How KPIs can help motivate and reward the right behavior

Paper #2 – Define team-based success and choose the right KPIs

Contents

In my previous series ("How Performance Management can help you to Navigate through Turbulent Times"), I proposed that, for organizations to become more accountable and transparent, leaders need to turn the traditional vertically shaped organization on its side to face the customer. But rethinking accountability and transparency is not so much about restructuring as changing the nature of *relationships*. Instead of an organization comprised of many units in a multi-layered hierarchy, the key change is that each unit is a link in a horizontal value chain that continuously connects and combines to deliver solutions to the customer.

As Figure 1 illustrates, in most organizations there are only four kinds of teams: executive, support services, value center and project management.

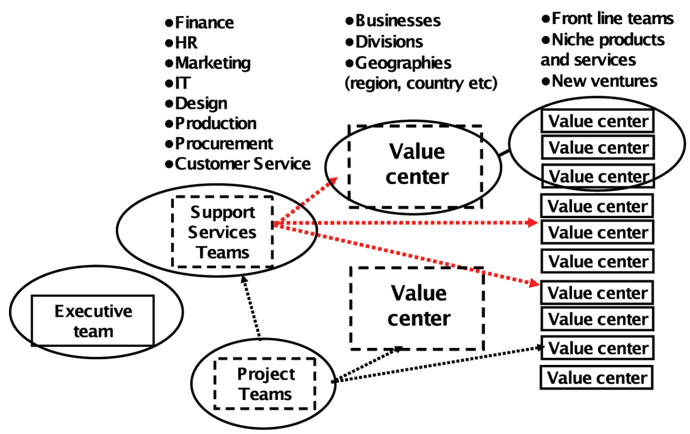

Figure 1: Identify teams and define success criteria

The *executive team* is the C-level suite responsible for setting purpose, goals and strategy, along with challenging other units to maximize their performance. The *support services* team (including finance, human resources, marketing, supply chain management, design, production, logistics, sales, customer service and information technology) is responsible for serving and supporting value centers. The *value center* team is responsible for planning and decision-making and delivering value (or profit). Value center teams invariably have their own profit and loss accounts and are typically created around lines of business, brands/product groups and regions/countries. The aim is to create as many value center teams as possible by sub-dividing them and adding new ventures. They should be based on a clear market niche and have a distinctive customer value proposition. On the other hand, the aim is to reduce the numbers and size of support services centers. In other words, the aim is to have as few indirect costs as possible. Finally, the *project management* team is usually established on a temporary basis to execute a specific improvement initiative such as acquiring a business or implementing an enterprise wide information system.

Leaders such as Jan Wallander (Handelsbanken), John Mackey (Whole Foods Market), Herb Kelleher (Southwest Airlines), Ken Iverson (Nucor Steel) and Taiichi Ohno (Toyota) all went to great lengths to clear out stifling bureaucracy, central control systems, head office empires, and all the machinery that makes large company operations complex, costly and slow. And they all created hundreds of small teams with profit (or value) creating accountability. At Handelsbanken, each branch team is a profit center with the scope and authority to run its own business (there are around 600 profit centers). At Whole Foods Markets each store is made up of multiple teams (for example, fresh fruit) that are accountable for their results and that have the authority to appoint their own team members. At Southwest, each "route"' and each airport "station" is a team. At Nucor Steel, there are only four layers of management between the CEO and the floor worker and only 66 people in the head office. Nucor's divisions are all independently run at the local level and employees work in teams that are largely self-directed. To remove barriers to communication, everyone is treated the same. There are no executive perks or privileges.[1] Each Toyota plant is full of workstation teams that are responsible for continuously improving their performance.

In this paper, my aim is to help you to define the success of each of these teams and choose the right KPIs that enable you to tell how well each one is performing. The selection process usually takes place through one or more "brainstorming" sessions often facilitated by an external consultant. Defining success is rarely straightforward and, although you may think it is a fundamental question that should already have been asked (and answered), it is surprising how few teams have done it.

Let's start with an executive team. How would it define success? Here are some success criteria you might think about: How well are we improving our financials? How well are we satisfying our customers? How well are we improving our operations? How well are we managing are our people? How well are we innovating and growing? How well are we managing risk? Those of you familiar with designing balanced scorecards will notice the similarities with the scorecard perspectives.

A value center (front line) team might want to know: How well are we improving our financials? How well are we satisfying our customers? How well are we managing our brands? How well are we managing our operations? How well are we managing our people? A value center team is primarily responsible for executing its strategy successfully. One large consumer goods organization uses three principal criteria for evaluating performance: (1) *Current year in context* taking into account economic factors, market factors (for example, market share), other external factors and structural factors; (2) *Sustainability*, taking into account growth, price, investment and margins and (3) *Strategy execution*, taking into account portfolio management, operational excellence, 'getting more from the core' and brand focus.

A support services team might want to know: How well are we satisfying our business partners? How well are we managing our people? How well are we managing our operations? How well are we improving our competences? And how well are we improving our systems and processes?

