How KPIs can help to motivate and reward the right behavior

Paper #3 – How to use KPIs to build insightful report

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To be useful, a measure or report must be fast, frequent and relevant. But information flows around most organizations at a glacial pace (only 8 percent of reports are available on demand[1]). It is often around mid-month before leaders and managers know what happened in the previous month. That means flying blind for about 6 weeks at a time. In fast changing markets filled with fickle customers, managers need to know immediately if things are starting to go wrong (or even when growth accelerates too quickly).

Relevance is the most important attribute of any report. In other words, if it shows a variation from the trend line, it should indicate that some action is required either to correct the deviation or to rethink the strategy or purpose. But nine out of ten reports are focused on accounting cycles rather than strategic demands or management needs.[2] Most organizations have twice as many reports as they need. Many should be either consolidated or eliminated. What remains should be those reports that provide real insight and early warnings of changes in the management landscape. Just as the fuel gauge in a car forewarns drivers that they have only 30-40 miles to go before they run out, so management indicators should act as early warning systems that tell them to sit up and take action. Contrary to providing more control, most reporting systems are a primary cause of why companies are *out of control*.

A well designed reporting system should tell managers six key pieces of information:

- Where are we now?
- What does the next 6-12 months look like?
- What is the trend?
- Why is the trend occurring?
- How are we doing against peers?

In other words, reports need some analysis to explain what is happening and whether any action is necessary. Any report that does not lead to action if the trend line changes should be a candidate for elimination.

The *context for action* is critical to the design of any report. The most common context is a fixed, negotiated target. But, as we noted in earlier papers, fixed targets (like many drugs) come with undesirable side effects that invariably overwhelm any benefits (for example, they limit performance potential and stifle innovation). As soon as a KPI becomes a target, then management behavior changes to "meet the target" rather than "make the right decision." We have to remember that any set of metrics only tells you part of the story. They should support management judgment, not replace it!

Some firms have overcome this problem by moving to ranges where managers set expectations for a range of outcomes and then aim for the best possible outcome. At each performance review, new action plans are submitted and the best ones funded. The aim is always to maximize the performance potential of the team. This removes the target ceiling and much of the dysfunctional behavior that is often a feature of poor goal setting and forecasting.

Another approach to setting the right context for a report is to use a medium-term stretch goal based on best practice and set by the local team (but this goal should not be interpreted as a fixed performance contract). This can then be used in conjunction with trends and forecasts to provide managers with insightful reports (see Figure 1).

	History								Forecast					GOAL
	Q0	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12	BP
KEY FINANCIALS														
Orders	290	300	312	324	290	302	314	326	339	353	367	382	397	500
Sales	280	290	300	312	324	290	302	314	326	339	353	367	382	500
Gross Profits	84	81	90	87	97	84	90	91	98	102	106	110	114	175
Gross margin	0.30	0.28	0.30	0.28	0.30	0.29	0.30	0.29	0.30	0.30	0.30	0.30	0.30	0.33
SG&A costs	50	55	57	56	58	52	51	56	59	58	60	59	61	75
Net Profit	34	26	33	31	39	32	39	35	39	44	46	51	53	100
Cash flow	44	37	44	42	51	42	49	46	51	56	58	63	66	115
KEY COST KPIs (% sales)														
SG&A Costs (% sales)	0.18	0.19	0.19	0.18	0.18	0.18	0.17	0.18	0.18	0.17	0.17	0.16	0.16	0.15
Packaging costs (% sales)	0.06	0.06	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.04	0.04	0.04	0.03
Transportation costs (% sales)	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.03	0.03
IT costs (K per employee)	3.6	3.6	3.6	3.3	3.3	3.3	3.3	3.3	3.0	3.0	3.0	3.0	3.6	2.4
KEY OPERATIONAL KPIs														
First time through rate	86%	86%	84%	85%	84%	85%	87%	87%	88%	88%	90%	90%	92%	96%
On-time delivery	87%	87%	88%	85%	88%	89%	90%	88%	89%	90%	91%	92%	94%	98%
Customer retention	66%	67%	70%	68%	72%	74%	75%	75%	77%	80%	82%	84%	84%	80%
Inventory (number of days)	65.0	66.0	66.0	64.0	62.0	62.0	60.0	60.0	55.0	50.0	45.0	40.0	35.0	30.0
Accounts receivable days	92.0	90.0	90.0	88.0	82.0	82.0	84.0	84.0	82.0	80.0	78.0	76.0	75.0	60.0

BP = Best practice

Figure 1: Move from budget variances to KPI dashboards, forecasts, trends and best practice goals.

