Driving Home Strategy With Performance Measures

Cedric Read and Scott Kaufman

EXECUTIVE SUMMARY

- This article makes the case for the finance function to lead the process of selecting the right measures to meet new shareholder value targets and ensure that strategies are carried out.
- A discussion of better management highlights measurement ideals and the benefits of performance measurement. The article discusses optimum number of measures, the ideal development teams, and potential areas of conflict among operating strategies.
- A scorecard links key shareholder value drivers to measures at each level in the organization.
- Case studies demonstrate how companies successfully devise and roll out new sets of measures and secure buy-in.

According to a recent survey reported in *CFO* magazine, 80 percent of large U.S. companies want to change their performance measurement systems. This tidal wave of change that began with U.S. companies is now reaching Europe and all developed countries. Global research shows that CFOs rank forward-looking, value-adding measures a higher priority in the future than in the past. Worldwide, management's challenge is to understand better the company's value drivers, establish strategies to raise stock prices, and link these into simple measures everyone can understand. That done, the company must reward people accordingly.

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All this interest in measures is in response to companies' desire for enhanced shareholder value. Frustrated by a failure to convert perceived improvements in operational performance into improved share prices, companies are adopting a value agenda to drive actions through performance measures. They stand to gain on several counts.

- If new measures increase the company's stock price, executives will share in this wealth creation because they own stock and hold options for more.

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- If management can convey company stock to employees, they too can be rewarded for generating value.
- The era of cost reduction is nearly over for many companies. They have wrung out all the savings to be had. Now they must attend to revenue lines of the income statement, not cost lines.
- Some opportunities to reduce working capital still exist if everyone in the company concentrates on receivables, inventory, and payables.
- The worldwide nature of business is making taxation much more complex and a fit subject for the value-based approach.
- To create future wealth, companies have to start investing again. In doing so, they need the cooperation of capital markets. And the capital markets are looking for above-average rates of return.

The era of cost reduction is nearly over for many companies.

WHAT GETS MEASURED GETS MANAGED

Consider a logical approach to managing for value: linking shareholder value targets (through corporate objectives and strategies) to development of a balanced scorecard, as shown in Exhibit 1. This is a fairly simple idea, which is why it appeals to so many executives—the people who set the overall tone of the company and carry the investors' mandate to increase the company's value.

The best executives translate the sometimes confusing mantra of shareholder value into easy-to-understand corporate objectives. They recognize how these goals, once fulfilled, will boost the company's stock price. But nothing will happen unless they set the right strategies in motion and energize the company. So they pick specific strategies from the infinite number offered and relentlessly pursue priorities such as globalization, process cost reduction, and new product offerings.

Then, some executives wait. And wait. They have missed the important next step: operationalizing strategy by measuring what is happening in the far-flung empire. What gets measured gets managed. Many executives are startled to find what good measures can do. Measures communicate value creation in ways the CEO's videotaped messages never could, *and* the results tell executives whether their goals can be reached in the stated time frame. The objective-strategy-measurement cycle renews itself regularly, spiraling through time toward shareholder value improvement with everyone working in unison.

The investment community monitors and benchmarks today's executives whether they like it or not. Why? Because it is their job to bring about change, to stimulate their own managers to act as if they are all shareholders in the company, to look at themselves as investors do, and to manage themselves accordingly. This is the performance management agenda for the next millennium. It involves innovative ways of devising strategy, embedding implementation into business planning, and reinforcing it with new ways of measuring activities and reporting results. Future performance man-

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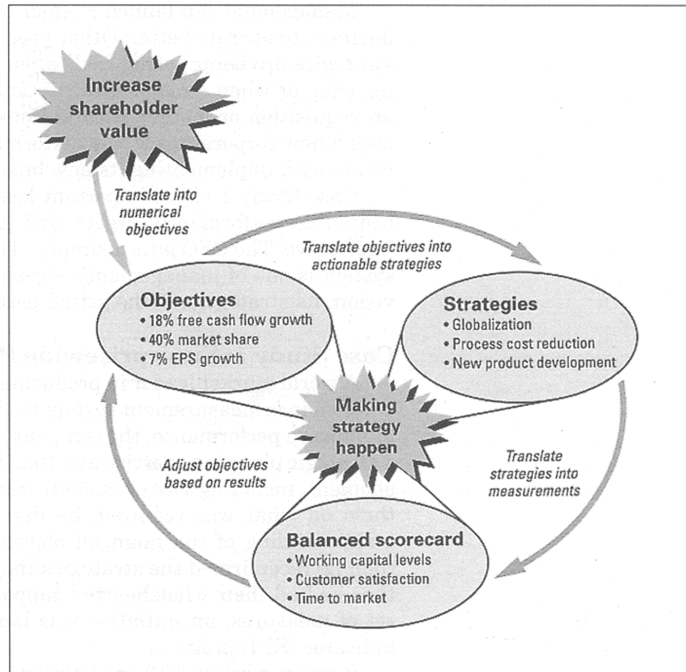
Exhibit 1. Developing Measures From Strategies



agement systems will link closely the interests of shareholders, corporate executives, and front-line managers within a common framework of accountability.

Some of the world's best-run companies are heralding their success in redrawing the measurement map. When General Motors stated in its 1991 annual report that it was establishing a new performance measurement system to "facilitate the basic changes taking place" in the business, the company declared, "This system covers all aspects of the business, including people development, product development, manufacturing, marketing, and shareholder satisfaction. The system includes a focused set of measures that deal with the primary factors influencing quality, customer satisfaction, and financial performance. . . . With full system implementation, we expect a more consistent application of common performance benchmarks across the entire organization."

