

## CHAPTER ONE

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# Overview of Operational Reviews

This chapter provides an overview of operational review concepts and principles and terminology. In an ever-changing economic and competitive environment, management is looking for more than historical financial data. Managers need and request information about the internal operations of their organization, and seek recommendations as to how they can manage and operate more economically, efficiently, and effectively. 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.

## OVERVIEW OF OPERATIONAL REVIEWS

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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***

## OPERATIONAL REVIEW CONCEPTS

Organizations have been in existence for thousands of years, some successful and long-lasting, others short-lived. Through the years there have been no clear cut criteria or formula for success. Many business organizations have been successful through such intangible attributes as luck, falling into a market niche, being the first, consumer acceptance, and so on. Other companies, even some using the best available business acumen and methods, have failed miserably.

Identifying, implementing, and maintaining the secrets of success is an elusive target. Banking on what has worked in the past and one's own internal Ouija board are ineffective substitutes for objective internal appraisal and external comparison and analysis—what is called an operational review. Operational reviews are becoming the tool of choice for gathering data related to programs of continuous improvement and to gain competitive advantage.

Operational review can be defined as a process for analyzing internal operations and activities to identify areas for positive improvement in a program of continuous improvement. The process begins with an analysis of existing operations and activities, identifies areas for positive improvement,

## OPERATIONAL REVIEW CONCEPTS

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and then establishes a performance standard upon which the activity can be measured. The goal is to improve each identified activity so that it can be the best possible, and stay that way. The best practice is not always measured in terms of least costs, but more often may be what stakeholders value and expected levels of performance.

***The Goal Is to Make Each Activity  
the Best Possible—  
And Keep It That Way***

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 and 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

Operational review results provide the company—owners, management, and employees—with data necessary for effective resource allocation and the strategic focus for the organization. The operational review process provides for those objective measures to determine the success of the company's internal goals, objectives, and detail plans, as well as external and competitive performance measures. Evaluating a company's performance against stakeholder expectations enables the company to pursue its program of continuous improvement on the road to excellence. Effective operational review procedures encompass both internal and external needs.

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**OVERVIEW OF OPERATIONAL REVIEWS**

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

Managers or supervisors who are responsible for an operational area have traditionally maintained the operation as they found it; that is they primarily accepted the organization, personnel, and functions they inherited. They were not allowed or did not understand how to make their assigned area of responsibility more efficient. And many times, there were systems in effect (such as overcontrolling bosses) that prevented such positive changes. The purpose of the operational review is to assist managers and operations personnel in looking at their areas of responsibility from an operational viewpoint. This means that operations are viewed with an eye toward whether they can be improved so as to be performed more efficiently, effectively, or economically.

Given today's increasingly varied and competitive economic environment, management places more and more emphasis on the evaluation of the economy, efficiency, and effectiveness of the organization's operations. Managers and employees of an operational area are often too close to operations, too resistant to change, too enmeshed in daily operations, and so on, to review their own operations objectively. Because both internal and external consultants have the fact-finding and diagnostic skills needed to perform such operational reviews, they are frequently asked to do so. In some organizations, a separate unit is formed strictly to perform operational reviews.

Operational reviewing got its start when management stopped being concerned solely with reviewing the reporting of information and started wondering why a transaction was made in the first place and whether there was a better way to do it. Operational review is the process whereby the reviewer determines whether members of management are using the resources entrusted to them in the most economical and efficient manner, to achieve the most effective results of operations.

***Why Was the Transaction  
Made in the First Place  
and Is There a Better Way?***

## WHY BUSINESSES ARE IN EXISTENCE

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What are some of the reasons an operational review should be performed? The focus and scope of operations in both the public and private sectors have changed in recent years. Management has increased demands for more relevant information on the conduct of its operations and related results than can be found in strictly financial data. Both business and government management seek more information with which to judge the quality of operations and make operational improvements. That is why operational review techniques are needed to evaluate the effectiveness and efficiency of operations.

## WHY BUSINESSES ARE IN EXISTENCE

Before even thinking 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 staying in business for the long term to serve 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 above) so that operational efficiencies and effectiveness can be compared to such overall organizational criteria.

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## OVERVIEW OF OPERATIONAL REVIEWS

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

### 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 paper-work 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 altogether. 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.

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**BUSINESSES A COMPANY IS NOT IN**

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- ***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 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 Businesses  
It Should Be in—  
And to Grow and Prosper***

If an organization accomplishes both of these goals successfully (paying attention to its business and staying out of the businesses it should not be in), it will more than likely (outside economic factors notwithstanding) grow and prosper through well-satisfied customers and keep itself in the positive cash conversion business in spite of itself.

Of course, a company also has to stay out of the numbers business—that is, looking at short-term reporting criteria such as the amount of sales, backlog, locations, employees, and the big devil, “the bottom line,” that others judge as success.

The company must decide which of the above factors it wishes to embrace as organizational criteria, which ones it decides not to include as criteria, and which additional criteria to include. These criteria become the overriding conditions upon which the company conducts its operations and against which it is measured.

## OVERVIEW OF OPERATIONAL REVIEWS

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### SOME BASIC BUSINESS PRINCIPLES

Each company must determine the basic principles which 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 does not 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.
- 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***

## CRITERIA FOR ORGANIZATIONAL GROWTH

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There seems to be an organizational trend toward empire building, particularly from the top, and the power and control that comes with it. Even with present movements toward downsizing, restructuring, reengineering, and so on, with their emphasis on getting by with less people and resources, those in power are trying to hold onto unnecessary empires of people and budget allocated resources. While management will agreeably reduce another manager's empire, there is considerable resistance when it comes to reducing the size of their own area. In many instances, even with short-term remedies at people reductions, there still remain unnecessary (non-value-added) individuals and layers of organizational hierarchy. Operational review principles, with its basic principle of doing the right thing, assists in building economic, efficient, and effective organizations, and maintaining them properly at all times using the correct techniques (best practices) for the situation. Operational review techniques assist the company in identifying its critical problem areas and then in treating the cause of the problems, not merely the symptoms of the problems. With sensible business principles as the hallmark for the company's operational criteria, the company can set a clear direction for positive movement and avoid merely improving poor practices. Clear business principles that make sense to all levels of the organization allow the company to identify and develop the proper organizational criteria. In this manner, everyone in the organization is moving in the same desired direction.

## CRITERIA FOR ORGANIZATIONAL GROWTH

An organization may choose to implement numerous criteria 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

## OVERVIEW OF OPERATIONAL REVIEWS

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- New distribution channels
- Market share increases 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

### Cost Reductions

Many times, costs can be reduced or eliminated without any appreciable diminishment of the organization's efficiency or effectiveness. These cost reductions should be aggressively pursued. Other times, management is strictly looking at short-term cost reductions to puff up the company's profitability. These cost reductions should be avoided because they typically only produce short-term gain for long-term pain. Remember the principle that a dollar of cost reduction produces a dollar increase to the bottom line net profits, but use this principle effectively.

### Price Increases

Company management may decide at any time to increase the prices charged to customers for their goods and services. Such price increases may be justified in the marketplace (and part of a strategic plan) or just management's desire to increase revenues (hoping everything else stays the same). In this situation, a dollar increase in revenues will not produce a dollar increase in net profits. The best that can be achieved is the net profit margin of this additional sale (sales dollars less costs = net profit per sale). It is possible that if the costs of this additional sale exceed the revenues generated, that each additional sale results in a decrease in the bottom line. In addition, such price increases may create external competition that may cause fewer sales or increased costs to make each sale.

## CRITERIA FOR ORGANIZATIONAL GROWTH

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### **Sales Volume Increases**

Part of the company's strategic plan may be to increase the level of sales to customers, both present and potential. It is usually easier to increase sales volumes with present customers than to prospect continually for new customers. If the company has been operating efficiently, their sales personnel should be close to its customers. They should know what each customer has purchased in the past, the sales trends over a period of time by product and/or product line, what their current and future needs are, whether the company has been making an adequate profit on its sales to the customer, and so on. If such things are not known about the customer, it may be an indication of poor sales practices and a performance gap between present practices and more desirable results. Part of the company's strategic plan should be to earmark specific present customers for increased sales: what products to sell to them, at what price and what amount, and how to sell to them.

The company may also decide to increase their sales volume to potential new customers. Again, such sales plans should be incorporated into the company's organizational plan. Overreliance on sales to new customers may be an indication of ineffective sales and customer service procedures with existing customers as well as costly sales practices for new customers.

Sales volume increases should always be part of overall company planning and integrated with other organizational functions such as sales and marketing, engineering, manufacturing, accounting, and so on.

### **New Market Expansion**

As part of the organizational plan, the company may decide to expand its operations into new markets. It may decide to expand on a local basis, nationally, or internationally. It could decide to introduce new products, enhance present products, or expand the sales of its products into new markets. Each of these decisions should be part of an organized plan with its own criteria and scheme as to how to achieve such results and the method for evaluating successful progress. Such expansion may not always be positive. Management must be sure that this is the best course.

