Peter F. Drucker: Delivering Value to Customers

You have to manage for results, do the right thing right and make serving the customer the center of everything

by
Gregory H. Watson

PETER F. DRUCKER is widely credited with creating management as a formal discipline. In 1954, he published the first book that defined business management, *The Practice of Management*. Before this book, there was no coherent body of management knowledge, and only two or three books even addressed management issues.

When it comes to the quality aspects of management, Drucker has established several ideas of importance to quality professionals. His concepts span from defining the purpose of a business to challenging leadership to manage information more effectively.

Throughout his career, Drucker has presented an idea toolkit to create profound knowledge and stimulate business improvement. This article, based on the lifelong writings of Drucker and an interview I conducted with him in summer 2001, traces the ideas behind his strategic architecture for delivering value and quality to customers.

Drucker almost always begins his discussions with a question like what is a business? To him the usual answer—the purpose of an organization is to make a profit—"is not only false, but it is totally irrelevant."

After rejecting this most obvious definition, Drucker then describes his basic concept as a starting point: If you want to know what a business is, you have to start with its purpose, which must be found outside the business itself—in society, since a business enterprise is an organ of society. "There is only one valid definition of business purpose: to create a customer."

From a quality perspective, Drucker develops the more traditional emphasis on financial return—that a business is an organization that "adds value and creates wealth." Value is created for customers, and wealth is generated for owners. While this is a simple statement, Drucker observes traditional management methods often mask this basic business purpose. Throughout his body of work, Drucker gives quality professionals many lessons in economics, business, finance and accounting.

Traditional measurements inadequate

Consider how Drucker takes on some of the mainstream thinking in business. "Enterprises are paid to create wealth, not control costs. But that obvious fact is not reflected in traditional measurements. First-year accounting students are taught the balance sheet portrays the liquidation value of the enterprise and provides creditors with worst-case information. But enterprises are not normally run to be liquidated. They have to be managed as going concerns, that is, for wealth creation. To do that requires information that enables executives to make informed judgments."

One theme in all of Drucker's work emphasizes the inadequacy of traditional cost accounting methods that create a short-term decision bias due to the need to regularly deliver a quarterly profit and assure investors their capital can be returned if the business is liquidated. This bias runs counter to the long-term need for organizational strength that delivers sustained success, increases customer loyalty and grows the wealth of the investors.

"There is only one valid definition of business purpose: to create a customer."

Drucker commented in our interview, "Financial people believe businesses make money." In reality, businesses make products for customers. Money is a result earned by products delivering value that customers are willing to purchase. "In a business you earn your money; in a nonprofit organization you deserve your money," he added.

"Because there is no bottom line in a nonprofit, performance is actually more important," Drucker continued. "Many nonprofits are not concerned with performance because they believe good intentions are enough. 'We are in a good cause. Therefore, the fact that we are totally ineffectual is unimportant.' I'm exaggerating, but not too much, I'm afraid."

All organizations must consider their priorities, he insists. "What results are we expecting? What are we trying to accomplish? Why are we here? We must remember, managing volunteers is much more challenging than managing employees because there is no paycheck!"

To achieve long-term business success, an organization must have a purpose that elicits the dedication of its people. This may be defined in a mission statement, vision or purpose that aligns the people with their organization. As Drucker stated in his book *Managing for Results*: "Businesses exist to produce results on the outside, in the market and in the economy." This statement introduces one of Drucker's premier ideas: management by objectives, or focusing the organization to achieve a set of results by aligning the work of its people to a shared set of objectives.

Measuring business results

Managing by objectives changes the job of the manager. Instead of supervising employees in their work, the manager elicits agreement on objectives, measures and goals and leaves the employees to define the means by which they will accomplish these objectives. To know the objective of a business, you must have impartial measurements of its performance. But it is not profit that is most important. Drucker sees economic value added (EVA) as a superior measure.