Managers at all levels have to develop their own measures—but within a framework and according to guidelines laid down for the corporation as a whole.

Managers at all levels have to develop their own measures—*but within a framework and according to guidelines laid down for the corporation as a whole.* If this is not seen as a corporatewide exercise, the measures in different parts of the organization will be inconsistent. Often, they will be over- or underdeveloped. Certainly

they will be unbalanced, typically emphasizing mainly financial results.

Management can launch a major overhaul anytime it wants the business to operate better. Other good times to begin are when new strategies are being introduced, when a new executive team is taking over, or when a major interruption to normal business, such as an acquisition or merger, occurs. Consider one company that initiated a new corporatewide key performance indicator program to coincide with implementing its new business.

Case Study 1 offers important lessons. The company has since beaten its performance targets, and its share price appreciation is impressive. The CFO puts it simply, "The performance measurement system is one of management's strongest tools to link a company's vision, its strategy, and the actual performance of the business."

Case Study 1: Enterprisewide Performance Indicators

A world market leader in producing health products used its new performance measurement system to alter behavior. Under pressure to improve performance, the company's CEO successfully completed a strategic planning exercise and then brought together senior management, including vice presidents from all over the world. Briefing them on what was required, he first made sure they shared his understanding of the financial objectives they needed to achieve, then he reconfirmed the strategies they were all following. Assured that he had their wholehearted support and enthusiasm for a new set of measures, an initiative was launched: the key performance indicator (KPI) program.

Because work on KPIs had already started in some areas but not others, he brought everyone back to the starting line and proposed guiding principles for the effort. After team-building workshops on how to implement these principles, he secured the needed buy-in to proceed. An enterprisewide target was agreed on for KPI development: only three months allotted for the first cut of KPIs, to be known as Phase 1.

A date was set when the team of some 40 senior managers would meet again to present the results. This process was supervised by a steering committee comprising business unit and functional heads from across the company. But the job of developing measures was carried out by managers and facilitated by a central support team. The steering committee's role was to ensure that managers achieved delivery milestones, had adequate resources, and followed the guidelines for developing measures: quality, consistency, balance, and integration.

Meeting at the end of Phase 1, senior managers presented their KPIs—developed with a consistent approach to breaking down the value chain—and their detailed operating strategies. With results of their work set out on 60 large boards around a conference hall, managers had the chance to cross-examine presenters and satisfy themselves that consistency had been achieved. Eventually, the company sifted measures to obtain a manageable set. For teamwork and pull-

ing together to meet the corporation's performance targets, this initial exercise was generally judged a resounding success.

Two years later, people from the corporate management team to the front line are sustaining enthusiastically the subsequent phases of KPI refinement and reporting. High-level measures have been translated into individual performance objectives, the final step in the process.

BENEFITS OF EFFECTIVE PERFORMANCE MEASUREMENT SYSTEMS

The essential question, then, is how to drive home management's value creation message throughout the organization, particularly to those unlikely to consult their shareholder value spreadsheets each time they make a decision. An effective performance measurement system should deliver several benefits.

By showcasing the most important goals and determining whether objectives are being achieved, an effective measurement system gives senior managers the best way to translate the shareholder value message into action.

Effective measurement systems are based on a balanced approach that includes nonfinancial metrics to track strategic progress, as well as measures that show short-term results.

- *Manage and create value.* By showcasing the most important goals and determining whether objectives are being achieved, an effective measurement system gives senior managers the best way to translate the shareholder value message into action.
- *Communicate strategy.* Performance measurement is far more effective than a company newsletter in giving the organization a *top-down* view of how management wants strategies to be carried out. *Bottom-up*, the measures indicate whether decisions being made achieve strategic aims. One large company trained more than 500 people in how to use measures properly and subsequently used those people as probes into the organization to tell everyone what was important and how the company was doing. Facts on performance against strategy replaced apocryphal stories, and the company could fully understand how well its strategies were taking hold.
- *Shift from short-term financial appraisal to longer-term tracking.* Effective measurement systems are based on a balanced approach that includes nonfinancial metrics to track strategic progress, as well as measures that show short-term results. 3M Corporation provides a great example. This company states publicly that it wants 30 percent of revenues to come from products no more than five years old. It measures this goal and motivates the organization to implement its strategy. But next quarter's earnings are just as much a concern as new products for 3M's future.
- *Look at the company—entirely differently.* The process of refining measures gives the top team a unique opportunity to improve its understanding of what middle managers believe is important and of how to motivate them. One airline looks at itself in the following way. It established a system of shared goals where each higher-level manager subdivides objectives, negotiating goals with subordinate divisional managers. Subgoals are divided in turn, until each unit in the division knows

clearly what its responsibilities are. In the process, many fresh issues emerge and are resolved, and the exercise strengthens buy-in and communication generally.

- *Promote realistic, demanding goals.* Setting stretch corporate goals is necessary. But when those goals are *impossible*, the practice becomes counterproductive. They demotivate, rather than motivate, because everyone knows they are not achievable. A well-designed performance measurement system gives management the means to meet the objective of shareholder value enhancement based on realistic appraisal of individual and collective capabilities.