### **New Distribution Channels**

As a criterion for organizational growth, company management may decide to develop additional channels for marketing and distributing their products.

## OVERVIEW OF OPERATIONAL REVIEWS

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For instance, if a company has traditionally sold its products directly to customers through their own internal sales force, it may decide to use outside sales groups, sales brokers, sales representatives, and the like. Such arrangements might supplement or reinforce their inside sales efforts or might replace the internal sales force in whole or in part. The company might also decide to distribute its products via additional distribution channels such as becoming an original equipment manufacturer (OEM), wholesaler, direct retailer, mail order house, internet seller, direct customer seller, and so on.

### **Market Share Increase in Existing Markets**

The organizational plan may include specific steps designed to increase the company's market share in existing markets. The plan may include desired results by product line, product, or customer. Specific results should be clearly spelled out and those responsible for successful completion of each work step in the plan should be identified. The plan should be realistic and practical, with achievable results within the organization's methods of operations.

### **Selling or Closing a Losing Operation or Location**

Sometimes an operation (product line, product, customer, etc.) or a plant or office location is deemed to be too costly in relation to the value (income or cost saving) added to the company. With the advisable information, company management can arrive at the proper decision to retrench. Without such an adequate information base, management may come to the opposite conclusion—to allocate more resources into the operation or location. In this instance, management would be more than likely allocating additional expenditures to a losing proposition. Management could establish a criteria of retrenchment, a criteria of developing an adequate information system, or both. The object of retrenchment is normally to reduce overall expenses while increasing net income, the bottom line. However, retrenchment will also decrease gross sales or income which may not be desirable to all of the stakeholders (e.g., owners or shareholders).

### **Acquire Another Company, Division, Operation, or Product**

Company management may decide that the quickest method for reaching a desired result (such as increased sales, reduced costs, increased net income)

## CRITERIA FOR ORGANIZATIONAL GROWTH

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is through acquisition. This could be accomplished by acquiring another company, a division of another company, a specific operation (e.g., research and development, information technology), a product line or product (e.g., a food company acquiring a complementary product), and so on. Such acquisitions should be considered using the concept of leverage. The resultant return on investment should exceed the cost of the investment. For instance, if the cost of the capital to make the acquisition is six percent, than the expected (and real) return on the investment should be sufficiently greater than six percent (e.g., over 10 percent) to cover the potential risk involved. Obtaining organizational growth through acquisition is not always positive as the company may acquire another's problems or may lack the expertise to take full advantage of the acquisition.

### **Developing a New Product or Service**

Company management may decide that the best method for achieving organizational growth or reaching a specific result is to develop a new product or service. To do this effectively, the company should have a real vision of its marketplace, its existing products, its customer's requirements, the desired need for the new product, its effect on existing products, and so on. The decision to develop and market a new product should be based on integrated decisions between the company's major functions such as sales, marketing, engineering, manufacturing, accounting, and so on.

### **Efficiency or Productivity Improvements**

The ability either to operate more efficiently at less cost or increase productivity at the same (or less) cost may also be a workable approach to reaching a company's organizational growth desired results. A dollar of costs saved (all other factors remaining the same) will produce an additional dollar of earnings to the bottom line. Increasing productivity produces more of the product or service at relatively the same cost, resulting in less cost per product or service produced. Both of these approaches can be implemented and controlled by internal management and operations personnel. There is usually more to be gained in the bottom line through cost efficiencies and productivity improvements than through the various methods of revenue or sales enhancements discussed above. Remember that a dollar in sales increase does not add a dollar to the bottom line, only the incremental amount of net income generated by the additional sale which could be a loss. Cost

## OVERVIEW OF OPERATIONAL REVIEWS

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efficiencies and productivity improvements are two of the major areas to be considered in an operational review as part of the company's program of continuous improvements and best practices.

### **Non-Value-Added Activities Eliminated**

Functions or activities which add no value to the product or service should be eliminated. As part of the operational review, such functions or activities should be identified. Company management should be able to identify those areas earmarked for elimination. For instance, they may identify all unnecessary quality control inspections or the preparation of purchase orders. They may express the desirability of eliminating an entire function, such as raw material storekeeping or credit and collections. This establishes the focus for those areas to be considered in the operational review. The review team can identify best practices and the most efficient methods for eliminating such functions or activities. They can also consider the resultant ramifications to remaining operations after the reduction or elimination of these non-value-added functions or activities. Typically, there is a multiplier effect, that is the elimination or reduction of one activity results in similar reductions or elimination of other activities.

### **Making Employees Responsible**

Make employees responsible for meeting company expectations and results through motivating self-disciplined behavior. With an effective monitoring system, this eliminates the need for management personnel to exist mainly for policing and controlling these individuals with minimal value-added activities. Use of operating systems that make sense to the workers (where they have had input in developing such systems), who use them within a working together atmosphere (rather than a working for atmosphere) will increase productivity to the extent that fewer employees overall are needed. The trick is not to bring on unnecessary personnel as the company grows, so that the company is never in a position to have to cut back drastically. Many times a company penalizes the individuals being downsized or laid off for something out of their control. Operational reviews help to keep the company in focus regarding the types and levels of personnel required at any time.

## MENTAL MODELS AND BELIEF SYSTEMS

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### Organizational Structure Revisions

There are many techniques for building an organization structure which are not dependent on the typical top to bottom military model that is based on policing and controlling those reporting to each higher level. Some other techniques for organizational structure include participative management, shared management, team management, self-motivated disciplined behavior (no manager), coaching and facilitative supports, and so on. There is no right answer for all situations. The company must learn to use a combination of these techniques as they fit the particular situation. The operational review process allows the company to achieve the best organizational structure overall, as well as within each function and activity. Operational review principles emphasize controlling results, not people; fixing the cause, not the blame; and doing the right job right, not just doing the job right.

***The Operational Review  
Must Focus on  
the Company's Direction***

## 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. These mental models and belief systems 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.

## OVERVIEW OF OPERATIONAL REVIEWS

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- 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 ensures 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 cannot run a business without the proper organizational structure.
- Managers know more than employees.
- Managers have a right to be obnoxious.
- Management is the enemy.
- Each function needs its own organizational structure.
- The more employees reporting to you (and the larger your budget), the more important you are within the organization.

The accurate identification of organizational mental models, belief systems, and performance drivers is extremely important in the company's operating strategy. If these things are not changed, best practice changes will change only the system and not company results.

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**ORGANIZATIONAL CRITERIA EXAMPLE**

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***Mental Model Changes  
Create Best Practice Changes***

**ORGANIZATIONAL CRITERIA EXAMPLE**

As previously discussed, 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:

***Organization-Wide Criteria***

- Operate all activities in the most economical, efficient, and effective manner 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 that 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.

## OVERVIEW OF OPERATIONAL REVIEWS

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- 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, purchasing, and so on.

### *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, maintenance, and so on.
- 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.

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## ORGANIZATIONAL CRITERIA EXAMPLE

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- Minimize the hiring of new employees by using methods such 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.

## OVERVIEW OF OPERATIONAL REVIEWS

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- Eliminate or reduce all unnecessary accounting operations that provide no value-added incentives.

***Organizational Criteria***  
***Focus Operational Review Criteria***

The development of such organizational and functional criteria provides the basis on which to focus the operational review and to evaluate current practices, identify critical problem areas, analyze detailed operations, identify best practices, and implement corrective solutions in a program of continuous improvements. Without the definition and communication of such organizational criteria, the company's operational review efforts may only succeed in developing best practices for functions and activities that in themselves are bad practices. The operational review process should not be an effort to improve bad practices but to develop procedures which bring best practices into the organization. Through the operational review process, operating functions and activities are evaluated as to their necessity as related to the achievement of organizational goals and objectives. If a function or activity is not necessary, it should be eliminated. If it is needed, it should be considered for improvement, looking for the best present practice, and continually analyzed in the company's program of continuous improvements. Through this process, the company starts to develop itself as a learning organization, with individuals responsible for achieving their own results. The operational review process becomes an ongoing integral tool, allowing the company to do things the right way and to keep doing them that way.

## 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 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 through due con-

## ECONOMY, EFFICIENCY, AND EFFECTIVENESS

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servation 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 more expensive equipment 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

Note that economy and efficiency are both relative terms, and it is not possible to determine whether the area under review has reached the maximum practicable level of either. However, the reviewer and operations personnel are continually looking for best practices in a program of continuous improvements. Economy and efficiency are continually being appraised and improved upon; they are not put in place based on the operational review and then ignored.

Economy and efficiency are concerned with achieving the optimum balance between costs and results. In performing this part of the review, the reviewer evaluates cost minimization, emphasizing reduction of costs, but not to the point where results are not accomplished. In addition, productivity maximization may be analyzed, but not to the point where the costs become excessive. In evaluating economy and

## OVERVIEW OF OPERATIONAL REVIEWS

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efficiency, the reviewer analyzes the use of resources: people, facilities, equipment, supplies, and money. For example, the reviewer might analyze the following:

- Allocation of responsibilities and authority within the organizational structure
- Physical deployment of distribution of resources
- Scheduling of resources: when people work, when facilities are used
- Segmentation of tasks into logical groupings
- Match between skill level, capacity, performance capability, and so on, and the way a resource is used
- Prices paid
- Charges levied
- Rate at which tasks are performed
- Number of tasks completed

Within the economy and efficiency concept, the reviewer does not ask whether the function is worthwhile in terms of what it accomplishes. The reviewer accepts that the function exists and asks whether that is the most economical and efficient way to get it done. Results are considered as part of the review of effectiveness.