"EVA is based on what we have known for a long time: What we generally call profits, the money left to service equity, is usually not profit at all," he says. "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources. It does not cover its full costs unless the reported profit exceeds the cost of capital. Until then, it does not create wealth; it destroys it."

Drucker continues, "By measuring the value added over all costs, including the cost of capital, EVA measures, in effect, the productivity of all factors of production. It does not, by itself, tell us why a certain product or service does not add value or what to do about it. But it shows us what we need to find out and whether we need to take remedial action."

Cost of capital is the return an investor could achieve by making an alternative choice for his or her investment. If this return is not generated, then the investor is having his or her investment diluted and principal destroyed. This concept differs from the traditional definition of profit (revenue minus costs).

Confusing profit margin with profit

Why is there such confusion over profit? "One reason is the common management mistake of identifying profit margin with profit, which is always profit margin multiplied by turnover," Drucker says.

The short-term view of cost accounting misses a key distinction between a static measure of the profit contribution potential (or the margin contribution of a product as defined by its standard cost) and the sales activity in the market that produces a revenue stream—or as the language of finance calls it, turnover.

Drucker made the following observation in 1973: "The essential thing about profit is there is no such thing. There are only costs … costs of doing business and costs of staying in business; costs of labor and costs of capital; costs of today's jobs and tomorrow's pensions."

Business can survive only when its profit is able to meet the demands of its future. In considering the cost structure of an organization, Drucker notes people are a resource, not a cost—a theme consistent from his General Motors study in the book *The Concept of the Corporation* (originally published in 1946) to his most recent article in the *Harvard Business Review* (January/February 2002).

Perhaps one of the most provocative quality related comments Drucker makes is when he defines the meaning of a profit center within an organization: "Inside an organization there are only cost centers. The only profit center is the customer whose check has not bounced."

Drucker's complaints against cost accounting are manifold. "The oldest and most widely used diagnostic management tools are cash flow and liquidity projections and such standard measurements as [financial] ratios. … If these readings are normal, they do not tell us much. If they are abnormal, they indicate a problem that needs to be identified and treated," he says. These standard financial measures do not tell managers where the problem is or what caused it. Further analysis and diagnosis are required to find a root cause.

While accounting separates operating expenses and capital assets in analyzing business performance, this separation actually distorts the effect of the cost of these assets. As Drucker comments, "For management purposes, there are no 'costless assets.' There are only 'sunk

Insights Into Peter F. Drucker

Peter Ferdinand Drucker was born in 1909 in Vienna, Austria. His early life was rich from the intellectual influence of his father, a senior civil servant in the Austro-Hungarian Ministry of Economics, and his mother, a medical doctor. These formative years were a product of both World War I and the Great Depression.

Drucker received his degrees courtesy of the European education system, which allowed him to read and study on his own and take examinations to demonstrate subject mastery. This learning style is the basis for his lifelong thirst for knowledge.

While Drucker pursued a doctorate degree in public law and international relations at Frankfurt University, he was also senior editor for finance with the *Frankfurter General Anzeiger* newspaper. He wrote a pamphlet on Friedrich Joseph Stahl (1802-1861), a legal philosopher and Jew, in 1933, just two months after the Nazis took power in Germany. The pamphlet was subsequently banned and burned by the new administration.

Drucker moved to London, and during the early years of Hitler's rise to power, he began work on his first book, *The End of Economic Man: The Rise of Totalitarianism*, an analysis of the irrationalism and nihilism of fascism that was ultimately published in 1939.

With his wife, Doris, Drucker immigrated to the United States in 1937, serving as a correspondent for the newspaper now called the *Financial Times*. His first American teaching job, at Sarah Lawrence College in Bronxville, NY, was terminated when he refused to support a faculty petition that supported communism.

He moved on to a successful career teaching at Bennington College in Bennington, VT. Then, in 1949 at New York University (NYU), Drucker founded the third formal management education program in the world (after ones at Harvard and the Massachusetts Institute of Technology).