Some companies win, others lose, in a measurement redesign. All companies start out with good intent, acknowledging that what gets measured gets managed and *gets done*. But few fully understand its real implication. The aim of value-based performance management is to get everyone doing things that ultimately create value—and nothing else. So what is wrong with measurement systems in use today?

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Better Measurement Results in Better Management

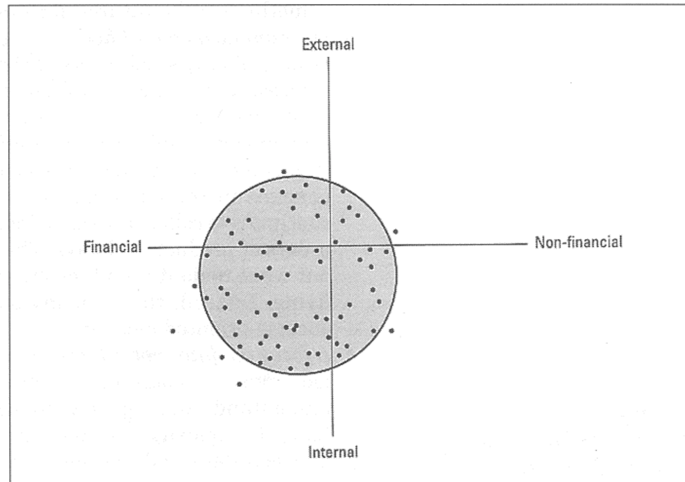
Managers spend far too much time designing new measures, especially when they move to a new position, often giving scant thought to how their measures connect with others in the organization. The result: Companies pile measures one on top of another. Before they know it, they have too many, and many that matter little to anyone but the managers who thought them up.

One very large company wanted to talk about measurement. The chairman had met with the CEO of another company who boasted he had cut his measurement set to 47. Appalled to think that any company could have so many measures, the chairman related the conversation to his CFO, only to hear, "That was a real accomplishment. We must have hundreds." On the spot, the CFO was told to look into the problem.

Too many measures guarantee you have virtually none. Excess measures rob the company of focus. When confronted with a new measure—or a vast array of old ones—people ignore it with the attitude that "this, too, shall pass." Experience shows that an ideal set consists of about 40 to 60 measures—just five or six for each important process. Only about 15 percent of these get to executive row. Having such a small set of measures is a revolutionary idea in the corporate world, but the benefits can be enormous.

The opposite problem occurs at the top of corporations. Senior executives tend to be concerned with only a few, broad measures. Results are used for external reporting and internal cheerleading. These measures can be very sweeping—worldwide earnings, for example. They are too vague and usually mean nothing to employees. Try asking lathe operators how often they think about shareholder value. Okay, how about marginal propensity to consume?

Exhibit 2. Analyze Your Measures to See Where They Need to Be Updated and Balanced



Now ask how many on-spec things they can make in an hour. Yes, you are still talking about shareholder value, but this time in the right language.

What is surprising is the number of companies that adopt the shareholder value mandate but persist in holding training classes to explain value equations to operational people. It is a waste of time. Concentrate instead on translating shareholder value into metrics that make sense to the individual's work.

Many organizations can easily discover the flaws in their current measurement systems. The first thing they detect is a snowballing of measures with no systematic examination of what they mean for the company's fundamental results. Then analysis reveals other problems (see Exhibit 2). Some measures are found to be outdated. Often, an imbalance exists because of a tradition of using internally focused, financial measures.

Measures may be based on traditional operating metrics that remain unchanged even though the company's strategies alter.

Traditional financial measures go only so far.

The following are among the most common failings:

- *Internal bias.* Measures may be based on traditional operating metrics that remain unchanged even though the company's strategies alter. Labor efficiency, for example, is a manufacturing measure that may represent only a minute fraction of product cost. This measure has one message: produce, even if warehouses are full or the customer does not want it yet. The labor efficiency measure may well conflict with the company's just-in-time philosophy.
- *Historical orientation.* Traditional financial measures go only so far. They must be balanced with an emphasis on the com-

pany's underlying business processes. Results-oriented measures reflect decisions of past management. They should be augmented with predictive process measures that indicate something of the future—for example, time-to-market.

- *Overemphasis on ad hoc local activity measures.* These gauge results of only small parts of the corporation. They may be of interest to just one individual and unconnected with strategy. How about cost per invoice processed? The recent wave of reengineering did much to proliferate such micromeasures.
- *A plethora of obsolete measures.* These often result from changes in the environment or organization. One company continues to collect the cost of nonstandard shipments for rush orders or production delays. This is rather like trying to figure out what to do if the plane crashes, instead of how to keep it flying. Instead, the company should use on-time delivery, a success-oriented measure.
- *A focus on data, not information.* Too many managers are buried under a mountain of data that is difficult to use and understand. And it gets worse with each new information system. Complexity chokes many companies. Distinguish between data and measures: A collection of data becomes a measure when it is accompanied by a goal and when management expects the goal to be achieved.

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All too often, the consequence of an obsolete measurement system is unnecessary conflict. The requirements of the new strategy jar with outdated measures that may be driving the company in the wrong direction. Unless the measurement system is recalibrated to monitor strategy implementation, little will change. The experience of Johnson & Johnson's CILAG subsidiary, in Case Study 2, shows how new strategies with old measures can give the wrong result.

