

## **Cost of Quality**

**A worked example of Cost of Quality for a new media company**

Discussion Document  
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## 1.0 INTRODUCTION

In this discussion document I share a Cost of Quality assessment example based on publicly available figures for EA Inc, I did a similar piece of analysis for AOL (UK) Ltd and the story was very similar. Clearly the actual Cost of Quality Initiative mentioned is the piece of work required to deliver the benefits discussed and recover from the issues raised. If after reading the paper you recognise this situation, on whatever scale within your business, call us to discuss the assessment and initiative work that we can do for you.

### 1.1 Overview

The Cost of Quality is often referred to as the “cost of doing things wrong”. Every time a business makes a mistake it costs money to make the mistake and then correct it.

The cost of doing it wrong is the hit, the activities to correct it usually match that which should have been done correctly so don't count. Well, not directly anyway but fixing the issue could have impacts that push the Cost of Quality up. For example maybe a game wasn't published correctly on a CD/DVD and so there could be a direct cost of fixing that and an indirect cost of missing a marketing window.

In his book, Quality is Free, Crosby suggests the cost is 10% to 15% of revenue. Vorley and Tickle in their book, Quality Management, suggested the figure is 5% to 25% of revenue. An incredible figure in terms of wasted revenue wherever it falls for a business.

If we take the 15% figure as EA has lower material scrap costs, for example, and to leave a little to the imagination – what's the estimated Cost of Quality for EA? Revenue was reported as \$2.95b for 2006, so that's, and I'm really sorry about this, \$442.6m a year doing-things-wrong.

We can't solve the problems of the world, can we? So, let's pretend their UK business is only responsible for 1% of the Cost of Quality, we've got \$29.5m Cost of Quality against 2006 revenue figures.

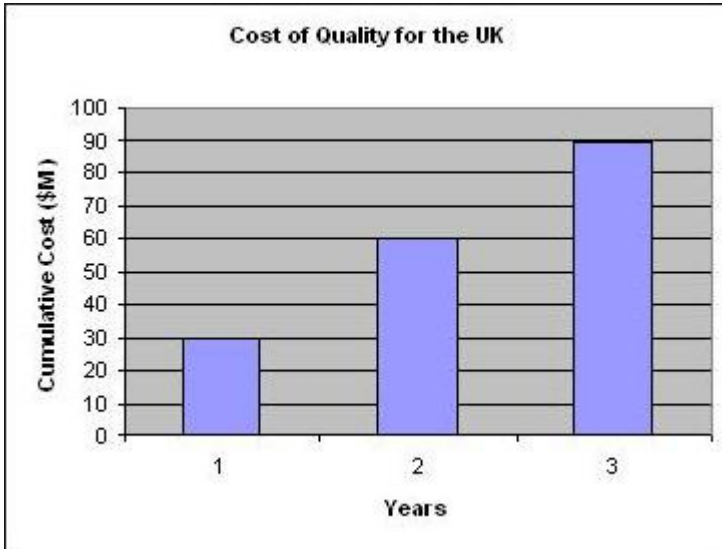
### 1.2 Interesting, but what does that mean?

So the argument would suggest we'd have to get one heck of a slice of additional market to get this money “back”, (or save by lay-off's, closing studios, etc.) How much would the marketing cost be to gain the extra market share? Is there sufficient market share they can get to make another \$29.5m from the UK market, let alone \$442.6m a year from the global market? But it doesn't fix the problem - aren't they then losing 15% of an increased amount?

I'm glad you asked, yes they are, what they need is a Cost of Quality Initiative over three years. Why? Because it makes the illustration work!

## 2.0 ILLUSTRATION

So, if we accept the figures the logic goes that EA going to spend \$29.5m every year over the next three years 'doing things wrong' in the UK. That's a total of \$88.5m in the UK now until 2009, a whopping \$1.3b for EA worldwide.



When first presented with figures like this it can be a challenge to accept it. The point is, even if the figures are 'off' the Cost of Quality is real and with the size of EAs business we're talking millions of dollars wasted.

### 2.1 But, where is the Cost of Quality coming from?

Everywhere, every part of the business that does something wrong, it could be:

- Bugs in software
- Marketing errors
- Material defect costs
- Accounting and purchasing mistakes or legal cases
- Losing the investment in staff through people leaving the business or layoffs
- Lack of efficiencies from process, business unit or studio acquisition

You get the idea, these are all things EA and most businesses have experienced – Cost of Quality is everywhere.

