dollar to the bottom line. Control your costs effectively; there's more to be made here than increased sales.
- Manage your company; don't let it manage you. Provide guidance and direction, not crises.
- Identify your customers and develop marketing and sales plans with them in mind. Produce for your customers, not for inventory. Serve your customers, not sell them.
- Don't hire employees unless you absolutely need them; and only when they multiple your effectiveness so that you make more from them than if you could do it yourself.
- Keep property, plant, and equipment to the minimum necessary to maintain your customer demand.
- Plan for the realistic, but develop contingency plans for the positive unexpected.

Joe generally agreed with these principles, although he, like many new business owners, had visions of sugar plums in his head as to having an enormous physical plant and employees under his control. He wanted to be automatically large just like his previous employer, making the assumption that more was better. Joe wanted immediate gratifi-

cation for being the boss and felt he should have the same perquisites as he had before. When I explained to him that when he worked for the large corporation he was spending other people's money, and now he was spending his money, he seemed to understand.

While he still wanted the big corporation comforts, he now wasn't willing to spend his money; for he realized that an unnecessary dollar spent in the business was a dollar out of his pocket. As part of the preliminary survey, I talked to Joe to acquire a background of his business and his present position. Joe told me that he initially started his business, after acquiring it from ACE Electronics, in a large garage (which used to be a bicycle repair shop) with low rent. At that time, he and his wife Flo were the only employees. Joe started with three small contracts for specialized printed circuit boards that Joe had developed while previously employed at ACE. He established relationships with four circuit board vendors (after over a dozen turned him down) to provide him with the product as needed. I took a quick look at what Joe was purchasing and realized rather quickly that he was ordering all customized boards. I suggested that Joe standardize his outside needs, and customize his product in-house, which would simplify his material purchasing for himself and his vendors as well as cut his material costs with no substantial increase in his manufacturing costs. Joe readily accepted this suggestion with the comment, "Why didn't I ever think of that?" This is what is known as a "free bone," providing something to the client either before you are engaged or in addition to contracted services. This approach also increases your professional credibility and enhances your image.

He and Flo initially set up the in-house production flow on large secondhand wooden tables. When they needed to meet customer delivery commitments, they would have the vendors deliver the boards and at the same time contract with just the number of individuals to customize the product. Flo would train the production staff; supervise production, packing, and shipping; and bill the customers. Joe was responsible for engineering, purchasing and vendor relations, and sales and marketing—working mainly out of his house and car. As Joe and Flo said in those days, "They were one big happy family."

As Joe was able to get more business, the cycle would continue. The first year, Joe worked to build the business, and sticking with specialty and custom circuit boards only, had over \$3 million in sales with a reported net profit after Joe and Flo's salaries of about \$440,000 (a net profit margin of over 13 percent—not bad for the first year of

any business). He and Flo, of course, were working more than they had in their previous jobs. However, they now had one additional ingredient—ownership—and they were building appreciation in their own business.

Fairly quickly, the word spread that Joe was providing a proprietary quality product at reasonable cost. Joe was now able to bring in more business than his little garage shop and he and Flo could handle by themselves. With Joe's initial success, he now believed that he had the business acumen to run any business successfully. Nothing builds incompetence greater than success.

The company started to grow and grow and grow. During this period, I would see him every so often and he would tell me how well he was doing—in terms of square feet of production and office space, total sales, amount of backlog, number of employees and total payroll, and so on. I cautioned him not to grow too fast and lose control and those elements that had made him successful initially, but he didn't listen. He was becoming just like his previous employer. I asked Joe what he saw as the problems with his company. He started off telling me how well he was doing—again by the numbers. I stopped him and asked him specifically what was the trouble. After hesitating, he finally admitted that he was so successful, it was driving him crazy—and Flo was in therapy. They had become one big unhappy, dysfunctional family.

The Agreement

After talking with Joe, reviewing his operations, general analysis of the financial statements, review of internal reports, and so on, it was agreed that we would review the following functions of the Joe Sorry Company:

- *Personnel*: both manufacturing and general and administrative, as to number and types of personnel necessary.
- *Manufacturing operations*: production and inventory control methods and procedures.
- *Product line analysis*: sales, cost, and pricing considerations of the various products.
- *Profit center concepts*: looking at the various businesses such specialty boards, custom boards, defense business, and basic boards.

