A Practical Guide to Performance Measurement

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In many organizations, the finance function is expected to set the overall direction and to provide guidance in developing and using all types of performance measures. This is not an easy task, because it's possible to measure just about everything. This article provides some practical ideas about performance measurements, including measures of financial performance, operational performance, customer satisfaction, and product or service performance. © 2005 Wiley Periodicals, Inc.

Because performance measurement is a broad topic, the term can mean different things to different people. So broad is the topic and so specific are some of its applications that entire books have been written on measuring performance for a specific area of business (e.g., *Measures of Manufacturing Excellence,* edited by Robert S. Kaplan), a specific type of performance measure (*Fast Cycle Time,* by Christopher Meyer), and even for a specific measure, economic value added (*The Quest for Value,* by G. Bennett Stewart). These are just three examples from the hundreds of books written on the topic of performance measurement and performance metrics. Seemingly, it's possible to measure just about everything.

The sports world provides a good example of how far you can take performance measurement if you really want to. Take any sport, league, team, playing position, or individual, and the number of possible statistics, metrics, and measures are mind-numbing. In baseball, the pitcher has performance statistics on earned-run average, strikeout percentage, average innings pitched per game, number of walks, and even the speed of every pitch. Substitute industry, company, business unit, function, and team or individual in the sports example, and, for many businesses, the conclusion is the same—the number of statistics, metrics, and measures is simply mind-numbing. But just because everything *can* be measured doesn't mean that everything *has* to be measured.

In business today, controllers, CFOs, and cost managers play a major role in performance measurement. At a minimum, a CFO has responsibility for financial measures of performance that are published monthly, quarterly, and annually for banks, investors, boards, directors, and regulatory authorities. With operational responsibilities for human resources, information systems, finance, accounting, tax, investor relations, planning, budgeting, and administration, controllers, CFOs, and cost managers also need performance metrics for these internal operations. These internal measures are weighted less toward financial performance and more toward productivity, effectiveness, cost, and quality.

In many organizations, everyone looks to the finance function to set the overall performance measurement requirements of the organization and to provide guidance in developing and using performance measures. This is not an easy task. After all, there are:

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- thousands and thousands of performance measures to choose from;
- hundreds and hundreds of users to satisfy; and
- scores and scores of time intervals to pick from.

In terms of performance measurement choices, there are measures of financial performance, operational performance, product or service performance, customer satisfaction, quality performance, employee satisfaction, employee performance, supplier performance, project performance, and contract performance. There are productivity measures (dollar-based, hours-based, and time-based), quality measures, cycle-time measures, pacing measures, lagging measures, efficiency measures, effectiveness measures, and measures of utilization (people and assets).

In terms of users, there are investors, boards, banks, lending institutions, executives, directors, managers, supervisors, teams, individuals, customers, and suppliers, each with different time horizons that range from hourly (or in smaller time increments) to daily, weekly, monthly, quarterly, or annually. Add to that prior sins, brick walls, and people that generally do not like to be measured, and it's welcome to the CFO's world!

PERFORMANCE MEASUREMENT VERSUS PERFORMANCE MANAGEMENT

At the CFO level, performance measurement is part of performance management; it includes not just the act of measuring performance, but also the process of managing performance. The difference is subtle but huge. Performance management is the cycle of:

- strategic planning and management to develop longer-term business objectives and
- short-term planning and budgeting to execute strategy and to achieve strategic goals and accountability during the fiscal year.

The management of performance never ends, and the measures of performance are cycled back through strategic planning and management to realign programs and incentives. When viewed in the context of performance management, performance measurement is just part of the picture—but a very important part.

Performance measurement is all about measuring the right things at the right time for the right people.

Performance measurement is all about measuring the right things at the right time for the right people. It's about measuring what's important to the business. It's about the quality of the measures and not the quantity. This applies to the CFO who deals with the highest-level measures (enterprise-level measures), which cascade down to divisions and operations below. It also applies to a plant accountant, at which level measures are for local use only and don't cascade any further. In either case, the basic characteristics of a good performance measurement system are the same. Performance measures should be balanced, built around strategy and goals, compared for relevance, cost-effective to produce and maintain, and linked to important components of the business.

BALANCED MEASURES

Robert Kaplan and David Norton make a convincing case for balanced measures (that is, measures that take into account employees, customers, internal processes, and financial concerns) in their book *The Balanced Scorecard.* As far back as the 1970s, Carl Thor, the former president of the American Productivity & Quality Center, advocated a "family of measures" as a way to get away from the dominance of short-term financial measures in performance measurement systems. "Balanced" does not mean that measures should be evenly divided among the boxes of a balanced scorecard. Financial measures should be heavily weighted in the balance formulation for the balanced scorecard. Financial measures are good proxies for customer satisfaction, employee morale, and a company's ability to execute its business processes efficiently and effectively. It's hard to imagine a situation of unsatisfied customers, unhappy employees, and inefficient operations earning high marks in financial measures of return on sales and return on invested capital.

Balance also applies to the use of performance measures to judge the accomplishment of goals and objectives. Targets need to be balanced between aggressiveness and achievability. Aggressive targets that are not achievable and achievable targets that are not aggressive are not particularly useful. Balance means both achievable and aggressive.

BUILD AROUND STRATEGY AND GOALS

Vision, mission, values, strategy, and strategic goals are the backbone and brain of any business endeavor; they serve as a road map to keep an organization moving in the intended direction. Performance measures are required to track the achievement of strategy and goals; they provide feedback on how well the strategy is working. Failure to link performance measures to strategy and goals is fatal. Performance measures with little to no correlation to strategy or goals are candidates for elimination. Performance measures may have to be added for goals not adequately tracked.

