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by Loren Gary

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How to Think About Performance Measures Now

Before asking whether your key performance indicators should be reshuffled, make sure that they enable you to tell the story of your company's strategy.

by Loren Gary

NOW THAT THE overall American economy is in recession, indicator lights on the managerial dashboards companies use to monitor performance are blinking red. Firms are taking a hard look at the tradeoffs between short-term cost-saving maneuvers and long-term growth plans. And those that are really up against the wall are scrutinizing their cash flow measures constantly.

"When the world changes, it's natural to ask whether you're measuring the right things," says David Larcker, Ernst & Young Professor of Accounting at the University of Pennsylvania's Wharton School. That is why key performance indicators (KPIs) are receiving a lot of attention right now. A KPI may focus on financial measurements such as days' cash on hand and operating income by unit or division, as well as the nonfinancial areas, such as mean-time response to service calls, cycle time, or percentage of sales from new products. But, as Larcker explains, the best set of KPIs should be viewed as a forward-looking system of measurements that help managers predict the company's economic performance and spot the need for changes in operations.

Is it time to reprioritize the measures you're tracking or adopt new ones altogether? In some instances, yes. But for most companies the problem is a disconnect between measurement and strategy. As Andrew Nelson, executive director of business strategy of the Seattle-based Group Health Cooperative, acknowledges, "With our nonfinancial performance metrics, such as the customer service and work environment measures, we just don't have the depth of understanding of what drives our business." Before you start tweaking your KPIs, it's crucial to ask the strategic questions first: Is your overall strategy still sound? Do the measures you use really relate to it? And are you using the data you collect on your measures to reevaluate your strategic priorities? These questions may not help you avoid the tradeoffs that a recession forces on you, but at least they'll ensure that you make the tradeoffs knowingly.

Linking budgets, measures, and initiatives to strategy

Of the 2,000 respondents to a survey conducted by consultant Lawrence S. Maisel and the American Institute of Certified Public Accountants, 80% said performance measurement systems were a way to achieve business results and create shareholder value. In practice, however, the respondents' performance measurement systems were focused rather narrowly on such traditional financial measures as cash flow, operating income, and sales revenue. That so many companies have taken up the performance measurement gospel is a development worth celebrating. But now that performance measurement has become all the rage, many firms are adopting the new terminology without understanding how their existing practices need to change. They don't really know what the key drivers of the nonfinancial areas of their business are, nor do they understand how these areas relate to each other or to the overall financial performance.

A KPI, in and of itself, doesn't tell you very much, says David P. Norton, president of the Balanced Scorecard Collaborative in Lincoln, Mass. Nor is the number of KPIs that you choose to monitor the most important consideration. The most crucial element, he says, is strategy: "You have to have a strategy first, and then you translate it into measures that you track."

The Balanced Scorecard concept, created by Norton and Robert Kaplan, Marvin Bower Professor of Leadership Development at Harvard Business School, is an outgrowth of the so-called value-based management techniques that first appeared in the late 1980s (see sidebar on p. 3). It helps you highlight the cause-and-effect relationships among performance drivers and identify the links to strategic outcomes. But a Balanced Scorecard is not strategic planning, Norton insists. "It's a tool that forces you to articulate your strategy. You should be able to look at your scorecard and reverse engineer it to see what the underlying strategy is."

In addition to traditional financial measures, a Balanced Scorecard includes metrics that help your company answer three critical performance questions:

- **How do customers see us?** Metrics for this category include customer satisfaction, price relative to the competition, and market share.

- **What must we excel at?** That is, what internal business processes will ensure that we continually meet customers' expectations? Typical measures here have to do with cycle time, productivity, and quality.

- **How can we continue to improve and create value?** Metrics such as the percentage of sales from new products or the rate of improvement in on-time delivery assess your firm's ability to learn and innovate.

Many firms do their strategic planning backward, Norton continues. Their strategic plan lists initiatives and uses internal business measures—time and cost metrics—as milestones. But a

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strategic plan should not be about managing initiatives. Your strategy should describe how your firm intends to create and sustain value for its shareholders. Typically, this overarching objective breaks down into three component themes: *operational effectiveness* (improving the efficiency of core business processes), *customer management* (understanding and leveraging customer relationships better), and *product innovation* (developing new products, markets, and relationships to sustain future growth). Operational effectiveness strategies show results in the near term—12 to 24 months. Product innovation strategies come to fruition over the long term—two to three years for service companies, three to five years for manufacturers, and as many as 10 years for pharmaceutical firms. The payoff for customer management strategies is somewhere in between; segmentation or service strategies, for example, often require two to three years.