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.

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**DEFINITION**

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Although it is management's continuing responsibility to assess the results of operations, its objectives and measurement criteria are not always clearly defined. Without such clarification, the reviewer cannot meaningfully evaluate the results of operations. If management has not done so prior to starting the operational review, the reviewer should work with management to:

- State the objectives
- Establish measurement criteria
- Establish methods for accumulating the data necessary to measure achievement of operational results.

Effectiveness is concerned with results and accomplishments achieved and benefits provided. In evaluating the effectiveness of operations, the reviewer asks whether the activity is achieving its ultimate intended purpose. Analysis is qualitative rather than quantitative.

The relationship of economy and efficiency and their impact on results can be seen as a seesaw; that is, there is an attempt to balance them to achieve just the right amount of each. In a perfectly balanced situation, the cost of operations would be maintained at the lowest possible level without sacrificing efficiency (or the methods of operations) and effectiveness (or the results of operations), thus effecting economy. At the same time, the methods of operations would be performed at the least possible cost without sacrificing results, thus producing efficiency. Is it clear, then, why economy and efficiency are normally reviewed together as part of the operational review procedure? The three Es—economy, efficiency, and effectiveness—as well as the seesaw effect between economy and efficiency, are shown in Exhibit 1.1.

***Economy, Efficiency, and  
Effectiveness  
(and Making Money)  
Is Everyone's Business***

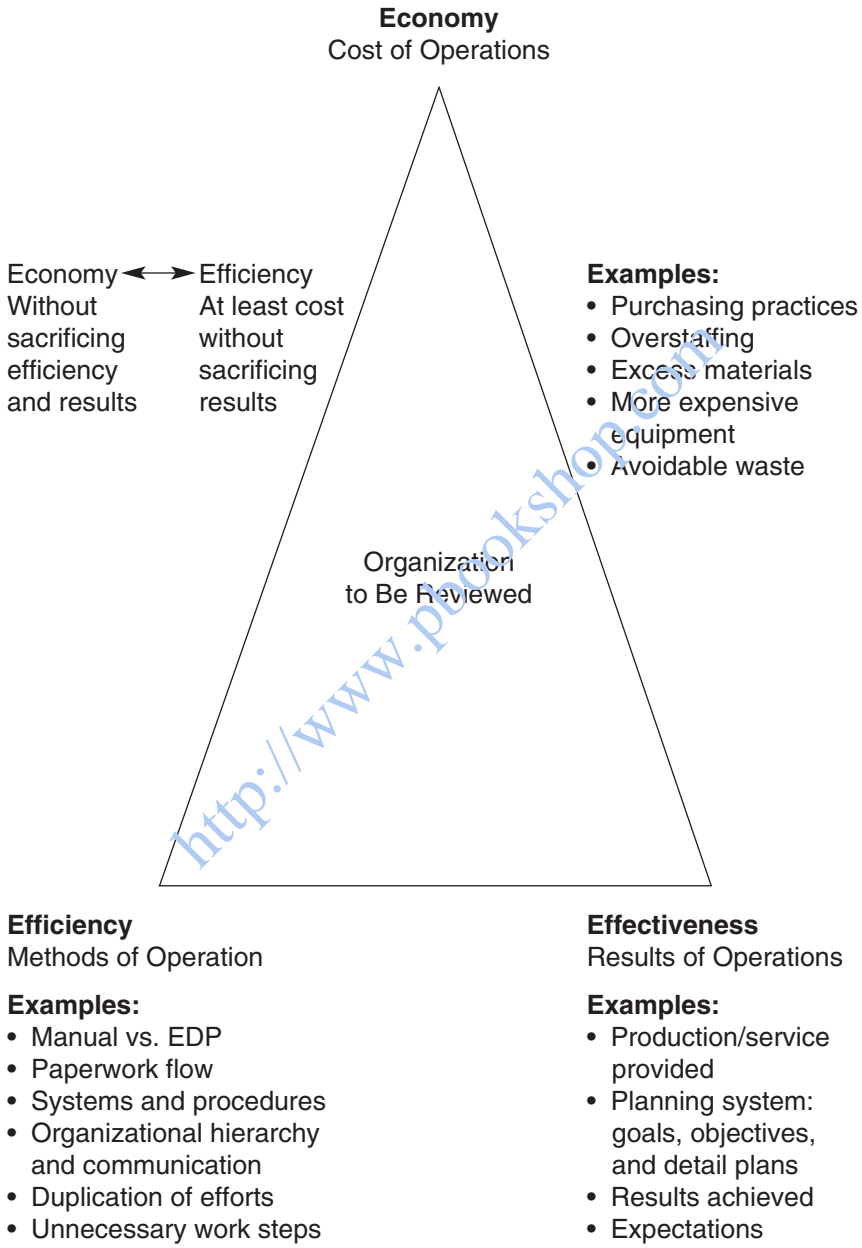
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**OVERVIEW OF OPERATIONAL REVIEWS**


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**EXHIBIT 1.1** The Operational Review Triangle: The Three Es: Economy, Efficiency, and Effectiveness
 

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## DEFINITION

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### DEFINITION

Operational review is a widely used term encompassing many aspects and techniques. However, no uniform, commonly recognized definition has been unanimously accepted.

The definitions that have been given for operational reviews include the following:

1. An extension of the audit function into all operations of a business.
2. The application of internal auditing to operations rather than financial controls.
3. The identification of opportunities for greater efficiency and economy, or to improve effectiveness in carrying out operational procedures.
4. A control technique for evaluating the effectiveness of operating procedures.
5. Nothing more than a review of controls, now including nonfinancial controls.
6. Review of activities other than those pertaining to examination of financial data.
7. Review technique that involves evaluating the efficiency and economy with which resources are managed and consumed.
8. Review of operations with a management viewpoint.
9. Review of operations made for internal management, not for external third parties, with the results circulated internally rather than externally.
10. Combination of economy, efficiency, and effectiveness, or program results evaluation.

Combining these definitions, it could be said that operational review is a review of operations performed from a management viewpoint to evaluate the economy, efficiency, and effectiveness of any and all operations, limited only by management's desires.

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## OVERVIEW OF OPERATIONAL REVIEWS

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***Operational Review  
Evaluates Economy,  
Efficiency, and Effectiveness  
from a Management Viewpoint***

### TERMS

In recent years various terms have been used interchangeably with operational review to describe this approach. Examples include:

1. Program review
2. Management review
3. Performance review
4. Performance review and evaluation
5. Departmental review
6. Nonfinancial audit
7. Compliance review
8. Cost-benefit analysis
9. Economy and efficiency evaluation
10. Effectiveness or results evaluation
11. Functional analysis
12. Full scope audit
13. Responsibility review
14. Comprehensive analysis and review
15. Internal benchmarking study
16. Activity-based costing/management review
17. Total quality management (TQM) study

## FINANCIAL AUDITS VERSUS OPERATIONAL REVIEWS

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18. Reengineering study
19. Organizational review
20. Value-added study (value-added vs. non-value-added activities)

Although the terms review, analysis, study, and evaluation are generally used to describe these procedures, as in the examples just mentioned, it is often a good idea to avoid the connotation that this is a procedure done by outsiders, which may have a negative impact upon the organization under review. To this end, internal review may be a better term to use with specific organizations. Often, the particular name given to the operational review procedure enhances internal management's trust and willingness to work with the reviewers (either internal or external), which is vital to the success of the operational review.

***Operational Review  
Is an Internal Review  
to Help Do Things Best***

## FINANCIAL AUDITS VERSUS OPERATIONAL REVIEWS

Among the differences between financial audits and operational reviews, using operational review concepts, is that the reviewer is less concerned with determining whether purchase requisitions, orders, and suppliers' invoices reflect proper approvals, as in a financial audit, but more concerned with such operational aspects as whether:

- The materials were really needed
- Quantities used or purchased were reasonable
- There was avoidable waste and exposure to damage or loss
- Requisitioners exercised undue influence over purchasing by designating sources of purchase.

For example, a typical financial audit step may be to determine whether vendor purchase requisitions and invoices have been properly approved.

## OVERVIEW OF OPERATIONAL REVIEWS

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However, when looking at the operational aspects of vendor purchases, the reviewer may ask:

- ***Were materials really needed?*** For example, were materials mistakenly ordered that could not be used owing to changes in production specifications, because the product specifications unit failed to communicate with the purchasing department?
- ***Were quantities used or purchased reasonable?*** For example, assuming the materials were usable, were goods bought for inventory above calculated safety stock levels because of the fear of incurring a stock-out?
- ***Was there avoidable waste and exposure to damage or loss?*** For example, were steel components and parts that were susceptible to rust bought and stored in an outside yard, owing to an overcrowded inside storeroom?
- ***Did the requisitioner exercise undue influence by stating specific sources or brands?*** For example, did the requisitioner specify an IBM microcomputer or a Xerox copier when a less expensive brand would do just as well?