Case Study 2: Designing a Consistent Measure Set

At CILAG AG, a pharmaceutical subsidiary of Johnson & Johnson based in Switzerland, Vice President of European Operations, Mike Baronian, wanted to improve efficiency and flexibility of the supply chain. Investigation of factors constraining the company's progress showed that different parts of the organization worked against each other because they were driven by conflicting operating measures.

Baronian explains, "Down in the factory, the number one objective of production managers was to maximize productivity, and they were doing a great job at this. Because we have a large range of products, their challenge was to minimize disruption during each shift caused by constant juggling of what we were going to make and when. As a solution the managers were inflating the lot sizes produced to keep runtimes between line changeovers as long as possible and to reduce downtime. But the downside was that we were carrying costly, high levels of inventory."

"On the other hand, the logistics manager, who is responsible for warehousing and distribution, was seeking to minimize time-to-market so we could get the product out as fast as possible and be flexible. To achieve this, he wanted a continuous flow of smaller lot sizes so he could supply the right mix of products and quickly change order configuration in reaction to changing customer needs. In other words, logistics wanted low inventory—the very opposite of what production managers were aiming for."

"Over in the sales department our managers were seeking to protect customer service levels across our wide product portfolio by making sure we always had ample safety stocks of everything. The result: high inventory. So we had people pulling in different directions with some unpleasant consequences."

"We've now changed all that. The supply chain is being driven with a consistent set of measures with our objective of maximizing cash flow at the core. Manufacturing lead times have been reduced from 35 to 9 days, efficiency and flexibility are up significantly, and we're running with lower overall levels of inventory."

The message is clear. If people are to avoid becoming trapped in silo mentalities, then corporate, business unit, and operating strategies—and the performance measures that support them—must be consistent across the entire business.

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Exercises like the one CILAG went through clarify the relationship between strategies and resulting measures. They provide a chance to reevaluate and test high-level assumptions. They focus on front-line experience of middle managers. For example, a company's mission to maximize shareholder value may translate into an objective of increasing cash flows by 30 percent. To achieve the cash goal, the company could be required, among other things, to manage its working capital so that it is cut by 15 percent. This would require tighter inventory control. What, then, are the key measures of inventory control? Days of sales in inventory? Machine setup time? Manufacturing lead time? Full-time quality? Or, more likely, a combination of all these?

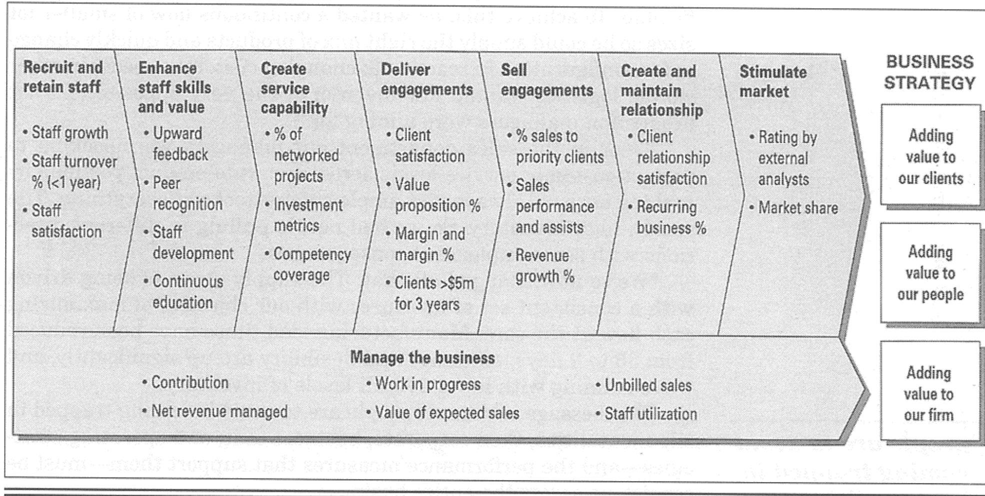
Then comes the nonfinancial question. What will inventory reduction do to the company's customer service strategy? Shareholder value improvement is not as linear as computer models suggest. Inventory reduction, while it may throw off cash, may also affect other variables, and these variables may interact. That is why it is important to have a balanced set of measures: so managers can simultaneously assess all consequences of a decision.

Designing an effective measurement system starts with understanding how the company's operational processes deliver benefits to each customer, whether external or internal.

IDENTIFYING THE VALUE CHAIN

So, what is the way forward for companies prepared to overhaul their measurement systems? Designing an effective measurement system starts with understanding how the company's operational processes deliver benefits to each customer, whether external or internal. Think creatively about your company's value chain. As a rule of thumb, an average of eight or nine processes and result objectives can provide the basic skeleton on which to build a company's mea-

Exhibit 3. Typical Value Chain and Performance Measures for a Professional Services Firm



sures (see Exhibit 3). The resulting chain, a blueprint of company activity, describes the functions whose processes the company must optimize in order to succeed. This blueprint guides the process of determining which measures will let the company know when performance is on target.