Only after these strategic themes have been determined should you identify measures for tracking your progress. Next, establish stretch targets for the measures you've chosen and then select initiatives that will help you achieve the objectives. This helps you avoid the confusion of treating initiatives as ends rather than means. An initiative is a means of implementing a strategic objective, so the metrics should measure progress toward achieving the objective, not the initiative.

"Now that we're in a recession," says Norton, "the question is not, 'Should my KPIs change?' It's, 'Is my strategy still sound?' In general, the answer to that first question is no: strategy is based on a whole set of assumptions about customer value proposition, internal business processes, and learning and growth, in addition to financial expectations. If your strategy is still sound, then it should stay the same. But although the strategy doesn't change, the tactics do—the emphases within the strategy may need to change. I would implore executives not to overreact. I hate to see companies revert to unbalanced management in bad times."

Balancing productivity with the need for growth

Think of strategy as incorporating two contradictory perspectives: growth (a long-term perspective) and productivity (a short-term perspective). "You're always balancing the two," says Norton. "Although you don't eliminate managing for long-term shareholder value, right now you may need to be emphasizing the productivity issues more. But it's been so long since the last recession, many managers have forgotten—or never had to learn—how to deal with a below-average economy. If you're not managing to a strategy right now, you're short-changing your future."

Bill Cochrane, CFO of Saatchi & Saatchi, was at the New York City–based ad agency during the recession of 1991. "Back then, it was basically slash and burn," he says. "We damaged a lot of client relationships in the process." This time around, there's a more surgical approach. When the growth rate of revenue by client started to slow in late 1999, one of the firm's bellwether measures—the percentage of revenue utilized by staff costs—started to climb. "That was our trigger," says Cochrane. "We started to furlough people, lay others off, and use more temps. But the Balanced Scorecard has helped us understand the importance of what we call permanently infatuated clients (PICs) to our business. We're cutting out everything that isn't client-focused right now. We're also evaluating activities that we've always done in-house to see if someone on the outside can do them faster or more cheaply for us. But client retention costs are minuscule in comparison to client acquisition costs. We're not going to do anything that jeopardizes our PICs—and so far, at least, we haven't lost any."

In the absence of a "do-not-touch" list of growth objectives, the outside pressure—from the board, investors, and Wall Street—to bring costs down becomes overwhelming, says Norton.

The Evolution of Performance Measurement

Metrics such as "economic profit" and "residual income," which account for the costs associated with capital, help firms spot areas in which capital is being invested unprofitably. But these metrics, while value-based, are lagging indicators; they offer little help for "forward-looking investments, where future earnings and capital requirements are largely unknown—investments such as new product introductions or new market entry," write Michael C. Mankins and Eric Armour, partners in the New York City–based strategy consulting firm Marakon Associates ("Back to the Future," *Journal of Business Strategy*, July/August 2001). More holistic value-based management (VBM) techniques, introduced in the late 1980s, link strategy to finance, enabling companies to understand "the sources and drivers of shareholder value" within their businesses and "identify new and different strategies to create even more value."

The Balanced Scorecard, introduced in 1992, is just one example of how VBM has become more than a set of tools to use on high-priority issues. Companies' KPIs now include such nonfinancial measures as customer satisfaction, quality, and innovation, and the KPIs are linked to strategic planning and capital investment processes as well as to compensation and performance management schemes. Today, VBM is a holistic discipline sometimes referred to as "managing for value," connoting something every manager should be doing all the time.

The trick is to clearly communicate this balanced position, to focus on productivity-related issues without backing out of the long-term strategy. St. Mary's/Duluth Clinics Health System, a nonprofit health care network headquartered in Duluth, Minn., started to get signals that the economy was changing right after it had developed its Balanced Scorecard in 1998. It responded by focusing on costs even more—this in an industry in which cost-consciousness is second only to cleanliness in its godlike virtue. But Dr. Peter Person, the CEO, has been careful to show the board of directors that these new cost-cutting measures won't hamper efforts to enter new market niches such as cardiology, orthopedics, ambulatory surgery, and imaging. "Especially now," Person says, "we need to be sure that we understand where our programs are profitable and where they're not. But we also need to execute our growth strategies as soon as possible."