Some of the other differences between a conventional financial audit and an operational review are summarized in Exhibit 1.2.

***A Financial Audit  
Is Not an Operational Review***

## WHY PERFORM AN OPERATIONAL REVIEW?

What are some of the reasons an operational review should be performed? The focus and scope of many operations in both the public and private sectors have changed in recent years. Management has increased demands for more relevant information on the conduct of their operations and the related results than can be found solely in financial data. Both business and government management seeks more information with which to judge the quality of operations and make operational improvements. That is why op-

## WHY PERFORM AN OPERATIONAL REVIEW?

### EXHIBIT 1.2 Financial Audit Versus Operational Review

Characteristic	Financial Audit	Operational Review
1. Purpose	Express opinion on financial condition	Analyze and improve methods and performance
2. Scope	Fiscal financial records	Business operations
3. Skills	Accounting	Interdisciplinary
4. Time orientation	To the past	To the future
5. Precision	Absolute	Relative
6. Audience	Stockholders, public	Internal management
7. Necessity	Legally required	At option of management
8. Standards	GAAP, GAAS*	Economy, efficiency, effectiveness
9. Opinion	Required	Not required
10. Audit results	Opinion, financial statement	Recommendations to management
11. Focus	Financial statement presented fairly	Operational positive improvements
12. Viewpoint	Financial	Management
13. Success	Unqualified opinion	Management adoption of recommendations

\*GAAP = generally accepted accounting principles;  
GAAS = generally accepted auditing standards

Operational review techniques are needed to evaluate the effectiveness and efficiency of operations.

Management, with the assistance of others, both internal and external, is being asked more frequently to evaluate an organization's operations. Although this is not a new service for internal management to provide, requests by top management for such specific operational reviews have increased as a result of the greater emphasis on the economy, efficiency, and effectiveness of operations and related results. In many cases, members of operations management do not possess the specific skills necessary for an objective evaluation of those activities reporting to them; they may be too close to the operations or they may be part of the problem. The technical

## OVERVIEW OF OPERATIONAL REVIEWS

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skills that internal and external consultants possess, particularly those of analysis, fact finding, and reporting, make them excellent choices for performing such operational reviews.

An operational review involves a systematic review of an organization's activities in relation to specified objectives. The general purposes of the operational review could be expressed as follows:

- **Assess performance.** To assess performance is to compare the way an organization conducts its activities with (1) objectives established by management, such as organizational policies, standards, goals, objectives, and detail plans, (2) comparisons with other similar functions or individuals within the organization (internal benchmarking), and (3) comparisons with other organizations (external benchmarking).
- **Identify opportunities for improvement.** Increased economy, efficiency, or effectiveness are the broad categories under which most improvements are classified. The reviewer may identify specific opportunities for improvement (best practices) by analyzing interviews with individuals (within or outside the organization), observing operations, reviewing past and current operational data, analyzing transactions, making internal and external comparisons, and exercising professional judgment based on experience with the particular organization or others.
- **Develop recommendations for improvement or further action.** The nature and extent of recommendations developed in the course of operational reviews vary considerably. In many cases, the reviewer may be able to make specific recommendations. In other cases, further study outside the scope of the review may be required. The reviewer should be continually looking for best practices (both internal and external) in a program for continuous improvements. It may seem that operations personnel would be involved in establishing and implementing recommendations. However, in most instances such procedures are set by management, causing operations personnel to resist and often sabotage them and work against their being successful. Organization structure tends to evolve over a period of time; with minimal regard to economy, efficiency, and effectiveness.

In most organizations there are built-in incentives to increase organizational levels; such as budget systems that reward larger organizations and

## SPECIFIC OBJECTIVES

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politicking to build empires. It is the reviewer's role to identify such organizational inefficiencies and recommend improvements. However, the reviewers do not put themselves in the position of recommending specific individual cuts. Assuming that the organization's personnel are all good employees (and hiring, orientation, training, and promotion policies and procedures are adequate), the reviewer may recommend achieving desired results with less overall personnel. However, it is then management's responsibility to decide what to do with extraneous personnel, through such measures as departmental transfers, retraining, lateral moves, and so forth. It is usually more desirable to use existing good personnel somewhere else in the organization than to terminate them.

***The Operational Review  
Is Performed to  
Maintain Organizational Excellence***

## SPECIFIC OBJECTIVES

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

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## OVERVIEW OF OPERATIONAL REVIEWS

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### *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

## SPECIFIC PURPOSES

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- 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

***The Operational Review  
Ensures Doing  
the Right Job, the Right Way,  
at the Right Time***

## SPECIFIC PURPOSES

In conducting an operational review, the reviewer should be aware of the purpose for the review. 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 and the purpose(s) should be

## OVERVIEW OF OPERATIONAL REVIEWS

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mutually agreed upon from the start. The purpose may be one or more of the following seven listed items:

1. To review and evaluate the adequacy of the accounting system and related internal accounting controls (including both accounting and administrative controls).
2. To analyze systems and controls, as related to internal controls, functional operations, and legal compliance.
3. To analyze the capability to accomplish agreed-upon stated goals, objectives, and results in management's approved plan.
4. 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.
5. To analyze and explain cost overruns or high unit costs for each function/activity for which such data can be quantified.
6. To assess and evaluate compliance with federal, state, and local laws and regulations; ensuring at least minimal compliance.
7. To identify and report deficiencies and areas for improvement and to provide technical assistance and follow-up where necessary.

## 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 13 ways:

1. *Identifying problem areas, related causes, and alternatives for improvement.* This is a major purpose of operational reviews. Although often aware of a problem, management cannot always define its dimensions exactly. The reviewer's third party objective viewpoint helps to achieve the proper focus on operational problems. To define a problem in some instances, the reviewer need merely talk to operations personnel and then share their viewpoints with management. Keep in mind that people in operations are usually more aware of problems and their causes than management personnel.

## BENEFITS OF OPERATIONAL REVIEWS

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The reviewer's role is also to identify the actual causes (not the symptoms or believed causes) of problems, which may be the result of management policy or actions. Finally, the reviewer must formulate realistic, practical solutions to these problems. This is where the reviewer's experience in working with numerous other departments and/or organizations is valuable. Remember to always look for best practices (internal or external) that can be practically implemented in your situation as part of a program of continuous improvement. A good rule for reviewers to follow is not to recommend any course of corrective action that they could not assist in implementing.

2. *Locating opportunities for eliminating waste and inefficiency; that is, cost reduction.* Keep in mind that each dollar of cost reduction (without sacrificing efficiency or effectiveness) contributes dollar-for-dollar to the bottom line. Cost reduction is a significant element in operational reviews. However, be wary of short-term cost reductions causing long-term problems (for instance, downsizing of operations and/or personnel when business falls off). It is the role of the reviewer to assist the company to operate at the lowest possible cost in relationship to adequate plans. Costs should always be at the correct level, and when costs need to be cut, proper decisions are made so as not to adversely impact operations. This is in contrast to typical cost cutting across the board, which not only constricts all operations, but also fails to provide for the necessary resources for those operations which actually need increased funds.
3. *Locating opportunities to increase revenues, that is, income improvement.* Increasing revenues also has an effect on the bottom line, yet only to the extent of profit margins for this additional amount of revenue. Increasing revenues may, in fact, be detrimental in terms of profits and operating efficiencies (both short term and long term). Often revenues or sales are increased to present a more favorable sales picture in the short term or to fill plant or service capacity, rather than on the basis of sound planning. Note that in most organizations a greater amount of resources and emphasis is devoted to revenue improvement than to cost economies, even though effective cost cutting offers greater rewards.
4. *Identifying undefined organizational goals, objectives, policies, and procedures.* It would be nice to think that all organizations are doing

## OVERVIEW OF OPERATIONAL REVIEWS

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effective long-term and short-term planning. However, in reality this is usually more the exception than the rule. Therefore, the reviewer will have to assist management in recognizing undefined goals, objectives, and detailed plans and developing such plans prior to starting the operational review. Without defined plans, there are no yardsticks or milestones against which to measure the organization's effectiveness.

5. *Identifying criteria for measuring the achievement of organizational goals.* As mentioned previously and there is great likelihood that plans and related goals and objectives do not exist and even when they do, there may not be appropriate criteria for measuring their achievement, thus requiring the reviewer to assist management in the development of such criteria.
6. *Recommending improvement in policies, procedures, and organizational structure.* The reviewer may find instances in which the cause of the problem lies with existing policies or procedures. Policies should be set by senior management and relate to the rules by which the organization conducts its business (e.g., service to the customer). However, many times either such policies get in the way of operations personnel performing their functions (e.g., excessive controls and paperwork to process a customer credit) or insufficient authority is delegated to allow them to be most effective (e.g., sending a service representative to the customer to investigate a complaint). In these instances, the policies may be wrong and in need of correction.

