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Gauging Results: What Measures Matter?

by Jonathan Low

WE ALL KNOW how to gauge a company's performance, right? We look at sales, earnings, asset productivity, and all the other standard financial metrics. No doubt part of your own job is to help your company reach its financial goals, so as to keep the share price high. You and your colleagues "watch" the P&L and the balance sheet to see how you're doing, and you expect investors and Wall Street analysts to do the same.

But if you really want to assess a company's long-term health—indeed, even if you just want to come up with plausible estimates of short-term financial performance—the usual financial indicators are no longer sufficient. More and more, it is nonfinancial measures that matter.

Consider some facts. The gap between book value and market value, or what a company is worth according to accounting principles vs. what it's worth on the market, is widening. More and more of a business's value simply isn't captured by traditional financial data. To put it another way, a larger fraction of the typical company's assets are intangible rather than tangible. Compare Amazon.com and Barnes & Noble, for example. Barnes & Noble has sales of $1.3 billion and a market cap (stock price times number of shares outstanding) of $2.2 billion. Amazon.com, with sales of only $357 million, has a market cap of $6.4 billion. Evidently the market believes that Amazon.com's value comes from sources other than just its sales.

What's more, past financial performance is no longer a good predictor of future performance. A recent study by Ernst & Young's Center for Business Innovation entitled *Measures That Matter* reports a surprising fact: the more nonfinancial information used by sell-side equity analysts, the more accurate are their earnings forecasts. The study also found that, for most companies, 35% of an institutional investor's valuation of the company is attributable to nonfinancial information.

So what are these nonfinancial measures that so greatly affect a company's performance and valuation? *Measures That Matter* surveyed hundreds of analysts and portfolio managers and identified ten variables that these professionals rely on:

The ability of a company to execute its stated strategy. This is the single most important metric. Analysts assess whether management can make tough decisions and seize opportunities quickly—and whether the company achieves its stated goals on time and on budget.

The credibility of management. Does the company do what it says? If not, it scores low on this measure.

The quality of the strategy. Analysts and portfolio managers ask themselves whether management's vision of the future seems likely to optimize value creation in a volatile, globalizing, and connected economy.

Innovativeness. Some companies are trendsetters, others followers. How readily does this one adapt to changing technologies and markets?

Ability to attract and retain talented people. Is employee turnover higher or lower than at key competitors? Do new hires surpass leavers in skills and experience?

Market position. Portfolio managers and analysts assess how quickly the organization can realize sales, profits, and cash flow from products and markets identified within the last three years, and how strong the organization's brand is.

Management experience. This refers not to time served but to the skills and experiences the management team brings to the organization. What is senior managers' success rate in similar situations?

Executive compensation. Are the organization's compensation policies aligned with its strategic interests? How many executives have their pay tied to value creation?

Quality of major processes. How well does the company execute its strategy? Does it have plans and processes that enable it to adapt to changing market conditions?

Research leadership. This is a gauge of how well management understands the link between creating knowledge and using it. Analysts examine measures such as the R&D budget as a percentage of sales, profit, and cash flow.

Companies need to understand the importance of nonfinancial measures. Those that fail to manage and communicate this kind of data leave investors and lenders to make their own judgments—judgments that are likely to be out of whack with performance. Some organizations will find their stock valued too low. Others will be overvalued and will take a hit when reality intrudes on perception.

The fact is, financial markets are already making their own assessments as to which metrics really matter, and the metrics increasingly are nonfinancial. Smart managers will focus on helping their company achieve superior performance on all these measures.

Jonathan Low, a former Labor Department official, is a senior research fellow at Ernst & Young's Center for Business Innovation in Cambridge, Mass.

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