Be Careful What You Measure (And Reward)!

By Jack Alexander

Generations of business managers have understood that employees and managers will attempt to improve on the performance of any variable that is measured. Utilizing performance measures is a critical element of an overall management system that should evaluate and improve performance, identify business trends and improve visibility and accountability. Nearly all Companies have implemented some form of non financial performance measures. Many of these companies have not yet achieved the full potential benefit of using performance measures and some have experienced unintended consequences.

Most employees and managers will respond favorably to the introduction of performance measures. Human nature tends to drive us to do better on any scorecard of performance, from the classroom (test grades and report cards) to the board room (E.P.S. growth and Total return to Shareholders). Since your team members will attempt to improve on the results of key performance indicators, it is critically important to select those measures carefully. Some considerations:

Develop Context. In developing a performance measurement system and in selecting individual metrics, it is vitally important to select measures that reflect the organizations objectives, including building long-term shareholder value. Two key elements that need to be considered are the firm's strategy and value drivers. We should be selecting measures that provide visibility into key strategic initiatives, for example the development and introduction of new products. In addition, by identifying key value drivers, we can make sure that the measures are tracking performance across key processes that will drive long term shareholder value, including sales growth, operational effectiveness, capital utilization, and risk. Developing a context and framework for the performance measures will allow managers to ensure that key initiatives and drivers flow down to various levels in the organization.

Create Balance. If not selected properly, a performance measure can have unintended consequences. Take for example, a manufacturing manager that is measured exclusively on inventory turns. The intent of selecting this measure would be for this manager to drive for improvements in the procurement and manufacturing processes. We would not intend for this manager to reduce inventory levels in a manner that would negatively impact customer deliveries and satisfaction. However, unless the manager's performance metrics include measures such as on time delivery percentage and past due shipments, we may be encouraging him to do so.

Another example of an area where it is essential to create balance is the selection of a measure of overall Corporate performance. Many managers are still measured and compensated on Earnings per Share ("EPS") growth. If this measure is not balanced with other key performance indicators, managers will of course optimize EPS, even at the expense of other important performance elements. For example, managers may drive short term EPS growth at the expense of higher capital investment and lower returns, risk, and long term success. By balancing the EPS metric with a few additional metrics such as Return on Invested Capital, predictive indicators of future sales growth and progress on strategic initiatives, managers will be incented to consider performance across key activities that drive long term success and value creation.

An effective technique is to focus on several key measures of performance and to create a performance dashboard to display these balanced measures. This helps to ensure that appropriate attention is drawn to all key measures and that managers and employees think about the interrelationships and tradeoffs between these measures. A mix of strategic, financial, operational and customer measures is essential. Incentive plans should be based on a combination of measures that incorporate strategic objectives long term shareholder value.

Provide tools: It is important to complement a performance management system with key tools to maximize effectiveness. Once a measure is selected and we put a stake in the ground for current performance, how should we set improvement targets? Two useful techniques are to benchmark other companies' performance on key measures and to quantify the effect of the activity and potential improvements on long term shareholder value. Benchmarking your company's performance to other companies and in particular best practice companies is highly effective. By using long term shareholder value measures, managers can evaluate the tradeoffs across various areas and select those activities and processes with the highest payoff in long term value.

In addition, managers and employees must be trained on the objectives and use of performance measures, and they must participate in the selection and implementation of key measures. Process teams must be established and provided tools to evaluate process effectiveness and implement improvements.

Summary

Performance measures are an essential part of an overall management system. Care must be exercise in designing the system of measures and selecting appropriate measures to ensure that managers and employees will be focused on organizational objectives and long term shareholder value. The Performance management system must also be complemented with other tools including benchmarking and process improvement to maximize results.

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