- *Operational reporting considerations*: such as key operating indicators, type of reporting, and use of reporting.
- *Planning and budget systems*: including strategic and long-term planning, organization and departmental short-term planning, detail planning, and effective budget techniques.

Proposal or Confirming Letter

Based on our agreement with Joe, we would submit either a confirming letter (where Joe has already agreed to have us perform the operational review) or a proposal letter (where Joe wants to review what we are proposing in writing prior to committing). In this case, as Joe agreed to our conducting the operational review, we submitted a confirming letter (see Exhibit 1.3). Note that if you are an internal auditor, it is still suggested that you submit either one of these documents as a letter of understanding to your internal client. Once agreed upon by the client, this becomes your contract.

THE INITIAL SURVEY

To achieve the greatest results from limited operational review resources (in this case about 200 budgeted hours of outside and inside assistance), the review team needs to identify the areas of major importance and those offering the greatest potential savings or benefits as quickly as possible. The identification of these areas is done as part of an initial survey, either prior to or as part of the planning phase of the operational review.

The initial survey form is a quick review tool to help identify critical areas for further review, where it is not feasible or is time or cost prohibitive to perform the more desirable (but time consuming) full planning phase. However, it is still the reviewer's responsibility to substantiate the identification of critical operational areas to be reviewed with adequate evidential matter. Improper identification results in spending unnecessary effort on less significant activities and insufficient effort on more important areas. The same questions and answers may also be reviewed with various personnel, such as departmental management, functional supervision, and operations and support personnel. The reviewer thus isolates patterns of agreement

EXHIBIT 1.3 SAMPLE CONFORMING LETTER

April 12

Mr. Joseph Sorry
President
Joseph Sorry, Inc.
#8 Lucky Chance Industrial Park
Broadacres, XX XXXXX

Dear Mr. Sorry

It was a pleasure meeting with you and Flo on April 4 to discuss how Reider Associates might assist you in the review and analysis of your operations. This letter confirms the arrangements agreed upon by us at this meeting.

Background

You are in the business of manufacturing various types of printed circuit boards for the electronics industry—such as specialty boards, custom boards, defense contractor requirements, and basic boards on a competitive basis. You bought the business from your previous employer, ACE Electronics, about three years ago and have had enormous success since then. In fact, recently you surpassed them both in sales volume and reported net income. However, with such growth, you have experienced many operational problems to the point that you are presently in a negative cash flow and short-term liquidity bind. In addition, the operation has grown so large that you can no longer exercise proper control, and your wife Flo, the titular Vice President of Operations, has opted for a less demanding role in the business. Due to these situations and others, you have asked Reider Associates to assist you in identifying workable solutions to these operational concerns.

Objectives of the Operational Review

Based on our preliminary review and our discussions with you and your personnel, we believe that the objectives of the operational review of your company would be to:

1. Determine the organization structure and the related number of personnel required to most effectively operate your company to meet your desired results.

EXHIBIT 1.3 CONTINUED

2. Determine which systems and procedures would be best to improve your manufacturing operations.
3. Determine which business or businesses—specialty, custom, defense, and basic—you should be in and which product lines you should be offering to whom and at what price.
4. Design operating systems and data processing procedures to enable all of your operating functions to assist in the effective management of the varied aspects of your business.
5. Identify opportunities for operational improvements within all functions of the Joe Sorry Company.
6. Develop effective planning and budget systems that will assist your providing effective direction and guidance for the company and its various departmental functions.

Identification of Major Areas

Based on our discussions with you and Flo and others in your organization, as well as our preliminary review of your operations, we have identified the following areas for concentration in the review of your operations:

- *Personnel*: including direct manufacturing and support functions, as well as selling, general, and administrative operations
- *Manufacturing operations*: including production and inventory control methods and procedures
- *Product line analysis*: reviewing the various product lines produced and sold including such aspects as sales, cost, and pricing considerations
- *Profit center concepts*: looking at the various businesses such as specialty boards, custom boards, defense business, and basic boards
- *Operational reporting considerations*: analyzing present reporting procedures and developing an effective operating reporting system that allows you to effectively manage all of the varied aspects of the business
- *Planning and budget systems*: assistance in developing effective planning techniques for your business, which would include strategic and long-term planning, organization and departmental short-term planning, ongoing detail planning, and effective budget techniques.