STRATEGIES TO DELIVER SHAREHOLDER VALUE

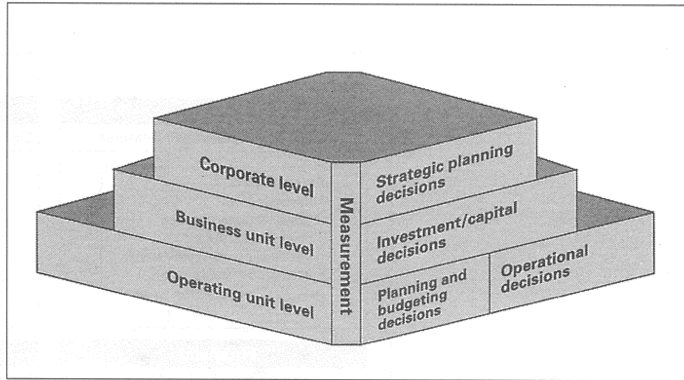
Once the design team identifies the company's value chain and the most important functions, it can work with senior management to document strategies to deliver shareholder value. These strategies may be directed at a single point or process in the value chain. More often, they cut across the whole chain and emphasize the main goals of corporate operations overall.

This exercise reveals which operating strategies conflict with either corporate objectives or with each other. Most companies have well-developed strategies, thought out carefully by top management. In a few, strategies are poor, outdated, ill thought through, or even missing altogether. In either case, the exercise is useful. The well-strategized company needs the lever of measurement to hasten results. Others will see how their strategy gaps make measurement hopeless.

Measures help a company manage both results and the processes by which results can be predicted and sustained over the longer term.

Measures help a company manage both results and the processes by which results can be predicted and sustained over the longer term. Having identified the value chain, the next step is to develop a cascade of measures throughout the organization. Working on the principle *that decisions are the points where value is created or*

Exhibit 4. Measures Tailored to Specific Needs at Different Levels



destroyed, best-practice companies frame their measures for the appropriate organizational level. Measures can then be targeted appropriately to indicate the results of strategic, tactical, or operational decisions.

Consider the various blocks of decision making and how they can be used to channel performance measures (as illustrated in Exhibit 4). At the strategic level, big issues are market share, strategic alliances, acquisitions, and divestments.

Decisions such as "Which market should we be in?" set the scene for the organization as a whole. At the business-unit level, decisions relate to capital investment and raise such questions as, "Should we invest in a new product distribution network?" At the operational level, planning and budgeting decisions are made. "Should we put on a night shift to deal with the order backlog?" These decisions must reflect reality. This is the crux of implementing a measurement system that is meaningful to executives *and* the front line.

Different Measures at Different Levels

Clearly, different measures are needed at various levels of the organization, and they need not mesh neatly. Take, as an example, first-time quality. It is measured at the end of every stamping press, every paint line, every molding device. This one measure might generate thousands of charts at operational level, but there is no reason to send them to top management. Managers need to concentrate on the results of the latest customer satisfaction survey, which reports perceived quality in the marketplace.

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Performance measures are best left where action occurs. Despite the clear connection between quality and shareholder value, it is the shift supervisor, not the chairman, who can influence these results. Similarly, high-level measures, such as economic profit achieved,

Exhibit 5. Make Individual Performance Measures Part of a Balanced Job Description

have little meaning to workers, but a display at the plant entrance showing the latest stock price helps remind them why the company is in business.

The most progressive companies ensure that the measure set cascades all the way to the individual: job descriptions, team and personal objectives, accountabilities, and key result areas should all be aligned with value chain strategies (see Exhibit 5). When these objectives and measures are the basis for individuals' performance target setting and appraisal, the business has a powerful means of communicating strategy and putting it into action at a personal level.

MEASUREMENT IDEALS: SYMMETRY AND INTEGRATION

Measures should be carefully documented—a task often left undone when a company develops its new measure set.

Each company's set of measures should reflect its own *processes and strategies*, but as already discussed, some principles of design and categories of measurement action hold true for all companies. Although no universal set of best measures exists, there are a few best practices for designing them.

Measures should be *carefully documented*—a task often left undone when a company develops its new measure set. Be sure to document strategy and carefully define measures, including how they

should be calculated, so they cannot be misinterpreted. Show the linkage between strategy and measures. One company published a white paper to explain the relation between strategy and measures, then followed up with a pocket booklet demonstrating how each measure interacts with others.

To encourage a symmetrical arrangement and provide structure where none really exists, the best CFOs design the corporate scorecard as a series of measure pairs. Here are some further guidelines:

- *Measures should be both leading and lagging.* Leading measures alert you to immediate results of an operation; lagging ones point to results of past decisions.
- *Measures should mirror both internal and external concerns.* Internal measures reflect achievement of your own objectives for process efficiency, people management, and so on; external ones reflect achievement of the objectives of key external parties, including suppliers, customers, and competitors.
- *Measures should be both cost-based and noncost-based.* Cost measures derive from the resource impact of an activity on the company's performance; noncost measures give a glimpse of what drives the costs. The stress should be on processes rather than on cost centers or departments. Costs are not created in a vacuum, nor are they caused by a single department. They cause one another.
- *Measures should be both quantitative and qualitative.* A great failing of many measurement systems is that they concentrate only on hard measures and ignore subjective interpretation. By ignoring subjective interpretation, they ignore management. An accumulation of measurement data, by itself, is of little value. What is important is what is done to get a measure back on track. What is the underlying problem? Are actions being taken? What are the probable consequences of these actions?

Costs are not created in a vacuum, nor are they caused by a single department.

Only managers close to the process can supply this information. That is why every measurement should be accompanied by a commentary—a discussion sent forward before the telephone call to ask the manager what happened. Such commentary brings life to the measurement. It pushes decision making down the organization and takes complexity out of governance. Performance management is not the exclusive duty of executives.

Meeting all these design principles is a prerequisite for success in the measurement exercise. That is why a manageable number of ideal measures is so difficult to come up with.