The world owes Drucker a debt for his influence on global quality: When he formed the NYU management program, he hired both Joseph M. Juran and W. Edwards Deming for the faculty. Together these three men had a strong influence on exporting quality management thinking to Japan.

Drucker's final career stop has been at Claremont (CA) Graduate University, where the graduate school of management has since been named in his honor. He is currently the Clarke Professor of Social Science and Management.

Although he has been a journalist and educator all his life, Drucker considers himself primarily a writer. The author of 30 books, whenever he is asked which he considers the best, he smiles and says, "The next one."

The author of 30 books, whenever he is asked which he considers the best, he smiles and says, "The next one."

costs,' the economist's term for buildings and other fixed investments. The question is never, 'What have they cost?' The question is, 'What will they produce?' And assets that no longer produce, except in accounting terms—assets that produce only because they appear not to 'cost' anything—are not assets, they are only sunk costs."

Playing games with measurement

"There is no better way to improve an organization's performance than to measure the results of capital appropriations against the promises and expectations that led to their authorization." What does Drucker mean by this suggestion?

Capital acquisition decisions are made based on the expectation for performance of a piece of equipment and its cost to the organization. This cost-benefit decision is based on the design performance of the equipment. Business leaders calculate the decision criteria using the ratio of the performance specification to the inherent variation contained in the design for this performance. In quality we call this ratio process capability (C_p).

Thus, decisions to buy equipment are based on a promise or expected performance value. The reality is often that when this equipment is installed, it operates less efficiently than the expectation at the time of its authorization; however, management changes the basis for measuring its true efficiency to evaluating its productivity using standard cost analysis. In this

Encouraging a Leader To Improve Quality

During my interview with Peter Drucker, I asked him a question on the minds of many quality professionals: How can a CEO be convinced to focus attention on quality improvement as a method to drive productivity and profitability?

"Only if you can show the profitability of quality in your reports. Preaching only gets you converts on Sunday, but they are sinners again on Monday," he responded. "Don't try to convince a CEO. It is not your job as a manager to educate your boss. It is much too difficult.

"Give him [or her] information in the form management is used to seeing—the effects of policies and procedures—but also report it in a form you can use to demonstrate to those difficult, but important, outsiders, the security analysts and the institutional investors," Drucker continued. "They are financial people and know nothing about business. I'm an old financial person, and I can say no financial person has ever understood business. Financial people believe businesses make money. Business makes shoes!"

What is this report Drucker encourages us to provide? His writings amplify his comments. He observes managers are accustomed to receiving regular reports describing the performance of their organizations. Though he criticizes the measurement systems used for business and the lack of information contained in these data, he also offers sound advice on how to improve these reports.

While most reports focus on the problems of the organizations—gaps between planned and actual performance—Drucker believes, "It is important for the change leader to have reports focusing on the areas in which the enterprise does better than expected, the areas of unexpected success and therefore the areas of potential opportunity."

It is the obligation of the worker to communicate clearly to the boss—to put "information in a form in which they operate and think"—so management can "translate it into action. And, in fact, top management cannot know these things because they were not put into a form that gave a convincing argument of the impact of polices and procedures on losing or gaining sales," Drucker asserts.

In the end business is about making products and delivering service—the shoes—to customers, not just about making money. The challenge for organizations is to design their business reports to clearly communicate the inherent status of their organizations.

"Preaching only gets you converts on Sunday, but they are sinners again on Monday."

method the expected real-world performance (a standard operating cost based on an average performance attained and not related in any way to the design capacity) is directly compared with the production plan to establish a yield or production output.

This method would provide a very different result if the basis of comparison were not the production plan but the original, or "nameplate," capacity used during the capital authorization. If the original capacity were used, many business process yields that currently average in the 80 to 95% range would drop by more than half. Good measurement of business results doesn't play games by changing the basis for analysis halfway through its execution—unfortunately, that is exactly what most capital acquisition decisions do!