Our Approach

The work steps that we plan to follow to assist you in identifying and remediating those areas in need of positive improvement in your operations are:

EXHIBIT 1.3 CONTINUED

1. General review of existing operational methods and procedures to provide us with a clear understanding of your operating functions, so that we can provide effective consulting assistance in developing and implementing improved procedures. This would include a review of all operating systems and methods, as well as management and administrative practices.
2. Interview a number of management/supervisory and operating personnel so that we can assess individual needs and concerns as well as incorporate such concerns into overall considerations. We will attempt to interview each of your personnel assigned management/supervisory responsibilities as well as a representative number of operations personnel in each function. We will also prepare an employee questionnaire for each employee's response. We will, of course, discuss the findings of our general review and interviews with you so that we can jointly agree as to the major issues for change to be included in our detailed review and analysis.
3. Detailed operational review and analysis of those critical areas identified in our preliminary review as previously described. We will perform sufficient analytical work to fully determine the present condition of each area, what it should be, the effect on operations, the cause of the condition, and practical recommendations for improvement.
4. Develop detailed findings and recommendations for improvement, which will be developed in a manner that will optimize each function's achievement of their individual goals and objectives. These findings and recommendations will be documented for your review in both an oral presentation and a written report.
5. Provide assistance to you and your staff in the implementation of recommendations that can be accomplished during the course of this operational review. Other longer-term recommendations will be reviewed with you at the oral presentation at the conclusion of our field work and subsequently documented in the final report summarizing the results of the operational review. We are available, of course, to provide the necessary assistance to you in the successful implementation of any of these longer-term recommendations.

Participation

Mr. Rob Reider, President of Reider Associates, will be personally responsible for the technical conduct and successful completion of this operational review of your company. We plan to assign two other members of

EXHIBIT 1.3 CONTINUED

our staff, Marlene Morris and Samuel Hornsworth, both of whom are qualified to perform the tasks required on this operational review. They would be responsible for the performance of the work steps as described in the Our Approach section.

As we discussed, we believe that it is essential for such an operational review to be successful to have client participation. Accordingly, we are recommending that your Vice President of Production, Ed Harrison, share joint management responsibility, and that the Controller, Patricia Flood, and one of the forepersons, Pedro (Pete) Herrera, work along with us. We would expect these personnel to participate in the review as necessary, to attend scheduled progress meetings, and to provide us with necessary input. We do not expect them to be assigned tasks that would consume more than two days per week during the course of the review or interfere with their regular duties and functions.

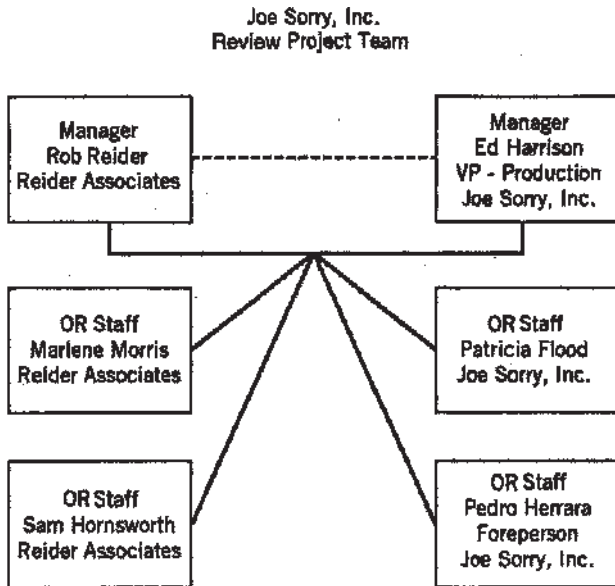


EXHIBIT 1.3 CONTINUED***Benefits to Be Provided***

The benefits to be provided from the conducting of an operational review of the Joe Sorry Company are many and varied. However, you should expect at least the following:

1. Identification of operational areas in need of improvement, related causes, and recommendations for improvement.
2. Effective reduction of unnecessary costs through the identification of opportunities for eliminating waste and inefficiency.
3. Identification of undefined plans or desired results, goals, objectives, systems, and procedures.
4. Assessment of the existing management information and control system, together with recommendations for design of a more effective system that allows for appropriate management.
5. Development of meaningful operating systems and procedures that will enable you and your personnel to better control, monitor, and evaluate the results of operations.
6. Implementation of improved operating techniques that will enable all levels of your personnel to perform their current and proposed job responsibilities more effectively with a greater level of competency and understanding.
7. Provide for an independent, objective evaluation of your operations with practical recommendations for positive improvements.