Procedures are the ways in which functions are performed based on stated policies. As such procedures refer to operations, it might seem that operations personnel would be involved in establishing and implementing them. However, in most instances, procedures are set by management, causing operations personnel to resist them (and many times sabotage them) and work against their success. Organizational structure tends to evolve over a period of time, with minimal regard to economy, efficiency, or effectiveness. In most organizations there are built-in incentives to increase organizational levels, such as budget systems that reward the growth of organizations and encourage politicking to build empires. It is the reviewer's role to identify such organizational inefficiencies and to recommend improvements. However, when reviewers do this, they do not recommend specific individual cuts. Assuming that the organization's personnel are all good

## BENEFITS OF OPERATIONAL REVIEWS

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employees (and that hiring, orientation, training, and promotion procedures are adequate), the reviewer may recommend achieving desired results with fewer overall personnel. It is then management's responsibility to decide what to do with extraneous personnel, possibly effecting departmental transfers, retraining, lateral moves, and so on. It is usually more desirable to use existing good personnel elsewhere in the organization than to terminate them. In most organizations that have a policy of termination, their personnel departments are hiring at the same time, often for similar positions.

7. *Providing checks on performance by individuals and by organizational units.* Assuming that proper results have been defined for individuals and work units, it is the reviewer's responsibility to ensure that adequate checks or measurement criteria have been established to monitor progress toward their achievement.
8. *Reviewing compliance with legal requirements and organizational goals, objectives, policies, and procedures.* The reviewer makes sure that the organization complies with the laws and internal rules under which it performs its functions. If there is a lack of compliance, the reviewer defines the consequences.
9. *Testing for existence of unauthorized, fraudulent, or otherwise irregular acts.* Such testing is normally a requirement for operational reviews, particularly where such acts have an adverse effect on operations.
10. *Assessing management information and control systems.* The reviewer will address a number of concerns in this area:
  - Are such reporting systems adequate to provide management and operations personnel with the information necessary to effectively operate all aspects of the organization?
  - Is the level of detail commensurate to the level of operations (i.e., more detail at lower levels; less detail at higher levels)?
  - Is information lacking that should be present?
  - Are all key indicators being considered (e.g., units shipped as well as items rejected and returned)?

## OVERVIEW OF OPERATIONAL REVIEWS

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11. *Identifying possible trouble spots in future operations.* Many times the reviewer senses a future problem based on troubles in the past. For instance, problems with past computer conversions may indicate future troubles with an extensive computer processing upgrade.
12. *Providing an additional channel of communication between operating levels and top management.* In many organizations there is a clear (or unclear) separation between management and operations—management makes the decisions and operations personnel carry them out. One of the most important benefits of the operational review is the reviewer's ability to convey operational concerns to management in those instances when such concerns are not being communicated on an ongoing basis.
13. *Providing an independent, objective evaluation of operations.* Both management and operations personnel are often too close to what is going on within their own operations to evaluate their results effectively. The independent operational reviewer can do this objectively, pointing out those areas in need of improvement as well as those that are being performed well.

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

## 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. Management has the primary responsibility for proper planning, conduct, and control of activities. Thus, review and evaluation of the way management itself plans, conducts, and controls the activities become a major consideration and focal point in the conduct of the review. 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.

## OPERATIONAL REVIEW PHASES

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The five phases through which an operational review progresses are:

1. Planning
2. Work programs
3. Field work
4. Development of findings and recommendations
5. Reporting

The operational reviewer may perform two types of reviews: preliminary and in-depth. Both types include all five phases. The difference between the two is the degree of emphasis, the specific techniques chosen, and the objectives of a particular phase.

In the preliminary review, for example, field work may consist of limited transaction testing and interviewing, and the report may be a briefing to management. In an in-depth review, field work may consist of detailed examination, using techniques such as work measurement, workload analysis, cost-benefit analysis, and so on, and the report may be formally written, with wider distribution. The type and objectives of the review to be performed will determine the nature of the work to be done.

### Planning

The reviewer obtains general information about the kinds of activities performed, the general nature of those activities and their relative importance, and other general information to help plan the early portions of the review.

### Work Programs

The reviewer prepares the operational review work program for the preliminary review of those activities selected for review in the planning phase. Well-constructed work programs are essential for conducting efficient and effective operational reviews. Such programs must be individualized for each situation, and each work step must state clearly the work to be done and why.

### Field Work

The reviewer analyzes operations to determine the effectiveness of management and related controls. Such functions and controls are tested in actual

## OVERVIEW OF OPERATIONAL REVIEWS

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operation, with particular emphasis on areas that are difficult to control and have high potential for weakness. The purpose of this phase is to determine whether a situation needs improvement, whether it is significant, and what should be done about it.

### Development of Findings and Recommendations

Based on the significant areas identified during the field work phase, specific findings are developed according to the following attributes:

- Condition: What did you find?
- Criteria: What should it be?
- Effect: What is the impact on operations?
- Cause: Why did it happen?
- Recommendation: What needs to be done to correct the situation (based on present best practices, and always subject to change)?

### Reporting

The reviewer prepares the report based on the results of the review in order to bring these results to the attention of those having an interest in, or responsibility for, the findings. In reality, the majority of findings, if not all, should have been reported to management with remedial action already being taken or completed prior to the formal report. The report becomes a summary of the results of the review.

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

## WHAT FUNCTIONS TO REVIEW

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

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## WHAT FUNCTIONS TO REVIEW

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selected areas? 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. Exhibit 1.3 is a sample checklist.

One way to decide which functions to review is to determine how critical each function is to the overall organizational operation. For instance, for a manufacturing business, the most critical area may be the inventory or production control functions. For a service-oriented concern, where personnel

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### EXHIBIT 1.3 Checklist of Major Organizational Functions

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#### ***Board of Directors***

Management  
Organizational  
Departmental  
Reporting and control

Cost accounting procedures  
Borrowing and debt outstanding  
General ledger and journal entry system

#### ***Planning Systems***

Organizational  
Departmental  
Detail planning

#### ***Computer Processing***

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

#### ***Personnel***

Hiring procedures  
Evaluation procedures  
Staffing levels  
Payroll procedures

#### ***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

#### ***Accounting***

Assets  
Liabilities  
Budget procedures  
Payroll and labor distribution  
Accounts payable  
Accounts receivable  
Billing and collections  
Financial reporting

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## OVERVIEW OF OPERATIONAL REVIEWS

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costs approximate 70 percent of total expenditures, the personnel function would be more critical. Normally, reviewers work with a limited budget in terms of hours allocated to the operational review, so they are greatly concerned with spending these hours on functional areas that offer the greatest potential for operational improvements in return for their effort. 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, 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, ineffective storeroom, shipping, or time recording procedures.
- Areas where functions are not performed efficiently or economically; for instance, 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 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, inventory levels, and so forth.
- Areas where management has identified specific weaknesses or needs for improvement, such as personnel functions, manufacturing procedures, computer operations, and management reporting.

Another factor to consider in choosing the critical operational area to review is the willingness of the personnel in the area to cooperate in the performance of the review. First, those in operational management should want to have their operations reviewed and be willing to work with the re-

## BUDGET

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viewer in the improvement of their operations. Without such top management commitment, the operational review is not likely to succeed. Second, staff and operating personnel must be willing to work with the reviewer both in performing the operational review and in the subsequent implementation of operational improvements. Cooperation at all levels of the organization is essential to a successful operational review.

The reviewer must enlist the cooperation of all personnel: members of management to ensure top commitment to the review, and operations personnel to help in identifying areas to review and proposed improvements. Normally, in most operations, the staff or operating personnel know precisely what is going on day by day and, with firsthand knowledge of operations, can help the reviewer to identify the most critical areas to review.

***Any and All Functions  
Should Be Subject  
to an Operational Review***

## BUDGET

In addressing the number of critical areas to be covered in the operational review, it is important to understand the relationship between budgeted review time and the scope of operational review work desired to be accomplished. In many situations, the budget hours are established first and then the scope of the operational review is made to fit within the budget. While this procedure may work from an internal standpoint in regard to budget and staffing, it does not fully take into account the aspect of such reviews that require flexibility and expandability of formulated operational review work programs. In addition, it is important for the reviewer and management to consider the cost against the expected benefits of the specific operational review. This is a significant concept in helping to determine how much time to allocate to the operational review.

In performing an internal or external type financial audit, the audit group is budgeting staff time and related costs. In effect, the financial audit becomes a cost center. In an operational review, on the other hand, operational benefits and dollar savings should greatly surpass the cost of the review

## OVERVIEW OF OPERATIONAL REVIEWS

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(savings should be at least three times its cost). In effect, the operational review becomes a profit center. Theoretically, the more operational reviews are done, the greater the savings realized by the organization. In reality, however, some guidelines are needed to establish the extent of an operational review in a given functional area, once the critical areas for review have been identified.