"Inside an organization there are only cost centers. The only profit center is the customer whose check has not bounced."

Quantifying quality

In our interview Drucker observed that you can present quality quantitatively in several ways. One is the cost of poor quality; another is the profit of good quality as shown in additional purchases; and a third is the long-term gain in brand image, consumer loyalty and repeat purchases. You're building a constituency among your customers, he says.

In this brief listing, Drucker helps us bridge our thinking about quality performance measurement from the viewpoint of the customer to the internally focused viewpoint of quality costs. He moves us to go beyond EVA to perform organizational diagnosis that will allow us to find the root cause of operational problems and improve the organization's value to its customers.

Assessing performance effectiveness

Drucker is not satisfied with traditional ways of analyzing the financial performance of business. "Traditional cost accounting postulates that total manufacturing cost is the sum of the costs of all individual operations," he states. "Yet the cost that matters most for competitiveness and profitability is the cost of the total process, and that is what the new activity based costing records and makes manageable."

The basic premise of activity based costing is this: "Manufacturing is an integrated process that starts when supplies, materials and parts arrive at the plant's loading dock and continues even after the finished product reaches the end user. Service is still a cost of the product, and so is installation, even if the customer pays.

"Traditional cost accounting measures what it costs to do something—for example, to cut a screw thread," Drucker continues. "Activity based costing also records the costs of not doing, such as the cost of machine downtime, the cost of waiting for a needed part or tool, the cost of inventory waiting to be shipped and the cost of reworking or scrapping a defective part. The costs of not doing, which traditional cost accounting cannot and does not record, often equal and sometimes even exceed the costs of doing."

In assessing the benefits of activity based costing, Drucker returns to three of his consistent themes: managing for results, the duality of doing things right while doing the right thing and the importance of the customer.

- "Activity based costing therefore gives not only much better cost control, but increasingly, it also gives result control."
- "Traditional cost accounting assumes that a certain operation … has to be done and has to be done where it is being done now. Activity based costing asks, does it have to be done? If so, where is it best done? Activity based costing integrates what were once several activities—value analysis, process analysis, quality management and costing—into one analysis."
- "Which one activity is at the center of costs and of results? The answer: serving the customer."

Better product pricing

While activity based costing provides a basis for understanding the true costs of doing business, it also provides the foundation for determining better prices for products. "Knowing the cost of your operations, however, is not enough," Drucker comments. "To compete successfully in an increasingly competitive global market, a company has to know the costs of its entire economic chain and work with other members of the chain to manage costs and maximize yield. Companies … shift from costing only what goes on inside their own organizations to costing the entire economic process."

In economic chain costing, legal entities become an "economic fiction. What matters in the marketplace is the economic reality, the costs of the entire process, regardless of who owns what." While traditional accounting features cost based pricing as the approach to establishing market prices, "a powerful force driving companies toward economic chain costing will be … price led costing," Drucker asserts.

"Traditionally, Western companies have started with costs, put a desired profit margin on top and arrived at a price," he continues. In price led costing a different scenario occurs: "The price the customer is willing to pay determines the allowable costs, beginning with the design stage. … Companies can practice price led costing, however, only if they know and manage the entire cost of the economic chain," Drucker says.

While this accounting practice is fully consistent with the theory and application of supply chain management and partnerships with key suppliers, it is difficult to put into action in a pragmatic sense. "It will be painful for most businesses to convert to economic chain costing. Doing so requires uniform or at least compatible accounting systems at companies along the entire chain," Drucker explains. "Yet each company does its accounting its own way, and each is convinced its system is the only possible one. Moreover, economic chain costing requires information sharing across companies, yet even within the same company, people tend to resist information sharing."

Determining competitive standing

Even when an organization applies EVA to focus its efforts on delivering value to its customers and uses activity based costing to improve management of process costs and product pricing, there is still the need for external validation of performance through the active gathering and analysis of competitive information.