Before executives can begin designing an ideal set of measures, they have to take stock of their existing set.

Brainstorming an Ideal Set of Measures

Before executives can begin designing an ideal set of measures, they have to take stock of their existing set. Sifting through existing measures is one of the most difficult parts of the job. An important

early step in the process is to survey managers. Asking what they consider to be the problems with the old measures and what they believe to be the most important things to include in the new set provides an X-ray of the company. Surveying the field can uncover what is wrong with the current approach and provide real suggestions on how to make the new one more effective.

To move from old measures to new, get key functional managers to set out what they would like to see as an ideal measure, then debate whether to shoot for perfection. Some companies use the *Delphi* approach to select the right measures through ranking and prioritization. This gives managers the opportunity to understand what is really important and what can be left aside. The Delphi process is subjective and, in many respects, less scientific than some would like. But it is an effective way to get the best insights from the best managers. And, as one company's experience shows, it works!

Case Study 3: Selecting Measures by Priority Ranking

Developing a new set of measures, this multinational company's CEO and CFO drew a selection team of 15 managers from various functional departments—product development, purchasing, distribution, sales and marketing, finance, human resources, information technology, and manufacturing and international operations. Once the list of potential measures was pared down to about 120, a staff group wrote one- or two-line definitions of each and sent these to the selection team along with a questionnaire. All team members were asked to rank each measure on a scale of 1 to 5, based on specified criteria. For reference, they had the company's value chain, which they had helped develop earlier, and the company's strategies, arranged by value chain category.

When the team returned completed questionnaires, the staff group used a PC to score and order each measure from most to least favored. The ranked measures were further stratified by the functional background of those voting so engineers, for example, could see what human resources people thought of particular measures and vice versa. After analysis of the data, selection team members decided on the measure set.

The first thing that struck the team was how few product design measures appeared in the top 40, even though revenue enhancement was a well-communicated company strategy. Financial measures dominated the list, though the company already was choked with such data. Obviously, the set was unbalanced.

For two days, the selection team thrashed out measures. At first, members remained true to their functional callings. Days of inventory had little appeal for sales people. The staff training index seemed irrelevant to financial people, while human resources thought it critical. But eventually, team members began to see through corporate eyes. Starting to recognize the full ramifications of a particular measure on shareholder value, they debated mea-

sures from the perspective of strategy. And over time, the team settled on a reasonably well-balanced set.

Just as important, several members agreed to *champion* particular measures, ensuring that their final definition and reporting format would be technically correct. The selection team also became the *inside* sales force for the new measures, assuring anyone who asked that measures had been selected in a rigorous and fair manner.

Afterward the CEO commented, "I don't know what we did, but we couldn't put our measurement process to bed even if we wanted to. There is too much momentum."

Measurement brings reality to strategy and makes strategy impossible to ignore.

Who should oversee the performance measure design process? A steering committee composed of senior executives who set the strategies and tone for the company. Who reports to these executives? A design team composed of the company's leading lights—people who will know what measures might and might not work. This team supports the design process and acts as a sounding board when needed. Together, these two high-powered groups ensure that the measures are right, and they reinforce the message that measures are important. They serve a communication and signaling role as well as a motivational one. Often, the CFO sets the steering committee's agenda.

Testing Measures Inside and Out

Finally, every measure in the new set should be test marketed. Is it properly defined? Can it be calculated simply and reported effectively? In each case, the design team should get buy-in from the person most familiar with the process whose effectiveness the measure is designed to assess. That person can tell the team whether the measure is practical and whether data backing it up can be collected easily.

The experience of a major corporation shows why testing is critical. The CEO had decided to move out of a commodity business and reengineer the product. Differentiated, it would presumably command a higher price. For many months, the engineers virtually ignored this strategy. But faced with new measures that would indicate how well the strategy was being achieved, they knew the time for stonewalling was over. A major debate broke out about the strategy. The engineers confessed that to match what competitors were doing, they would have to add electronic components to the product offerings, and they lacked the design skills to do so. Temporarily shelving his strategy, the CEO set in motion an acquisition plan to obtain technology and skills from outside the company. As this example demonstrates, measurement brings reality to strategy and makes strategy impossible to ignore.

One of the strongest drivers of shareholder value is the stock market's evaluation of the length of time the company can sustain itself.

During measure testing, check shareholder value once again. Test that the measures reflect the longer term as well as the here and now. One of the strongest drivers of shareholder value is the stock market's evaluation of the length of time the company can sustain itself. When the stock market saw that PCs could affect the

mainframe business of a computer hardware company, its stock lost much of its attraction. Similarly, the market reacts badly when a pharmaceutical company loses its patent protection. These are longer-term matters, not what happened yesterday. That is why measures of new product development, customer satisfaction, and employee training deserve a special place in the overall set.

FINANCE'S KEY ROLE IN METRICS DESIGN AND IMPLEMENTATION

Designing a new performance measurement system can go smoothly or create dissension and turbulence.

Designing a new performance measurement system can go smoothly or create dissension and turbulence. In one company, senior management spent two years developing a process-oriented approach with a new measurement system designed by a team drawn from different functions. But development sessions degenerated into heated arguments about what was a good measure, what should be measured, and what separate components should go into each measure. When the system was finally implemented, employees felt no connection with it. Objecting that their viewpoints had been ignored, they complained of "death by a thousand graphs" after seeing presentations of the new results. The company's process for identifying measurements may have been right, but it obviously failed to achieve buy-in.