A project management team might want to know: How well are we managing our major projects? How well are we meeting our cost goals? How well are we meeting our project milestones? And how well are we managing our resources?

At this stage, the success criteria are couched in high-level terms. Keeping the criteria for each team to a range between four and six is important; otherwise, the measurement and reporting system will become overloaded. The real challenge comes next. How do you choose the right key performance indicators (KPIs) that enable you to measure and report upon these high-level performance criteria?

As we will see, individual KPIs are important but they rarely capture enough knowledge about what's happening to tell managers whether one or another success factor is being achieved. You wouldn't know, for example, if customer relationships were in good or bad shape just from looking at customer complaints (many unhappy customers don't complain – they just never return or repurchase). This KPI would give you some clues but it would not tell the full story. So we need a minimum of three KPIs to support each success factor.

Take customer relationships again. How many metrics would you need to be confident that you know whether these are strong and improving or weak and deteriorating? You might want to start by breaking down customer relationships into three key issues: (1) How good are we at attracting new customers? (2) How good are we at satisfying our customers? and (3) How good are we at improving the profitability of our customers? Think of the metrics you might use for the first issue (attracting new customers). You might think about the number of seminars, one-to-one contacts, demonstrations, brochures, leads, prospects, proposals and percentage of proposals that are closed. These are all quantifiable factors that can be counted and some might provide a useful correlation with actual sales. You can then move onto to customer satisfaction and customer profitability and think of another ten to twenty possible metrics. You could easily end up with over fifty metrics that in one way or another help you to measure customer relationships.

The aim is to choose only three to five KPIs at each management level. As far as customer relationship management is concerned, some managers might choose number of leads generated, willingness to recommend and customer retention. But each of these three KPIs is derived from its own unique measurement scale (number of leads generated is an absolute number, 'willingness to recommend is derived from surveys and customer retention' is a calculated ratio). It is not obvious what action to take if these KPIs move up or down.

Before choosing the best metrics there are many other questions that need to be asked. Mark Graham Brown in his excellent book *Beyond the Balanced Scorecard* suggests the following:

- What is the purpose of this metric (what behavior is it expected to drive)?
- What is the definition of this metric?
- What type of metric is this (for example, single measure, analytic, ratio)?
- What is the unit of measurement and expected scale?
- What is the formula for calculating this metric?
- What data collection method will be used?
- Does the data exist on this metric?
- Does historical data exist on this metric?
- Who is the owner of this metric?
- Who will be responsible for collecting the data?
- Have targets (for example, red, yellow and green ranges) been set for this metric?
- What is the desired polarity for this metric (higher is better, lower is better, in the middle is better)?[2]

The metrics to choose are those that have high data integrity and help managers learn and improve. But it is hard to strike the right balance between using only a few simple KPIs and providing relevant, actionable measures and reports. For these reasons, some companies are combining a number of KPIs into what is becoming known as "analytics." An analytic focuses on a particular aspect of performance (for example, customer relationships or employee satisfaction and is made up of a series of sub-analytics, each of which tracks a different dimension of performance (not just more detail). The idea is that each team should have 3-6 analytics to measure its performance, each with 2-3 supporting KPIs or (depending on the depth you wish to go to) further sub-analytics and KPIs. A scorecard that includes 3-6 high-level analytics each with 2-3 sub-analytics and 2-3 KPIs per sub-analytic is likely to have more than 50 KPIs. However, with well-designed software (an essential ingredient of the analytics system) you only need to drill-down to them when there is a problem.

To understand how analytics work, think of how you measure your health. You might think of a number of key measures such as body weight, blood pressure, exercise level, sleep and so forth (see figure 2).

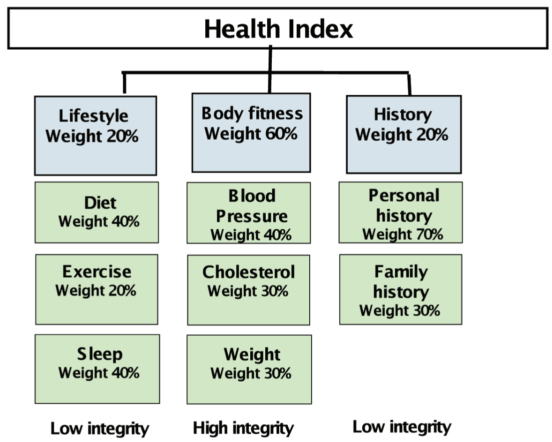

Figure 2: How healthy are you?

You can probably think of 10-15 measures that are important. But wouldn't just a few measures and one composite 'index' be helpful? You might think of three distinct measurement categories including lifestyle, body fitness and medical history. Then you might consider the relative importance of each one. While most people are aware of their diet, exercise and sleep patterns, they are not usually good at measuring them accurately. On the other hand, blood pressure, cholesterol and weight are precise measures often taken by professional medical people. History is also judgmental rather than precise. Thus, you might want to give body fitness a much higher 'weighting' in the overall health index than the other two. By converting all the measures of health into one common scale (score out of 100) and forming one health index underpinned by 10-15 PIs you can more easily monitor whether your overall health is improving or declining.