There are a number of factors to consider in establishing the operational review budget:

- *Scope of the operational review.* For example, are all significant operational areas to be reviewed, or only the major ones identified?
- *Frequency of the operational review.* Is the operational review to be done on a one-time basis, which requires more up-front planning and research; or is it to be performed for an area that is reviewed on a regular basis and requires minimal up-front efforts?
- *Nature of the business operations.* A service business dealing primarily with selling staff time, such as a medical, legal, or CPA practice, normally requires less time for an operational review than a manufacturing business that produces, ships, sells, and services a fairly wide product line.
- *Degree of management effectiveness.* Functional areas that are ineffectively managed normally require more operational review time than those that are more effectively managed.
- *Expectation of benefits.* Those areas that afford the greatest expected benefits, in terms of the number of potential recommendations or savings, should be the areas reviewed first. However, these areas will take more time to review than those with lesser expectations.

Operational reviews, to be most successful, require a large amount of preplanning, fact gathering, and research. This can make the costs of conducting an operational review considerable. However, when compared with the potential benefits and savings, costs become less significant. That is why, when determining how much time to spend on the operational review, it is best to use a cost-versus-benefit approach, tempered, of course, with the reality of available staff and hours. In effect, an effort should be made to cover competently as many of the major critical areas as possible within the limited staffing constraints.

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**ENGAGEMENT DEVELOPMENT**

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***The More Operational Reviews  
that Are Performed,  
the Greater the Savings***

## **INITIAL SURVEY**

To achieve the greatest results from limited operational review resources, the reviewer identifies those areas of major importance and those offering the greatest potential savings or benefits as part of an initial survey, either prior to or as part of the planning phase of the operational review. If performed before the planning phase, either because the client requests it, because of a relatively small scope or budget, or for some other reason, the survey usually consists of some type of management and operational questionnaire. The purpose of the questionnaire is to determine what functions are performed, who performs each function, and why and how each is performed.

Answers to these questions should provide insight into the organization's objectives, activities, work performance, systems and procedures, limits of authority, and so on. The reviewer uses the questionnaire as a guideline and does not rely solely on yes or no responses. This is a quick review tool to help identify critical areas for further review when it is not feasible to implement the more desirable, but time-consuming, full planning phase. However, a survey of this kind should not be used in lieu of the planning phase, as it is still the reviewer's responsibility to substantiate, with adequate evidence, the identification of critical operational areas to be reviewed.

Exhibit 1.4 is a sample operational review initial survey form. The purpose of the initial survey is to identify areas of major importance in the total organization or specific operations to be reviewed. Improper identification results in spending unnecessary effort on less significant activities and insufficient effort in more important areas. The survey should provide for more detailed answers, rather than simple yes or no responses. The same questions are reviewed with various personnel, such as departmental management, functional supervision, and operations and support personnel. The reviewer thus isolates patterns of agreement and disagreement, as well as various interpretations and perceptions that lead to the correct conclusions.

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## OVERVIEW OF OPERATIONAL REVIEWS

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### EXHIBIT 1.4 Sample Operational Review Initial Survey Form

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#### ***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.
5. How adequate are existing reports in furnishing information for making management decisions? Describe.

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**ENGAGEMENT DEVELOPMENT**

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**EXHIBIT 1.4** *(Continued)*

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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.

***Computer Processing***

1. Where is computer processing presently located in the organization?  
Obtain or prepare copy of information technology organization.

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**OVERVIEW OF OPERATIONAL REVIEWS**

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**EXHIBIT 1.4** *(Continued)*

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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.
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.

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## ENGAGEMENT DEVELOPMENT

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### EXHIBIT 1.4 (Continued)

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#### ***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.
- 

Where necessary, each question is supported by available documentation. This form could also be used as part of the more formal planning phase, but should be more specific to a departmental or functional area.

## ENGAGEMENT DEVELOPMENT

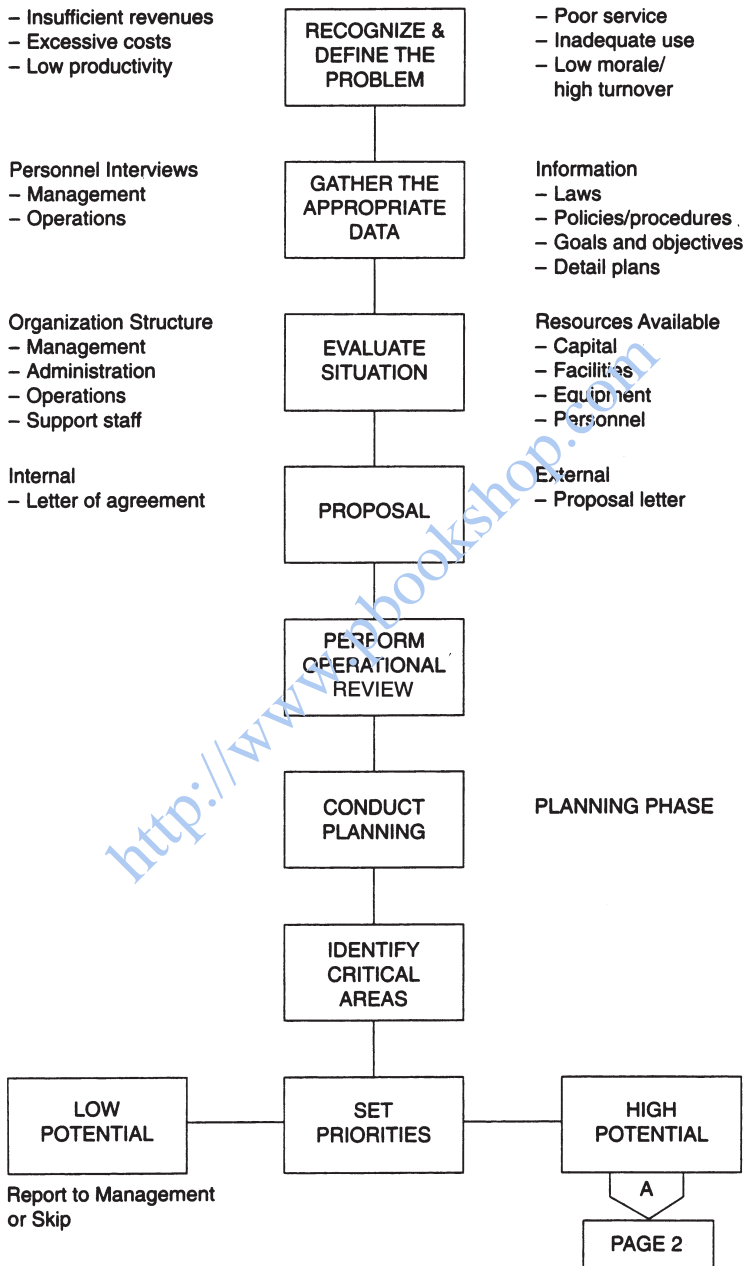
An operational review could be conducted by an external consulting firm, an internal review group, an independent in-house unit, departmental personnel, or a combination of staff from these entities. Whichever organization has primary responsibility for conducting the operational review, the major steps in its development and performance should be similar. These steps are summarized in Exhibit 1.5.

### **Recognize and Define the Problem**

The first step is to recognize and define the problem. Normally, it is management's prerogative to identify the major problem area(s) to be addressed