For most organizations, the CFO is an integral and important part of the top management group responsible and accountable for developing the overall mission, vision, and strategy of the organization. But that's not the issue. In building and linking performance measurements to strategy and goals, it's more a matter of depth to the mission, vision, and strategy. Broad-based missions, visions, and strategies that lack specifics or are vague as to strategic goals and objectives are difficult to link to performance measures.

Relevant Comparisons

Meaningful and useful performance measurements need to be compared to something. In itself, a performance measure alone doesn't mean much. In most performance measurement systems, comparisons come in two varieties: comparisons with previous periods and comparisons to the budget. Such internal comparisons insulate organizations by failing to provide meaningful comparisons with the outside world. Relevant comparisons would include competitors, industries, benchmarks, and capital markets.

Cost-Effective to Produce and Maintain

With the use of information technology, the cost of collecting and maintaining performance measures shouldn't be an issue in most organizations. At a minimum, most organizations use integrated finance and accounting systems and integrated operating systems. Today many large organizations have implemented enterprise resource planning (ERP) systems. These systems can provide a treasure trove of information—though often companies don't exploit all of the information available. The opportunity for many CFOs is to use this information advantageously in developing or improving the organization's performance measurement system.

In this context, "cost-effective" means increasing the value of performance measures to the organization without incurring additional costs—that is, productivity and improvement achieved through better, more value-added measures for the same cost.

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Relationship to Cost Structure

Some organizations are material-intensive; that is, a large portion of the total cost structure is attributable to materials and outside purchases. Other organizations are labor-intensive, capital-intensive, or research-and-development–intensive. Performance measures for the management of costs should be weighted toward the bigger pieces of the pie, so they are industry- and company-specific. Cost management strategies differ between these types of costs, so the performance measurements should differ also.

Material-intensive companies like manufacturing companies, for example, might have strategies for cost control that depend heavily on the following:

- Supplier negotiations;
- Contract terms;
- Minimizing material loss in manufacturing (improved material utilization);
- Use of alternative materials and quality specifications; and
- Strengthening buying power.

Labor-intensive companies can control cost and improve productivity in the following ways:

- Training employees to increase their skills and knowledge;
- Improving operating procedures;
- Reducing turnover;
- Providing tools and aids;
- Use of technology;

- Location of labor; and
- Controlling health costs.

The performance measures required to support cost-control strategies and actions look substantially different between industries, so they should be weighted and aligned according to the cost-structure pie chart of the specific organization.

HALLMARKS OF PERFORMANCE MEASUREMENT

Controllable, actionable, realistic, flexible, accurate, and *credible* are adjectives that serve as the hallmarks of good performance measurement. As organizations continue to tie performance to executive pay, these hallmarks become especially important. "Accurate" and "credible" take on new meaning after Enron, Sarbanes-Oxley, and the increased scrutiny of corporate governance.

Not every organization needs a total overhaul of its performance measures. Many have great measures of performance in place, so all they may need is a tweak or two. A CFO who wishes to improve or overhaul performance measures might start by taking an inventory of existing performance measures and documenting available data for measuring performance. A critical and thorough evaluation of the current measures should reveal opportunities for improvement and root out measures that are unrelated to the organization's strategy and goals (and thus provide limited value to the organization). The evaluation of the current measures should also identify what is not being measured but should be.

In designing new performance measures, think "key" and "significant." The number of things measured should be dozens, not hundreds. Identify performance drivers and link the measures to the drivers of performance. A key design criterion is the ability to compare measures to relevant targets and to get away from comparing the organization to itself. This is a good thing to do even if existing measures don't change. Start by documenting and identifying industry and market performance measures and linking them to existing measures. Salvage as much of the old performance measurement system as possible, but eliminate those measures that don't provide sufficient comparisons with the outside world.

In designing new performance measures, think "key" and "significant."

In implementing new performance measurements, timing is critical. The best time to implement is during the annual plan and budget process when negotiating and approving goals, objective performance targets, and performance measures with operating units. Something as significant as a change in performance measures has to be embedded in the annual plans, goals, objectives, and budget. There are other reasons to implement performance measures along with the annual plan and budget:

- A method for communication vehicle is already in place.
- It gives people time to embrace new measurements.
- It provides an opportunity to tie compensation to performance.
- It's possible to link with the performance contract and expectations of the business units, divisions, departments, and operating units.

The best time to start is right after the budget cycle. For most calendar-year-end companies, that means getting started in the first quarter of the year for the next year—that is, while planning for the coming year and the budgeting cycle are still fresh in everyone's mind. This provides a great time to reflect on the planning and budgeting cycle to identify weaknesses and improvements that could be implemented to strengthen the performance measurement system.

SUMMARY

While written from the perspective of the CFO, the article can be easily adapted to other positions in finance with similar responsibilities. For example, the controller of an operating division for a large international corporation or the lead accountant at an individual manufacturing plant may have only some of the responsibilities of a CFO but is still involved in setting goals, objectives, performance measures, and strategies for the operating entity. A person in this position has an important opportunity to improve and develop performance measures.

At these levels, strategy is often limited to execution, and performance measures are often driven from the top. That doesn't mean that the local controller or financial person can't supplement the mandated requirements with local measures of performance. The characteristics of a good performance measurement system (that it be balanced, built around strategy and goals, provide relevant comparisons, be cost-effective to produce and maintain, and take the cost structure into account) and the hallmarks of performance measurement could be applied in either case.

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