When designing a new measurement system, act like a chess player: Remember the end game. Eventually, everyone in the company will be affected by the system. Any apparent shortcuts are likely to lead to a disastrous ending. The company *must do it right the first time*. Much more than just a technical activity, redesign is a major change process that requires both technical skill and a broad understanding of the implications of change.

An effective measurement system touches all aspects of a company's value chain and must be owned by operating managers.

An effective measurement system touches all aspects of a company's value chain and must *be owned by operating managers*, but successful companies rely on the finance function to spearhead implementation of their new systems. Why?

- The more global the company and the more disparate its operations, the greater the need for a mechanism to assess results of management decisions. A ubiquitous function, finance has representatives in every far-flung part of the company. Working to implement the new measurement system, finance staff can also help operating managers interpret what it is saying.
- The greater the mandate to emphasize shareholder value, the greater the need for a framework built on statistical information as well as financial data. Finance staff can quickly assess the relationships between measures, including nonfinancial ones, and their impact on the ultimate creation of shareholder value.
- Perhaps most important, the finance function has demonstrated its competence in fulfilling the traditional role of score-

Exhibit 6. The Multibillion Dollar Turnaround at General Motors

	1988 Midsize Cars	1997-98 Midsize Cars
Investment costs	$5.9 billion	$1.6 billion
Development time	72 months	37 months
Assembly hours/vehicle	39.0	18.9
Number of parts	3,200	2,300
Number of plants	5	3
Number of combinations	1,900,000	1000
Unit volume	600,000 per year	700,000 per year

keeper. Despite occasional rivalry between finance staff and other organizational groups, operating managers know they cannot go it alone in today's avenging shareholder value climate. They look to the CFO and the finance function for leadership.

Rolling Out the New Measure Set

After a major overhaul of the measurement system—including careful testing—management, through the CFO and finance staff, should put the new measures under lock and key. Refinements should now be made only when measures need to be realigned with new strategies.

***In the most successful introductions of new measurement systems, management gives employees a year's grace—an* amnesty period.**

In the most successful introductions of new measurement systems, management gives employees a year's grace—an *amnesty period*—during which they are expected to communicate unpleasant occurrences without retribution. In subsequent years, employees become more accountable for their actions and for meeting targets more closely. The purpose of measurement is not to root out and punish wrongdoers, but to enhance shareholder value. If something is going wrong in the company, it is better to hear about it, find the root cause, and release financial or other resources to fix it.

With the design and testing process complete, implementation begins. The results can be astounding. Just three years after General Motors announced it was establishing a new performance measurement system, *Fortune* magazine published a gratifying article (see Exhibit 6).

Considering the potential impact of a new measurement system, the rollout must be planned as carefully as the measures themselves. The steering committee should meet regularly to assess preliminary results, discuss any difficulties, and make the connections between measures and executive compensation.

Also, the company needs to understand the stock market's reaction to the greater transparency of action. Communicating the company's intention to adopt shareholder value, buttressed with pertinent measures, management often sees its stock price move upward. There may be some joy in this, but for the price to *stay up*, the company has to *deliver* shareholder value.

Ensure Success With Incentives

Companies always want to know how they should link measurement systems to incentives. This matter is far more complicated than it seems. First, the compensation structure has to be consistent with strategy and relate incentives to the right goals. Policy is shaped by short- versus long-run considerations and by relationships, be they interdivisional or between parent and subsidiary company.

The short- versus long-term dimension is the age-old problem of judging when to reward managers for turnaround situations and when to reward them for longer-term growth objectives.

The short- versus long-term dimension is the age-old problem of judging when to reward managers for turnaround situations and when to reward them for longer-term growth objectives. The mix of divisions and subsidiaries in the corporate portfolio forces management to tailor schemes according to competitive factors driving each business unit. For example, it would be inappropriate to expect a mature, cyclical chemical business to generate the exceptionally high returns and growth rates of a fast-moving software business. This is where the strategic goals of the business must be matched to a favorable basis for rewarding managers' efforts.

Most early adopters of value-based measurement systems have tied an ever-larger percentage of executive compensation to total shareholder return. Different corporations use a mix of current cash, current stock, deferred cash, deferred stock, or restricted stock. Some firms establish bonus pools that get distributed when certain goals are met. This is quite common in companies that have adopted EVA™ (e.g., LucasVarity), developed by Stern Stewart & Co. (For discussion of the relative merits and demerits of various valuation techniques, see Myers, 1996.) In these cases, the bonus pool consists of a *bank* of deferred economic profit from which payouts are made annually.

At lower levels, the problem is more complex. Systems like those founded on EVA are difficult to cascade through middle management to the layers below. Monsanto attempts to share wealth creation with all its workers by including company shares in its reward system. Others tie the accomplishment of measurement goals into an individual's annual appraisal. The problem is that no one group, much less one person, fully controls many of the company's most important metrics. Take on-time delivery. To get an item to a customer on time, requires that the engineer must bring it to market when required, purchasing must buy the right components at the right time, operations people must make it on time, the order entry department must correctly record the customer's specifications, and the outbound logistics staff must send it promptly. Conceivably, everyone who takes part in this process could be rewarded individually

The problem is that no one group, much less one person, fully controls many of the company's most important metrics.

for meeting the on-time delivery goal, but a team-based approach—or, better, one tied to overall corporate goals—is more viable.