Time and Cost

Based on our experience on similar operational reviews, our preliminary survey of your operations, and discussions with you, we estimate that our time participation should not exceed 140 hours at an estimated cost of \$12,000 to \$16,000 (see attached Confirming Letter Budget Estimate). We will, of course, bill you only for the time actually expended on this review. In addition we are to be reimbursed for out-of-pocket expenses.

We appreciate the opportunity to provide these important services to you and your company and look forward to working with you. If you have any further questions, please let me know. As we discussed, we are planning to begin the operational review next Monday. If the arrangements described above meet with your approval, you may indicate your acceptance by signing and returning the enclosed copy. We will then proceed as planned.

EXHIBIT 1.3 CONTINUED				
Approved By: _____ Joe Sorry, President Joe Sorry, Inc. Date: _____	Very truly yours, _____ Rob Reider, President REIDER ASSOCIATES			
CONFIRMING LETTER BUDGET ESTIMATE				
Joe Sorry Inc. Confirming Letter Budget Estimate				
	Manager	Staff	Total	Client
Review Area:				
1. Personnel				
—Manufacturing	4	16	20	8
—Selling, G&A	2	10	12	6
2. Manufacturing Operations				
—Production Functions	4	8	12	6
—Inventory Operations	2	4	6	2
3. Product Line Analysis	2	4	6	—
4. Profit Center Concepts	4	2	6	—
5. Operational Reporting	4	4	8	6
6. Planning and Budget Systems	4	4	8	6
Total Review Time	<u>26</u>	<u>52</u>	<u>78</u>	<u>34</u>
Other Functions:				
Prepare Work Program	4	6	10	6
Review Results	8	2	10	10
Develop Findings	4	8	12	8
Oral Reporting	4	4	8	4
Written Report	4	8	12	8
Total Other Time	<u>24</u>	<u>28</u>	<u>52</u>	<u>36</u>
Grand Total Time	50	80	130	70
Standard Billing Rates	\$120	\$ 80		
Total Estimated Fees	\$6,000	\$6,400	\$12,400	
Contingency @ 10%			1,240	
Grand Total			<u>\$13,640</u>	
Fee Quoted			<u>\$12,000 to \$16,000</u>	

and disagreement and various interpretations and perceptions that help reach the correct conclusions.

We asked Joe and Flo Sorry to respond to our initial survey prior to the start of our review. Our purpose was to increase our knowledge of their operations and gain some insight as to potential problem or critical areas. Their responses to our initial survey form are shown in Exhibit 1.4.

THE ENTRANCE CONFERENCE

Because many small (and large) businesses are skeptical or not knowledgeable about the operational review process, it is good practice to start the review with an entrance conference between the review team and the company's owners, management, and operations personnel. Based on the Joe Sorry situation, the purpose of the entrance conference would be to:

- Build initial rapport and a cooperative atmosphere between the review team members and operations personnel.
- Provide clear understanding to operations personnel as to the purpose, objectives, scope, approach, and expected results of the operational review.
- Clarify which tasks the review team will be performing on the operational review and what is expected of operations.
- Reduce operations personnel distrust as to why you are there and build confidence in what you are doing on the review.
- Communicate Joe and Flo's support of the review team's efforts, and that this review is something they want done.

The entrance conference at the Joe Sorry company was conducted by the review team, with Joe and Flo and the managers present, as well as affected operations personnel. This helped to prevent misunderstandings, which could be settled immediately prior to starting the operational review. The successful entrance conference served to create a favorable first impression and set a positive tone for the remainder of the review.