Drucker states, "What a business needs most for its decisions—especially its strategic ones—are data about what goes on outside it. Only outside a business are there results, opportunities and threats."

"Together, EVA and benchmarking provide the diagnostic tools to measure total factor productivity and to manage it," he adds. EVA provides the wake-up call that says the organization's performance is not delivering the value desired by customers, and benchmarking provides a rapid learning opportunity for what to do about it.

"Benchmarking assumes correctly that what an organization does, any organization can do as well. And it assumes, also correctly, that being at least as good as the leader is a prerequisite to being competitive," Drucker continues. Benchmarking assists business leaders by forcing them to look outside themselves and consider opportunities for learning from external sources—opportunities that may allow them to innovate within their industries.

"Activity based costing also records the costs of not doing, such as the cost of machine downtime, the cost of waiting for a needed part or tool, the cost of inventory waiting to be shipped and the cost of reworking or scrapping a defective part."

Innovation for business sustainability

To sustain success in a business—delivering long-term strength—a business must emphasize its requirements for innovation and entrepreneurship. Innovation is a significant theme in much of Drucker's writing. His perspective is defined by this observation: "Yet no matter how powerful a company is in its industry, noncustomers almost always outnumber customers."

Consider Six Sigma. Drucker believes its most important contributions will support innovation once organizations learn what their noncustomers need. "The most valuable aspect is Six Sigma builds quality into the design. Six Sigma says you design it so it can be made. It puts quality and productivity into the design from the beginning." As always with Drucker's ideas, the beginning begins with the customer!

Delivering more value

Throughout his life Drucker has demonstrated his agile thinking and ability to forge new trends. He stays ahead of other management thinkers because of his commitment to lifelong learning, which causes him to keep well-informed in many areas.

Interestingly, he believes many top executives have business problems because they are poorly informed about the fundamentals of the business's performance and don't really know how to interpret business information. "Not many executives are information-literate. They know how to get data. But most still have yet to learn how to use data," Drucker says.

To meet this information challenge, executives must remove a serious cause of business failure: "the common assumption that conditions must be what we think they are or at least what we think they should be. An adequate information system has to include information that makes executives question that assumption," Drucker adds.

He applies the Socratic method to stimulate top management to think about how it is running the organization. Three of his basic questions are formulated around the results of the organization:

- What is our business today?

- What will be our business?
- What should be our business?

Management's job is to discover the answer to these questions and implement solutions that deliver results. It is our job as quality professionals to report the necessary data. We must also ask ourselves these same critical questions:

- What information do we owe?
- To whom do we owe it?
- When should we give them this information?
- In what form should we present it?

Learning the language of business is the next personal growth opportunity for many quality professionals. Let's hope Drucker's ideas will provide a foundation for our continuous learning about how to deliver more value to customers.

BIBLIOGRAPHY

Drucker, Peter F., *Management Challenges for the 21st Century* (New York: HarperBusiness, 1999).

Drucker, Peter F., *Managing for Results,* second edition (New York: HarperBusiness, 1986).

Drucker, Peter F., *Managing in a Time of Great Change* (New York: Penguin Putnam, 1995).

Drucker, Peter F., *The Concept of the Corporation* (New Brunswick, NJ: Transaction Publishers, 1993).

Drucker, Peter F., *The Practice of Management* (New York: HarperBusiness, 1993).

Drucker, Peter F., "They're Not Employees, They're People," *Harvard Business Review*, January/February 2002.

GREGORY H. WATSON *is chairman of ASQ's Board of Directors, managing partner of Business Systems Solutions Inc. and an academician in the International Academy of Quality. He holds master's degrees from the University of Southern California (in systems engineering) and the law school at Antioch University, Seattle (in legal analysis).*

IF YOU WOULD LIKE to comment on this article, please post your remarks on the *Quality Progress* Discussion Board at www.asqnet.org, or e-mail them to editor@asq.org.