PERFORMANCE MEASUREMENT OR MANAGEMENT?

If executives can't measure it, they can't manage it.

The point of talk about measuring performance is simple: *If executives can't measure it, they can't manage it.* Once a company revises its measurement system, it has taken an important first step toward dealing with the real issue of performance *management*. But there is much more to be done. Knowing the company's financial drivers and what has been achieved in the past, management can establish new goals for each measure. Goals are concrete expressions of what is important. They communicate the message of teamwork and accountability. They say, in effect, "We plan to enhance shareholder wealth, and one way to do it is by reducing our time-to-market to 27 months. Let's work toward that goal."

Absurd as it sounds, here is an important caution: The *measures must be used*. Managers must revise meeting agendas and make measurement information the main topic of conversation. What are the measures saying? Is the company achieving its quality standards? Are customers satisfied? Do too many engineering changes interfere with prototyping new products? Is the company gaining market share? Has it met its training goals? And, most important, is the company generating cash for its investors?

Goals are concrete expressions of what is important. They communicate the message of teamwork and accountability.

The best-run companies focus on measures *in many ways*, some of which follow:

- Incorporate key performance information in a tailored report that is shared with key managers organizationwide so that everyone sees what is going well and what isn't.
- Insist on commentary from the measure's keeper to understand the steps being taken to hit targets.
- Recognize that failure to achieve some goal may be more the fault of company systems and processes than an individual's shortcoming, and invest to rectify the problem.
- Demand that key managers keep meetings in focus and concentrate on what the measures say and how targets are to be achieved.
- Adjust goals and strategies periodically to meet new business conditions.
- Include measurement target-setting as part of the annual budgeting process and expand budgeting beyond the traditional halls of accounting.
- Communicate externally what the company plans to do.

Institutionalization of measures in the business cycle is critical to make change happen.

Processes such as capital expenditure appraisal, acquisitions and mergers, as well as budgeting, planning, and management reporting, all provide opportunities for the CFO to intervene using the new measures. *Institutionalization* of measures in the business cycle is critical to make change happen. Subsequent reinforcement of

measures, through changes to computer systems and culture, completes the picture.

Making use of measurement information—hard work that cannot be done in isolation—really is the *glue* that binds the organization together. It means management must concentrate on things that make the company successful. Often, measurement results indicate a structural deficiency in the company's processes. Products take too long to develop because no process is in place to ensure progress. Or customer deliveries are late because the production planning system is inadequate. Or market share is squandered because the cost system overprices fast-moving items. Here is where performance management really bites.

Correcting a structural deficiency means spending money, perhaps a great deal of it. None of the usual remedies will work. Changing the manager, reorganizing the division, or tightening the budget might make people feel they have done something, but the measures will continue to tell the unvarnished truth. Structural change, brought about by investment, is the only answer.

In many ways, as shown earlier in Exhibit 1, performance management is a circle. Measures are put into place to allow the company to achieve its shareholder value objectives. But these measures, derived from strategy, may indicate that the strategies are flawed, and businesses have to reinvent themselves. Measured performance, good or bad, should tell you whether you are making progress in the right direction. Establishing a new measurement system is one of the most important things the CFO can do.

Measured performance, good or bad, should tell you whether you are making progress in the right direction.

CFO'S CHECKLIST

- **Introduce the Balanced Scorecard.** Link business strategies to shareholder value and value drivers. Develop the value scorecard—get it on the corporate agenda.
- **Focus on Decisions.** Translate high-level strategy into detailed operating strategies for each component of the value chain. Frame measures with the strategic, tactical, and operating decisions you need to take at the heart of the business. Look for conflicting measures; identify what is missing, the overlaps, and what is new.
- **Bring in Operational Reality.** Make lower-level measures part of a consistent set. Use the acid test: Do measures really mean something to front-line managers and operatives on a day-to-day basis? Tie team and individual accountabilities and evaluation into the corporate measure set. Use the rollout to resolve overlaps and duplication in roles and responsibilities—and to communicate business strategy at the personal level.
- **Link Operational Measures to Value Drivers.** Map your key operational measures to your value drivers, such as revenue, operating margin, or capital expenditure. Experiment with sensitivity analyses. Show your front-line managers the

Translate high-level strategy into detailed operating strategies for each component of the value chain.

impact on shareholder value of their decisions—for example, whether to insource or outsource.

- **Decide on the Right Number of Measures.** With too many you won't see the wood for the trees. With too few you won't connect the dots. Make sure they go cross-functional. Maintain a healthy balance between measures: leading and lagging, external and internal, financial and nonfinancial. Cover the entire enterprise, not just the usual areas.
- **Seek Ownership Through Involvement.** The CEO should lead this initiative from the top. The CFO is ideally suited to oversee the implementation and to ensure that measures are in harmony. Coach both business and functional managers, at all levels, to develop their own collective and individual measures that conform to corporate guidelines.
- **Maintain Momentum During Rollout.** Experiment and test. Grant an amnesty period. Allow poor performance to reveal itself without punishment. Keep overhauled measures under lock and key, but keep them up to date.
- **Move From Measuring to Managing Performance.** Go for some quick wins. Intervene in the business cycle and introduce new measures in the annual budget round. Link them to incentives. Communicate with investors. Institutionalize measures in value-reporting systems.

The CFO is ideally suited to oversee the implementation and to ensure that measures are in harmony.

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