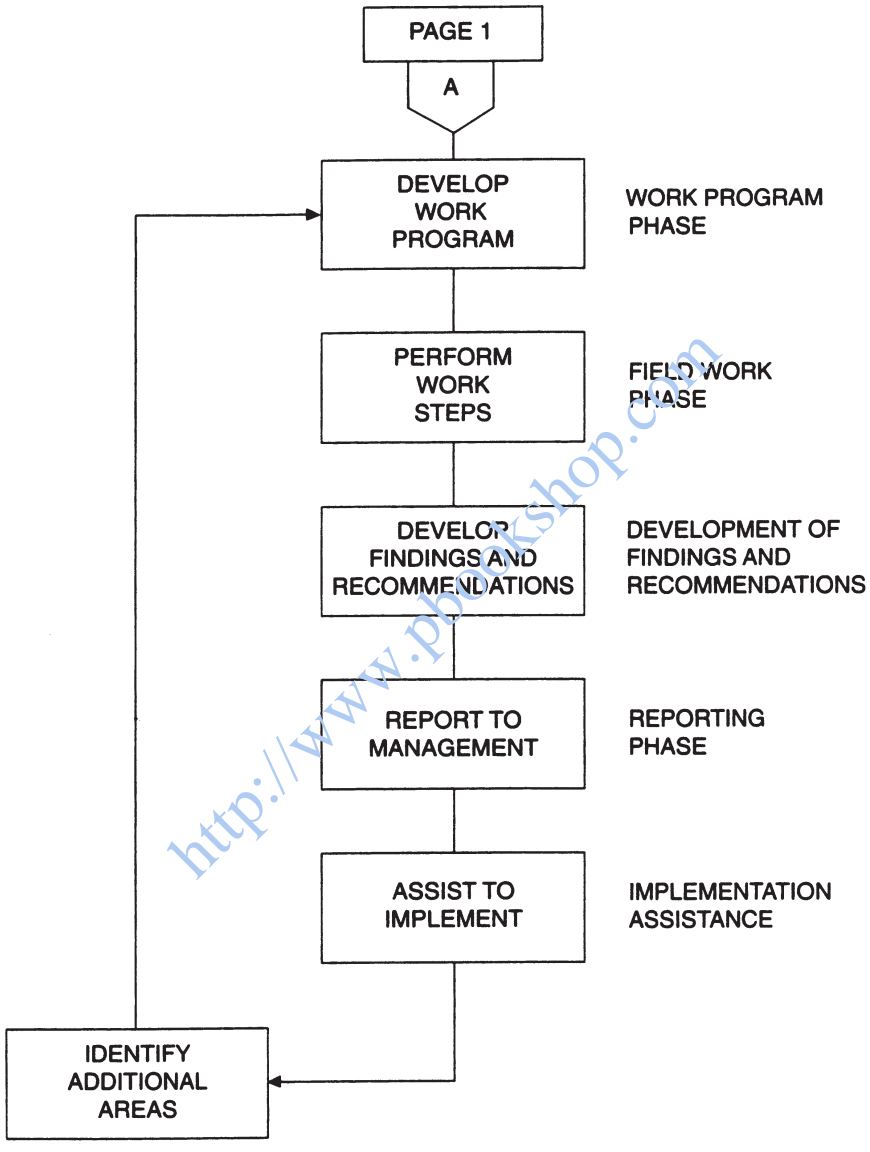
OVERVIEW OF OPERATIONAL REVIEWS

EXHIBIT 1.5 Operational Review Engagement Development



ENGAGEMENT DEVELOPMENT

EXHIBIT 1.5 (Continued)



## OVERVIEW OF OPERATIONAL REVIEWS

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in an operational review. However, if requested by management, the reviewer can either assist in the problem definition described previously or perform a preliminary survey to identify significant operational areas to be reviewed.

### Gather Appropriate Data

The second step is to gather the appropriate supporting data a function usually performed by the operational reviewer. The purpose of this data gathering is to provide background information relative to the problem areas defined in the first step, so as to substantiate the problem situation.

### Evaluate the Situation

The next step is to evaluate the situation within the organization to determine the organizational structure and resources available. These are the factors on which the reviewer bases the proposal to management for conducting the operational review.

### Proposal Letter

When the reviewer has gathered sufficient background data on the operational problem areas identified for review and has decided on the review plan, a written proposal or engagement letter must be submitted. The proposal clarifies for management such considerations as:

- Background of the situation describing the need for the operational review
- Operational review engagement objectives
- Scope of the review engagement or which operational areas are to be included.
- The reviewer's approach to conducting the operational review
- Proposed general work steps to be included in the conduct of the operational review
- Operational review staff and client personnel who are expected to participate in the operational review, including each one's responsibilities and expectations as well as time commitments

## ENGAGEMENT DEVELOPMENT

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- Reporting requirements to management, such as progress meetings and final reporting, including a description of all deliverable output
- Benefits to be provided as a result of conducting the operational review
- Estimates of time and cost

Although an external consulting firm usually submits the proposal letter to management, it is also good practice for an internal group to submit a similar proposal prior to the start of the operational review engagement. The major purpose of an internal proposal letter is to ensure clear communication, as to the purpose and scope of the operational review, between the review group and management. In this context, the internal proposal becomes a letter of understanding between the internal review group and management. The contents of the internal proposal letter would differ somewhat from an external proposal, and would only include those areas necessary to the situation.

Exhibit 1.6 provides an example of an operational review proposal, or engagement letter, for the Example Company, as well as sample time and cost budget estimates for the planning and field work phases. These cost estimates are for the reviewer's use in determining the cost of the engagement and are not given to operations management. An external consulting firm proposing to perform an operational review for a client may have to estimate time and costs before starting an engagement. To enable the reviewer to estimate accurately requires sufficient initial survey work and adequate prior experience on similar engagements. Although it is obviously advantageous to estimate the amount of field work required after completion of the planning phase, the client normally wants to know these amounts up front. The samples provided are for a relatively sizable operational review. In a situation where potential operational review engagements may be smaller in scope, the two phases may be combined and the numbers scaled down.

### **Perform the Operational Review**

Once the proposal letter has been submitted and accepted by management, the actual operational review begins, using the proposed phase approach of planning, work program, field work, development of findings and recommendations, and reporting. Should management request it, the reviewer might also help to implement the recommended operational improvements,

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## OVERVIEW OF OPERATIONAL REVIEWS

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### **EXHIBIT 1.6** Samples Operational Review Proposal Letter: The Example Company

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Dear Mr. Worthington:

It was a pleasure meeting with you on January 23 to discuss how Reider Associates might assist the Example Company in the review and analysis of Purchasing Department operations. This proposal letter summarizes our understanding of your situation, the assistance to be provided by us, our approach to providing such assistance, and an estimate of our time and fees.

#### *Background*

You have expressed some concern relative to the quality of present systems and methods that your Purchasing Department personnel are currently using. In addition, you are concerned about implementing more sophisticated operating and data processing techniques, so that Purchasing Department personnel can better manage their operations and provide the necessary services in an economical and efficient manner.

In response to these and other situations, you have recognized the need to provide system review and analysis assistance addressing these concerns. Accordingly, you have requested that Reider Associates submit this proposal relative to how we might assist your efforts in designing and implementing such an operational improvement to meet your needs.

#### *Objectives*

The objectives of the operational review of Purchasing Department operations would be to:

1. Determine which systems and procedures would be best to improve Purchasing Department effectiveness.
2. Design operating systems and data processing procedures to enable Purchasing Department functions to operate more efficiently and economically.
3. Identify opportunities for operational improvements within the Purchasing Department.
4. Review and analyze present data processing procedures to determine their effectiveness and to recommend improvements, for greater efficiency of operations.

#### *Scope of the Engagement*

This engagement is to be confined to those Purchasing Department areas reporting to the vice-president of operations, located at your central headquarters. Therefore, the engagement will exclude all non-Purchasing Department operating areas reporting to the vice-president of operations located at central headquarters, as well as Purchasing Department functions at other sites.

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**ENGAGEMENT DEVELOPMENT**

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**EXHIBIT 1.6** *(Continued)*

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As we discussed, we would plan to review operating systems and procedures, as well as interview selected management/supervisory and operating personnel in the following Purchasing Department work units:

- Purchasing
- Purchasing Supervisor
- Buyers I & II
- Clerk Supervisor
- Clerical Supervisor
- Clerk Typist
- Standard Specifications Unit
- Standard Specifications Unit Supervisor
- Procurement Technician
- Management Trainee
- Clerk Stenographer
- Clerk

*Our Approach*

We propose to assist you in the review and analysis of present Purchasing Department operating procedures and methods, which will encompass techniques and procedures needed presently, as well as provide for flexibility for growth and adaptation to changed circumstances. Accordingly, we plan to provide our assistance in the following steps:

1. General review of existing operational methods and procedures to provide us with a clear understanding of your Purchasing Department functions so that we can provide effective consulting assistance in developing and implementing improved procedures. This would include a review of management/administrative practices and procedures, as well as related operating systems and methods.
2. Interviews of a number of Purchasing Department 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, 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 general review. 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 recommendations for improvement.

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## OVERVIEW OF OPERATIONAL REVIEWS

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### EXHIBIT 1.6 (Continued)

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4. Development of detailed findings of recommendations for improvement, which will be developed in a manner that will optimize each Purchasing Department function's achievement of its individual goals and objectives, as well as deal with issues identified by us in our general operational review and participant interviews.

These findings and recommendations will be documented for your review in both an oral and a written report.

5. Assistance to you and your staff in the implementation of recommendations that can be accomplished during the course of this consulting assistance. 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 consulting engagement.

#### *Our Participation*

Mrs. Betty White, manager in our operational review consulting department, will be personally responsible for the technical conduct and successful completion of this operational improvement program. She has provided similar assistance to numerous clients.

We plan to assign Mr. Bill Brown, supervisor, and Mr. Joe Super, senior, of our consulting staff to this engagement. Both of these people are uniquely qualified to perform the tasks required in this engagement. They will be responsible for the performance of the work steps, as described in this section "Our Approach." We will assign other personnel as necessary, with your approval. We also plan to utilize the services of Mr. Mike Clark, an independent consultant, in the areas of his expertise, which are systems and procedures, flowcharting, facilities layout and work flow, and data processing.

We are attaching to this proposal resumes for each of these people.

#### *Client Participation*

Based on our experience, we consider client participation to be essential for such an operational improvement program to be effective and successful. Accordingly, we recommend that a management member be assigned as part of a task force to work along with us in formulating the details of the operational improvement program. We would expect this person to participate in the engagement as necessary, to be available to attend progress meetings as scheduled, and to provide us with necessary input (particularly related to his or her functional area) as required. We would recommend Mr. Cliff Chambers, purchasing supervisor, to assume the overall client management responsibility.