Analytics have a number of rules:

- An analytic focuses on a particular aspect of performance, not just more detail.
- Each team should have 3-6 high-level analytics each with 2-3 sub-analytics (each with around 3 KPIs attached) to measure its performance. This can result in around 30-50 individual KPIs, but you only need to drill-down to them when there is a problem.
- Analytics are always shown as scores out of 100.
- Analytics should be "weighted" according to importance, data integrity and credibility.
- Analytics require a "context for success" (preferably not negotiated, annual targets). Some organizations use relative measures based on peers or best practices. *Where peer comparisons are difficult, estimates (or ranges) based on industry best practices* can be used.
- Analytics usually require software tools rather than spreadsheets and presentation slides so that key people can monitor performance on a daily basis.

Figure 3 shows how an executive team might see the performance of its whole business through the lens of six analytics and seventeen sub-analytics. The use of analytics is a recent innovation and often takes managers some time to assimilate and master.

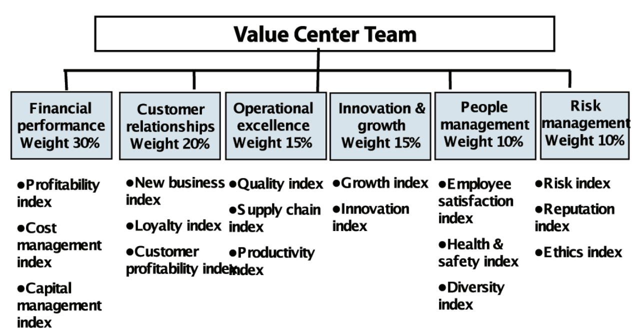

Figure 3: Examples of business analytics

Six implementation guidelines

1. **Identify the key teams**. The KPI reporting system should focus on four teams: (1) the executive team (2) support services teams (3) value center teams and (4) project management teams.
2. **Define the success factors for each team**. The discussion should involve the whole team so that there is buy-in from all key people. The point is that these measures are owned by the team. They have not been imposed on them by a higher authority. Members will also know that they will be evaluated and rewarded on these same success criteria.
3. **Agree on the KPIs to be tracked and reported.** Think of both quantitative and qualitative measures as well as a mix of leading and lagging indicators. Choose between three and five that pass the data integrity test. It is important to remember that similar teams require the same KPIs; otherwise it will be difficult to compare results.
4. **Choose KPIs that encourage the right behavior**. Think of the behavior you want and ensure that the KPIs chosen encourage that behavior. Think about traffic wardens. How would traffic wardens behave if they were measured on the number of parking tickets they hand out? Now the purpose of having traffic wardens is presumably to keep the traffic flowing smoothly. But, as soon as they are measured on the numbers of tickets they issue, they become more aggressive and hand out tickets to taxi drivers, delivery vehicles, undertakers, emergency plumbers and even firemen. The same behavioral outcomes will result if police are measured on the number of arrests they make instead of preventing crime. Yet the government prosecution service is encouraged to only take on those cases it is sure to win (as they are measured on convictions).
5. **Choose KPIs that are understandable**. Employees must know what's being measured, how it's being calculated, and, more importantly, what they should do (and shouldn't do) to affect the KPI positively. This means it is not enough to simply publish a scorecard; you must also train teams (and individual members) whose performance is being tracked and follow up with regular reviews to ensure they understand and are acting accordingly.
6. **Consider moving from individual KPIs to analytics**. Analytics translate all KPIs into common indexes out of 100. This enables KPIs to be weighted by relative importance and aggregated to form higher-level indicators. Analytics can be introduced gradually as they start to replace more detailed KPIs. This enables the organization to select and implement the software necessary to make analytics 'come alive' and show their real power and relevance within an integrated, enterprise-wide information system.

Conclusion

The primary role of traditional measurement systems, which are still used in most companies, is to pull "good information" up so that senior managers can make "good decisions" that flow down. However, information is much more relevant if it is available on demand and action can be taken immediately by the team doing the work. This is the role of KPIs. They enable front line teams to regulate their own performance and thus continuously improve. It is a vital component in the accountable and transparent organization.

About the author

Jeremy Hope is a cofounder of the Beyond Budgeting Round Table. He has written four books on performance management including "Beyond Budgeting" (co-author Robin Fraser) and "Reinventing the CFO", all published by Harvard Business School Press. He has helped many large organizations to improve their performance management systems and is also a keynote speaker at many conferences on performance management. You can contact him at jeremyhope@bbrt.org or call 44-1274-533012

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Endnotes

[1] Joseph H. Bragdon "Profit for Life" Society for Organizational Learning, Cambridge MA, 2006, 59-60

[2] Mark Graham Brown Beyond the Balanced Scorecard Productivity Press, 2007, 53

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