EXHIBIT 1.4 INITIAL SURVEY FORM

**Joe Sorry, Inc.
Operational Review
Initial Survey Form**

Planning and Budgeting

1. How does Joe Sorry, Inc. plan? Describe the system of planning.
Response: Basically, day-to-day planning, with Joe making the decisions as to what needs to get out.
2. Does a long-range plan exist? If so, attach copy.
Response: Joe's plan is to be the biggest he can, in terms of sales and income.
3. Do current short-term plans exist? If so, attach copy.
Response: As mentioned, only Joe's day-to-day plans.
4. What are plans for expansion or improvement?
Response: Recently expanded and already need more capacity.
Talking to industrial park people as to additional available space.
Systems need to be improved; that's why you're here.
5. What are plans for physical plant development?
Response: Hoping you can tell us.
6. What are plans for future financing?
Response: Present short-term line of credit of \$3 million.
Looking for long-term financing.
7. What are personnel plans?
Response: Looking to increase management capability by adding Vice Presidents of Personnel, Purchasing, Sales (Marketing?), and Engineering. Also adding some middle-level management positions such as Plant Manager, Maintenance Manager, Shipping and Receiving Manager, and Production Expeditors.
8. How does the organization budget? Describe the system.
Response: Controller prepares annual budget and reviews with Joe and Flo each month.
9. Does a current budget exist? Provide copy.
Response: Yes, copy attached.

EXHIBIT 1.4 CONTINUED

10. Do budget vs. actual statistics exist for the last two full years of operations?

Response: No. Done on a month-to-month basis.

Personnel and Staffing

1. Does an organizational chart exist? If so, provide copy.

Response: No.

2. Do functional job descriptions exist for each block on the organization chart? If so, provide copies.

Response: No

3. Do staffing statistics by functional area exist? If so, provide copy.

Response: Only via payroll records. Some departments may maintain their own, but don't know.

4. Is there a system of employee evaluations? Describe.

Response: Joe evaluates all management personnel. Managers evaluate personnel reporting to them; Joe then makes final decisions.

5. How are employees recruited, hired, and fired?

Response: Recruitment no problem—people want to work here—we're known for good pay in area. Hiring and firing done by department managers with Joe's review and approval.

6. How are employees oriented and trained?

Response: Responsibility of each department.

7. What are promotional policies?

Response: Recommendation of manager and Joe's approval.

8. How are raises determined?

Response: For the two full years we have been in business, Joe has decided on across the board increases (6% and 8%) for nonmanagement employees and individual raises for managers.

9. Is there a grievance mechanism?

Response: Departmental managers handle. May refer to Joe.

10. What type of personnel records are maintained?

Response: Payroll records and time cards for nonmanagement.

EXHIBIT 1.4 CONTINUED***Management***

1. Who is considered top management? Provide list of names.
Response: Joe Sorry, President
Flo Sorry, Vice President of Operations
Ed Harrison, Vice President—Production
2. Who is considered middle management? Provide list of names.
Response: Janet Birch, Personnel Manager
Bill O'Hallaron, Quality Control Manager
Russ Rogers, Purchasing Manager
Todd Dailey, Engineering Director
Patricia Flood, Controller
Al Slap, Customer Service Manager
3. How adequate are existing reports in furnishing information for making management decisions?
Response: Reports too late, have already taken action.
4. Are there internal downward communication tools to the staff?
Response: By Joe, as necessary.
5. Is authority effectively delegated to management and lower levels?
Response: Each department runs on its own; Joe oversees the overall operation.

Policies and Procedures

1. Do written policies exist? If so, provide copy.
Response: No, Joe sets all policies.
2. Are systems and procedures documented? If so, provide copy.
Response: If any, within each department.

Computer Processing

1. What computer equipment is used? Provide list and locations.
Response: Each department has PCs networked to a central file server.
No list is available.

EXHIBIT 1.4 CONTINUED

2. What major applications are computerized? Provide list.

Response: Accounting Systems
 Manufacturing Systems
 Purchasing System
 Engineering—Computer-Assisted Design (CAD)

3. Are management, operational, control, and exception reports provided? Describe.

Response: Lot of reports, mainly used by each department.

Manufacturing Systems

1. Is a computerized manufacturing control system being used?

Response: Yes. Check with Ed Harrison.

2. What type of manufacturing processes are being used? Describe.

Response: Six assembly tables with six positions each.

3. How are jobs controlled in manufacturing?

Response: By customer and by demand.

4. Is a manufacturing cost system used by job?

Response: No, only by total for the month.

5. Are operational and management reports provided to control manufacturing operations? If so, provide copies.

Response: Not sure. Check with Ed Harrison.

6. Is an inventory control system being used? Computerized?

Response: Yes, and it is computerized.

7. What type of inventory control procedures are being used?

Response: Reorder points and reorder quantities.