## ENGAGEMENT DEVELOPMENT

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### EXHIBIT 1.6 (Continued)

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In addition, we would suggest assigning an operations staff member from both the Purchasing and Standards Specifications work units to this engagement to work along with us. We would not expect either one of them to be assigned duties that would consume more than two days per week during the course of the engagement.

#### *Progress Meetings*

Progress meetings will be held at least every three weeks, at which time we will discuss such things as (1) progress to date, (2) specific findings and recommendations, (3) decisions to be made, (4) implementation efforts, and (5) ongoing plans. We will, of course, document these progress meetings in brief written reports.

#### *Reporting*

At the conclusion of this engagement, we will submit our findings and recommendations to you at an oral presentation, which will provide you with an opportunity to review and discuss these findings and recommendations. As a follow-up to the oral presentation, we will subsequently document our findings and recommendations in a formal, written report.

#### *Benefits to Be Provided*

The benefits to be derived from the conducting of an operational review for your Purchasing Department are many and varied. However, you should expect at least the following:

- Identification of operational problem areas, related causes, and alternatives for improvement.
- Effective reduction of unnecessary costs through the identification of opportunities for eliminating waste and inefficiency.
- Identification of undefined organizational goals, objectives, policies, and procedures.
- Assessment of the existing management information and control system.
- An independent, objective evaluation of operations.

We believe the assistance to be provided by us will also ensure a positive and effective method of implementing improved operating techniques, which will enable all levels of Purchasing Department personnel to:

- Understand their basic roles and functions so that all individuals can implement such operational techniques and principles within their own areas,
- Develop meaningful operating procedures that will enable them to better control, monitor, and evaluate the results of their operations,

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## OVERVIEW OF OPERATIONAL REVIEWS

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### EXHIBIT 1.6 (Continued)

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- Perform their current job responsibilities more effectively with a greater level of competency, a better understanding of operational procedures, and a greater ability to apply their knowledge in their particular situations, and
- Develop a greater sense of teamwork and working together, which should make operations more effective and efficient.

#### *Time and Cost*

We recommend that the operational review be conducted in two phases to be most effective and to optimize the benefits to be derived by your organization, as follows:

##### *Phase I: Planning*

The planning phase would consist of a general review of your purchasing operations to provide us with a working knowledge of your operations, as well as to identify those significant areas offering the greatest payout in operational improvements that we believe should be analyzed in greater depth during the Phase II field work. We would, of course, bring to your attention all operational improvements and related recommendations identified by us during Phase I so that you will be able to implement immediate or short-term positive changes.

##### *Phase II: Field Work*

As a result of the Planning Phase, we will identify those critical operational areas where we believe further review and analysis will result in substantial improvements which will far outweigh the costs of conducting the operational review. Based on our mutual agreement, we would then develop an operational review work program directed toward further review and analysis of each of these critical areas, resulting in the development of findings which would improve the reporting of specific recommendations for improvement.

Our fees are based on the amount of time expended on the engagement, extended by our standard billing rates. Based on our experience in similar engagements, our initial survey of your operations, and discussions with you, we estimate our time participation and related costs to be as follows:

##### *Phase I: Planning*

Three weeks of elapsed time, at an estimated cost of \$10,000 to \$12,000

##### *Phase II: Field Work*

From 10 to 12 weeks of elapsed time, at an estimated cost of \$28,000 to \$32,000.

**ENGAGEMENT DEVELOPMENT**

**EXHIBIT 1.6** *(Continued)*

Our estimated costs for the Field Work phase are based on our present knowledge of your situation and what we believe is necessary at this time. However, should the situation change, based on what we find out in the planning phase, we will inform you immediately as to the need to change our time and cost estimates either upward or downward.

In addition, we are to be reimbursed for out-of-pocket expenses incurred for travel, lodging, subsistence, and the like. We will, of course, attempt to minimize both fee and expenses and will bill you only for actual time and expenses incurred.

It is our practice to submit progress billings at two-week intervals.

We are ready to begin this engagement within one week of your acceptance of this proposal. However, to meet your desired timetable, we suggest starting no later than March 1.

\* \* \* \* \*

We appreciate the opportunity to submit this proposal and look forward to working with you on this important and challenging project. If the arrangements described above meet your approval, you may indicate your acceptance by signing and returning the enclosed copy.

Very truly yours,

\_\_\_\_\_  
Rob Reider, President  
Reider Associates

Approved

by \_\_\_\_\_

George Worthington, Vice-President Operations

Date \_\_\_\_\_

## OVERVIEW OF OPERATIONAL REVIEWS

### EXHIBIT 1.6 (Continued)

#### Work Program and Operational Review Engagement Budget Estimate (in hours)

Client Name: The Example Company  
Phase I: Planning

Date: February 2, 20XX

#### *Engagement Work Program*

	Mgr.	Supv.	Out. Staff	Cli. Cons.	Time	Total
1. Goals & Objectives						
a. Review legislative/ internal materials					6	6
b. Planning systems & procedures		26				26
2. Budgets		11				11
3. Organizational Chart and Procedures						
Manual	14					14
4. Flowcharts				28		28
5. Reports					18	18
6. Personnel			21		12	33
7. Facilities			4	12		16
8. Review Planning						
Phase Results	10					10
Total Time	24	37	25	40	36	162
Other:						
9. Prepare Work Program	12				12	24
10. Review Management	24				16	40
Total Other Time	36				28	64
Grand Total Time	60	37	25	40	64	226
Standard Billing Rates	\$80	\$60	\$30	\$75	—	
Total Estimated	\$4,800	\$2,220	\$750	\$3,300	—	\$10,770
Contingency: 10%						1,230
Grand Total						\$12,000
Proposed Fee Quoted						<u>\$10,000 to \$12,000</u>

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**ENGAGEMENT DEVELOPMENT**


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**EXHIBIT 1.6 (Continued)**


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Work Program and Operational Review Engagement  
Budget Estimate (in hours)

Client Name: The Example Company  
Phase II: Field Work

Date: February 2, 20XX

*Engagement Work Program*

	Mgr.	Supv.	Staff Sr./Jr.	Out. Cons.	Cli. Time	Total
1. Company Policy & Organization						
a. Organization Status of Purchasing		50				50
b. Responsibility for Purchasing		20				20
c. Authority for Purchasing			10			10
d. Decentralized Purchasing			20			20
2. Purchasing Department Operations						
a. Proceedings Flowcharts				50		50
b. Department Forms					20	20
c. Physical Facilities					12	12
d. Value Analysis Program					8	8
e. Collateral Operation				16		16
3. Review of Purchase Transactions						
a. Selected Transactions			8	12		20
b. Examination of Purchasing Transactions			12	18		30
4. Records & Reports				34		34

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**OVERVIEW OF OPERATIONAL REVIEWS**


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**EXHIBIT 1.6** (Continued)

	Mgr.	Supv.	Staff Sr./Jr.	Out. Cons.	Cli. Time	Total	
5. Review Field Work Results	24	24			12	60	
6. Development of Findings	8	8	22		32	80	
7. Oral Reporting	10				10	20	
8. Written Report	12	20			8	40	
Total Time	54	132	40	112	50	490	
Other							
9. Prepare Work Program	12	8	4	6	2	8	40
10. Review Management	80				20	100	
Total Other	92	8	4	6	2	28	140
Grand Total	146	140	44	118	52	130	630
Standard Billing							
Rates	\$80	\$60	\$40	\$30	\$75	—	
Total Estimated Fees	\$11,690	\$8,400	\$1,760	\$3,540	\$3,900		\$29,290
Contingency: 10%							\$2,720
Grand Total							\$32,000
Proposed Fee Quoted							\$28,000 to \$32,000

but client personnel may feel confident enough to implement the agreed-upon recommendations on their own. As part of the reporting process, it is also important to identify other significant operational areas in which the operational review approach could offer specific improvements and quantifiable benefits. This could lead to a follow-up operational review engagement for the external consulting firm, particularly if it has proven its worth in the current operational review. For the internal review team, it may result in management 's asking for additional operational reviews. Not only is such an approach productive in selling the entire operational review concept, but it reinforces the concept of the internal review group existing as a profit center in conducting operational reviews. The "profit center" concept is based on convincing management that the benefits to be derived from operational reviews far exceed the costs involved. This is where the quantification of findings is extremely important.

Another aspect to consider is that if the operational review is performed properly with the help of departmental personnel, the department retains

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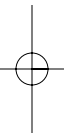
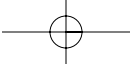
## ENGAGEMENT DEVELOPMENT

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the residual ability to perform operational review procedures in other areas. As the operational review team cannot normally cover every operational area that could be improved within the scope of the original operational review, the team should identify those additional areas for further review and, possibly, for review by the department. Management then decides whether to pursue these areas on their own or with the operational reviewer's help.

One of the goals in acquainting an organization with the operational review approach is to multiply the effectiveness of operational reviewers. In other words, while performing the operational review, reviewers are also training client personnel. In this way, operational review procedures and results are quickly multiplied throughout the organization, and the reviewers can then spend their time on the most significant areas and tasks.

***The Operational Review  
Is a Learning Process  
for the Individual,  
the Work Unit,  
and the Organization***



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