### 2.2 Cost of Quality Initiative

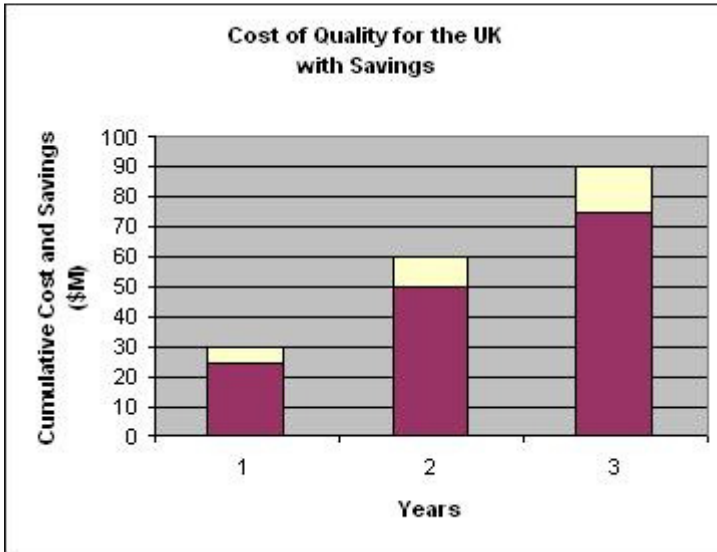
I was once told that the way to resolve issues of this scale is to 'Throw \$30m at the problem'. Naturally, that comment was made in a slightly throw-away manner but maybe that wasn't so crazy after all, let's have a look.

Let's pretend the business has said 'OK, let's round that UK Cost of Quality sucker off to \$30m because it makes the math easier - here's the game - you've got \$30m for your Cost of Quality Initiative, however you get it at \$10m a year over the three years. But you must save that amount (we heard somewhere that Quality was free) or save more for us, permanently or we'll make your Mum cry... or something' Sounds like a bum deal? Not so!

At first it seems like we need to achieve a >30% reduction in the Cost of Quality from year one so we're breaking even and then keep it up! But we don't and heck we can't keep that up. The figure we're looking for is more like a 17% reduction or ~\$5m. Why is that then?

### 3.0 BY THE POWER OF COMPOUND SAVING!

It's magic graph time, let's chart that UK figure up in a pretty way:



What we see is that in year one we save the business only \$5m, this sees us spend \$10m to save half that amount and we still incur a Cost of Quality of \$25m. The business accepted it would waste \$30m, we come along and cost it another \$10m, but saved £5m off the Cost of Quality... at this point EA might say "Guys, are we missing something or do we have to make your Mum cry now?" No so fast Larry...

But we're bang on target for the minimum success criteria, break even. Don't believe me? Let's look at year two. In year two we spend another \$10m on our Initiative and reduce the Cost of Quality from our year one start point by another \$5m. The year two Cost of Quality is \$50m, not the \$60m that would have been spent had we not started.

So, now we begin to see the compounding effect. In year one we saved \$5m, in year two we saved the year one \$5m and the year two \$5m. That's a \$10m saving in year two from what the business thought it would spend over the period until we enlightened them. But we've spent \$20m! Don't fret, see year three.

In year three we save the year 1 \$5m and year 2 \$5m, plus another \$5m in year three. That's a \$15m saving compared to what was expected before we started. Add that up and it's \$30m – clear as mud? The point is:

- In year zero, for want of a name, the business expected Cost of Quality to be \$90m over three years.
- We agreed to find at least \$30m savings against that figure.
- What we knew was the savings were cumulative, the benefits would compound.

When we saved the \$5m in a particular year we saved it over the next years, because it's money that didn't get wasted as the company accepted and expected it would. So:

- A \$5m saving in year one is worth \$15 over three years.
- A \$5m saving in year two is worth \$10m over two years.
- A \$5m saving in year three is worth \$5m over the one year

### 3.1 That's \$30m – we just broke even

Which on reflection is fantastic but would get us only an on target performance review, it's a tough business.

## 4.0 CONCLUSION

As stated above it doesn't matter if the figures are 'off', the Cost of Quality is real, it can be calculated and it can be saved. If the company wants to recover the cost and save it year on year it's worth paying for that. You won't get the 'same' money by increasing market share, in fact the Cost of Quality will rise if your business develops in areas where there are quality issues that remain unaddressed.

In our example we can see how a 'crazy' figure such as \$30m isn't that crazy to fix the problem. But if you're looking at a Cost of Quality of \$29.5m or \$442.6m every year, possibly increasing and until your business ceases to trade - now that's absolute madness!

A Cost of Quality Initiative is no Silver Bullet and the reality is getting rid of people or closing studios might be what a Cost of Quality Initiative recommends. But it's a far better approach than those in the long term, it has a better effect on the business and staff and there are hidden gains through Osmotic Adoption.