8. Are inventory statistics and data maintained? Does it include data such as items in inventory, dollar value, usage, on hand balances, etc.

Response: Yes, but can't be relied upon.

Responsibility and Authority

1. Are responsibilities clearly defined and understood by managers and staff personnel?

Response: Joe defines responsibilities for managers, managers for their employees.

EXHIBIT 1.4 CONTINUED				
<p>2. Has authority been delegated effectively to managers and lower levels within the organization? Response: Employees have authority to function on their own, come to Joe if there is a problem.</p>				
<p>Joe Sorry, Inc. Annual Budget (in thousands of dollars)</p>				
			Dollars	%
Sales			\$ 6,000	100%
Cost of Goods Sold			<u>4,000</u>	<u>67%</u>
Manufacturing Profit			\$ 2,000	33%
Selling Expenses			550	9%
General & Administrative			<u>350</u>	<u>6%</u>
Operating Profit			\$ 1,100	18%
Taxes			<u>\$ 300</u>	<u>5%</u>
Net Income			<u><u>\$ 800</u></u>	<u><u>13%</u></u>
<p>Joe Sorry, Inc. Monthly Budget Report—March</p>				
	Actual		Budget	
	Dollars	%	Dollars	%
Sales	\$ 418	100%	\$ 500	100%
Cost Of Goods Sold	<u>295</u>	<u>71%</u>	<u>333</u>	<u>67%</u>
Manufacturing Profit	\$ 123	29%	\$ 167	33%
Selling Expenses	54	13%	45	9%
General & Administrative	<u>38</u>	<u>9%</u>	<u>30</u>	<u>6%</u>
Operating Profit	\$ 31	7%	\$ 92	18%
Taxes	<u>\$ 10</u>	<u>2%</u>	<u>\$ 25</u>	<u>5%</u>
Net Income	<u><u>\$ 21</u></u>	<u><u>5%</u></u>	<u><u>\$ 67</u></u>	<u><u>13%</u></u>

At the conclusion of the entrance conference, all personnel were given the following two forms to fill out and return to the review team:

- Violations of Principles of Good Business Practice (see Exhibit 1.5)
- Job Responsibilities Questionnaire (see Exhibit 1.6)

CASE SITUATION: Leasing Insurance Costs

Reader: Review the case situation below and document your answers to the question presented. Then review the suggested responses.

During the course of your operational review procedures, you found that the company was paying for liability and property damage insurance as part of their lease agreement on 14 tractors and 19 trailers. The cost of the insurance was hidden in the fixed weekly/mileage rates billed by the lessor.

The company's policy is to self-insure or assume certain risks (such as auto collision and certain other property losses, and the front end of unknown claims such as liability claims) and to purchase protection for any other risks under a blanket policy.

Question for Consideration

1. What steps would you take to follow through on this operational practice?

Suggested Response

1. What steps would you take to follow through on this operational practice?
 - a. Compare annual hidden insurance costs paid to the lessor as part of fixed weekly/mileage rates with what insurance would cost under the company's self-insurance and blanket insurance for major losses.
 - b. Request insurance charges from lessor for preceding year.
 - c. Determine insurance costs under company's blanket policy.
 - d. Based on amount of savings (if any), decide what to recommend:

EXHIBIT 1.5 VIOLATIONS OF PRINCIPLES OF GOOD BUSINESS PRACTICE

Please review the following items representing violations of good business practices. Place a check mark next to those items that you believe Joe Sorry, Inc. or your department to be guilty of doing. Recording your name on this survey is optional. Please return your completed form to Rob Reider of Reider Associates.

A. Planning

- 1. Not setting or updating organizational standards or goals
- 2. Not establishing clear long-term or short-term objectives.
- 3. Not developing detail plans as to how plans are to be carried out
- 4. Not developing budgets that relate to short-term plans
- 5. Not prescribing a system of review and replanning

B. Organizing

- 1. Not hiring the right people for the job
- 2. Not orienting, training, or instructing supervisees
- 3. Not assigning work on an even distribution
- 4. Not having the right number of personnel—more or less
- 5. Not providing adequate resources, facilities, or equipment

C. Scheduling

- 1. Not providing schedules and budgets for each job
- 2. Not highlighting oldest, off-schedule, or over-budget jobs
- 3. Not setting priorities for incoming work
- 4. Not readjusting schedules when changes are necessary
- 5. Not requiring approval for nonscheduled work