"If you're up against it, you've got to focus on the short run," says Larcker. "Ultimately, it all comes down to the measures that can improve your cash position." For example: increase your sales, adjust your prices, generate more frequent inventory turns, minimize defects, and boost your productivity. If you aren't in such dire straits, a tiered approach that combines the short, medium, and long term—the operational effectiveness, customer management, and product innovation themes—makes the most sense.

Use the data you collect to evaluate whether you're tracking the right measures and giving them the proper weight.

DuPont Engineering Polymers (Geneva, Switzerland), which makes plastic coating, has seen orders from its largest clients (in the automotive and electronics industries) drop off significantly. President Craig Naylor puts his blended approach this way: "The strength of the balance sheet is more important now, as is strengthening customer relationships. Yet I still believe in the net present value of the shareholder value approach. So we're looking at changing priorities based on a view of what will be permanently changed after this recession—that is, what won't get better when the economy picks up again."

Adjusting your metrics

Always go back to your strategy before you even consider tweaking your KPIs. When you do that, you may conclude that some of the following advice makes sense for your company:

- **Choose metrics further down the value chain.** Industrial firms that are more removed from the marketplace—a fabric manufacturer, say, as opposed to a clothing retailer—can experience a bullwhip effect in downturns. When you reduce production by 10%, you cut orders to your supplier by 10%. Your supplier, in turn, reduces orders to its supplier by more than 10% because it now has excess inventory. This ripple effect continues up the value chain. The result, says Bruce Chew, senior group leader at the Monitor Group in Cambridge, Mass., is that "small changes in the marketplace lead to larger and larger changes the further up the chain you go. So instead of simply tracking your own order and sales figures, you may need to track end-customer sales and inventories of all the suppliers in your value chain" to get an accurate sense of which way the demand for your products may be going.

- **Make sure you're using the right cost numbers.** "Full-cost numbers, based on accounting methods that track every dollar the company spends, may work well in an expanding economy," says Chew. But when the economy shrinks, they can sometimes give you a misleading sense of how a contemplated action will affect the economics. If you're thinking about cutting production by 10%, it's important to ask questions such as: Which of the activities that I normally do will go away in this scenario? To which vendors and suppliers will I not have to send the check that I normally have to write? And which assets will I be able to turn into cash? The answers will determine what your actual cost figures will be when you cut production by 10%. The lesson here: develop metrics for the specific decisions you're looking to make.

- **Don't obsess over a single metric.** One of Chew's clients discovered it was at a 15% price disadvantage relative to its competitor—and in a falling market no less. The company calculated how many jobs it would need to eliminate in order to make up for the price differential. Focusing exclusively on head count, the company lost track of productivity: output declined as the size of the workforce shrank, and the 15% cost disadvantage never went away.

What's the right number of measures to track? Opinion varies fairly widely. "How many can a person keep in mind at one time?" asks Larcker. "I'd go with the magic number seven, plus or minus two." Kaplan and Norton, however, figure that a well-designed Balanced Scorecard should have 23 to 25 measures, and that no more than five should be financial. Suffice it to say that intuition still plays a role.

But don't get bogged down in the question. However many metrics you decide on, be a zealot about feeding the data you collect back into your analysis. Over time, you'll be able to see whether the measures you're tracking are in fact the right ones and whether you're giving them the proper weight. One firm Larcker studied, a corporation with thousands of retail outlets, became convinced that voluntary turnover among employees was the key driver of its share performance. Subsequent data analysis revealed a more specific metric—turnover among the managers of the retail stores—to be the real driver. Only after it got the measure right was the company able to launch initiatives—incentive and training programs for its

store managers—that actually made a difference in the overall stock price.

"At the end of the day, it's not enough simply to say, 'Hey, our customer satisfaction measure improved 20%,'" says Larcker. "That's stopping a step short. For value-based management to be beneficial, you need to be able to see how your KPIs translate into bottom-line performance." Which is why "strategy is not a one-time event," says Norton. "You should always be reevaluating it." ❖

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