D. Coordinating

- 1. Not providing for coordination of company goals and objectives with those of each department
- 2. Not periodically reviewing the needs of all work units
- 3. Not communicating organization policies and departmental procedures to personnel
- 4. Not effectively communicating downward
- 5. Not coordinating information relating to various departments

EXHIBIT 1.5 CONTINUED*E. Directing*

- 1. Not providing clear expectations and instructions
- 2. Not reviewing work and providing positive feedback so as to provide correction rather than ongoing criticism
- 3. Not fixing the situation rather than fixing the blame
- 4. Not providing a coaching or facilitative environment
- 5. Not periodically reviewing work loads and priorities

F. Obtaining Feedback

- 1. Not providing feedback on the quality of work, so as to build on work done well and remediate work not done well
- 2. Not comparing results with communicated expectations and investigating variances—both positive and negative
- 3. Not effectively communicating to the worker where a job does not meet standards
- 4. Not effectively inspecting ongoing processes at strategic points in the system (adequate quality control procedures)
- 5. Not acting on customer complaints or returned work

G. Achieving Information

- 1. Not replacing ineffective standards, procedures, or systems
- 2. Not establishing a program of positive improvement
- 3. Not reviewing operations so as to be most economical, efficient, and effective
- 4. Not encouraging (or coaching and facilitating) employees to upgrade their capabilities
- 5. Not correcting or reporting variances promptly

Note: This form was sent to all 135 employees.

EXHIBIT 1.6 JOB RESPONSIBILITIES QUESTIONNAIRE

Instructions

The purpose of this form is to help you describe the duties and responsibilities of your job and the jobs of your supervisees. A separate questionnaire is to be completed for each employee under your supervision, as well as one for your own job. In the event that two or more employees perform identical duties, only one questionnaire need be completed. However, the names of all employees covered by the questionnaire should be included in the identification section. Please read the entire questionnaire carefully before answering any questions; type or print your answers clearly.

**Please Return this Questionnaire to:
Mr. Cliff Chambers
By April 30, XXXX**

Identification

Employee Name _____ Title _____
 Division _____ Department _____
 Name of Immediate Supervisor _____
 Title of Immediate Supervisor _____
 Your Name _____ Date _____

A. *Description of Regular Duties and Tasks.* Describe each of the duties and responsibilities in the employee’s regular routine, in two or three sentences. The first sentence in each case might tell what the employee is supposed to do, and the next sentence might tell how it is done. Do not refer to previous job descriptions or attempt to describe what you think the job *should* be. Write what is *actually* done. In addition, enter the number of hours usually spent on each duty or responsibility under either the “Daily,” “Weekly,” or “Monthly” column.

If you do not have enough room to describe the job duties and responsibilities, you can complete them on the back of Page 2 or on a blank piece of paper, which should then be attached.

EXHIBIT 1.6 CONTINUED			
Duties and/or Responsibilities	Time		
	Daily	Weekly	Monthly
1. _____ _____	_____	_____	_____
2. _____ _____	_____	_____	_____
3. _____ _____	_____	_____	_____
4. _____ _____	_____	_____	_____
5. _____ _____	_____	_____	_____
<p>B. <i>Difficulty of the Job.</i> What, in your opinion, is the most difficult feature of the job, and why is this so?</p>			
<p>C. <i>Description of Contacts.</i> List the persons (by general job title, not name) with whom the employee comes in contact in the performance of normal job duties. Contacts may be either (1) within the employee's own department or division or (2) within other divisions of the firm. Under the heading of "Frequency," indicate whether these contacts (conversations, correspondence, meetings, etc.) are made "not often," "moderately often," "very often," or "constantly."</p>			

EXHIBIT 1.6 CONTINUED		
Contacts Within Your Own Department or Division		
	Reason for Contact	Frequency
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
Contacts with Other Divisions of the Firm		
	Reason for Contact	Frequency
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
<p>D. <i>Work Flow</i>. The purpose of this question is to determine where the employee's work originates and where the results of employee's contributions to the work terminate; that is, where do the data for completing a form originate, and where copies of the form are sent.</p>		
Form Title	Data Source (No. Forms/Week)	Frequency
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

EXHIBIT 1.6 CONTINUED						
Form Title	Form Destination					
	Copy A	Copy B	Copy C	Copy D	Copy E	Copy F
<p>E. <i>Additional Remarks.</i> State additional information that you believe would help in describing or understanding the duties of this job.</p>						
<p>F. <i>Types of Employees' Jobs Supervised.</i> List the job titles of employees supervised and the number in each classification.</p>						

If substantial savings, recommend insurance provided by the lessor to be dropped, and insurance to be provided under company's blanket policy.

If no savings or if savings are not substantial, recommend continuing present practice of lessor providing insurance (may also look into lessor reducing coverage and/or insurance premiums presently being carried).

If practice of obtaining insurance as part of the lease agreement is more economical than the policy of self-insurance, consider changing the self-insurance policy.

If the policy of self-insurance is the most economical route, review operations to determine to what extent the policy is being ignored and resultant cost.

Note: In a real-life version of this particular situation, it was found that lessor insurance costs totaled \$39,000 for the year, and that the costs under the company's self-insurance and blanket policy would have been \$6,000. Accordingly, an annual savings of \$33,000 was realized by reverting back to the self-insurance policy. This situation would be reviewed periodically in the future to ensure that conditions hadn't changed or that other best practices had come into existence.

REVIEW QUESTIONS

Reader: Answer these questions as a review and reinforcement of areas presented in this chapter. Try to answer the questions for yourself prior to reviewing the suggested responses.

1. An operational review involves a systematic review of an organization's activities in relation to specified objectives. What are the three major purposes of such an operational review?
2. What are the major components of operational reviews?
3. List the benefits of an operational review to top management and staff.
4. What are the four major attributes that a successful operational reviewer should possess?
5. What are the five phases of an operational review?

SUGGESTED RESPONSES

1. An operational review involves a systematic review of an organization's activities in relation to specified objectives. What are the three major purposes of such an operational review?

Response

- *Assess Performance.* Compare the manner in which activities are conducted to established objectives or other appropriate measurement criteria.
- *Identify Opportunities for Improvement.* Through effective operational review techniques, identify those operational areas where increased economy, efficiency, or effectiveness would provide positive improvements.
- *Develop Recommendations for Improvement or Further Action.* Analyze the situation and determine the best alternatives and practices in the specific situation to effect positive improvements.

2. What are the major components of operational reviews?

Response

- *Financial.* Proper and adequate accounting and reporting procedures, basically the same as a conventional financial audit or review.
- *Compliance.* Adherence to rules expressed in applicable laws and regulations, and internal policies and procedures.
- *Economy and Efficiency.* Performance of operational activities economically and in an efficient manner. Is this the most economical and efficient way to get the right job done in the right manner.
- *Effectiveness.* Results and accomplishments achieved and benefits provided. Is activity achieving its ultimate intended purpose? Is the purpose the right one?

3. List the benefits of an operational review to top management and staff.

Response

- Identification of problem areas, related causes and alternatives for improvement
- Locating opportunities for eliminating waste and inefficiency—cost reduction
- Locating opportunities to increase revenues—revenue enhancement

- Locating opportunities to increase revenues and reduce costs—profit improvement
 - Identification of undefined organizational goals, objectives, policies, and procedures
 - Identification of criteria for measuring the achievement of organizational goals and objectives
 - Recommending improvement in policies, procedures, and organizational structure
 - Providing checks on performance by individuals, groups, work units and the organizational structure
 - Reviewing compliance with legal requirements, organizational goals, objectives, policies, and procedures
 - Testing for existence of unauthorized, fraudulent, or otherwise irregular acts
 - Assessment of management information and control systems
 - Identifying possible trouble spots in future operations
 - Providing an additional channel of communication between operating levels and top management
 - An independent, objective evaluation of operations
4. What are the four major attributes that a successful operational reviewer should possess?

Response

- Ability to spot the trouble areas.
 - Common sense, to avoid milking mice when you should be chasing elephants.
 - Ability to place yourself in the management position, analyze the problem, and ask the question from a management perspective.
 - Effective communication skills relative to operational review results. The success of the operational review is measured by the degree with which your recommendations are implemented through your ability to convince and persuade management.
5. What are the five phases of an operational review?

Response

- The planning phase
- The work program phase
- The field work phase
- The development of findings and recommendations phase
- The reporting phase