In this example, the team is looking at a twelve-quarter moving performance window showing seven quarters of actuals, five quarters of forecast and a medium-term goal. This goal provides the context for the report (and it doesn't remain static; it is updated as best-in-class performance improves). It tells the reader what success should look like and how far away the business is from achieving that result. The executive team can see (usually for the first time) a more complete view of performance, including both financial metrics and non-financial KPIs. These prompt different questions from those usually asked about budget variances such as, 'Why are we not improving against our peers?' 'What actions have we taken and what more do we need to do?' and 'Why are our forecasts consistently too optimistic/pessimistic?" They focus on performance improvement issues and relate directly to strategy. Now compare this review with the typical budget meeting where line-by-line variances are discussed. What do we learn from such a review? Not much is the answer.

What would a business review meeting be like? For a start, there would be no "actual versus budget" report, and no explanations of variances. These meetings have a different emphasis. Instead of explaining variances, the team focuses on where they are in the *context of medium-term aspirational goals*. When presented with trend-line reports and some history and some forecast information, executives are forced to think about different questions, such as, Are you closing the gap on the medium-term goal and, if not, what are the reasons? What actions have you taken and what more needs to be done? The aspirational goal gives the report real meaning. Such a report provides a context for success that leads to the right questions and (hopefully) the right actions.

One UK CFO put the benefits in this way: "We can see patterns and pictures of how things are changing and this enables us to ask a lot more relevant questions about performance. One of the things I track is moving annual totals on operating profit and cash flow for each of the businesses. If I see the two moving out of line I then ask what's happening. And that triggers a constructive dialogue with the business unit team. It might, for example, mean that a business is over investing in which case we need to pull back. We also do some scenario planning exercises and we use the forecast information to support them."

Yet another approach is to focus performance measurement on relative improvement because this is the only result that really matters. Though not perfect (no measure or measurement system is perfect), relative measures offer fewer dysfunctional side effects and are grounded in competitive reality rather than internal negotiation.

The overall effect of this change is a performance management process based on a *relative improvement contract* rather than a fixed performance contract. It assumes that it is not wise to make managers predict and control their future actions. The implicit agreement is that executives provide a challenging and open operating environment and that teams deliver continuous performance improvement using their knowledge and judgment to adapt to changing conditions. It is based on mutual trust. But it is not a soft alternative to the fixed performance contract. High visibility of individual and team performance offers no hiding place. Teams must perform to high levels of expectation. Otherwise they will fail to survive.

As Handelsbanken has proved, being the "best" at something is highly motivational and can also be measured over time (Handelsbanken's declared aim is to be the "best and most profitable bank in the Nordic countries"). The bank reports the results of each region and branch every month. Each team can see how it has performed versus peers (though no comments are made on performance by senior managers). Comparisons cover cost-to-income ratio, return-on-equity, customer satisfaction (and complaints) and credit ratings. To improve faster than their competition, Handelsbanken invested not in achieving greater scale and market share but in changing its business model and introducing innovative management practices. With no quotas or short-term targets to reach, managers are free to set medium-term improvement goals and take the appropriate actions to improve faster than others. Of course, even at Handelsbanken 25 percent of branches will be in the fourth quartile! The difference is that the performance of these branches is likely to be higher than top quartile branches in rival banks.

There are many independent and industry benchmarking services that you can use to track relative performance. For example, the American Customer Satisfaction Index (ACSI) was established in 1994 to provide a new economic indicator tracking the quality of products and services from the perspective of the customer. Research is showing the ACSI to be a leading economic indicator, and a predictor of financial performance at the firm level.[3] Individual sectors also have their measurement compilers. One of the best known is in the auto industry where the JD Power charts track the relative performance of cars in many countries across the world. In the employee satisfaction field, *The Great Place to Work Institute* has been tracking satisfaction levels for over 20 years.[4]

As we have already noted, the aim is not to have endless negotiations about targets with all the time-wasting and dysfunctional behavior involved. Reports focus on relative performance. So each team will be placed into a 'league table' of similar teams. One type of presentation is to divide all teams into four quartiles and show each quartile in a different color (see figure 2).

	History								Forecast					GOAL
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KEY OPERATIONAL KPIs														
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On-time delivery	87%	87%	88%	85%	88%	89%	90%	88%	89%	90%	91%	92%	94%	98%
Customer retention	66%	67%	70%	68%	72%	74%	75%	75%	77%	80%	82%	84%	84%	80%
Inventory (number of days)	65.0	66.0	66.0	64.0	62.0	62.0	60.0	60.0	55.0	50.0	45.0	40.0	35.0	30.0
Accounts receivable days	92.0	90.0	90.0	88.0	82.0	82.0	84.0	84.0	82.0	80.0	78.0	76.0	75.0	60.0

BP = Best practice

Figure 2: Reports show trends and forecasts (plus peer group comparisons)

So, at a glance, report users can see a pattern of relative performance that informs a more insightful discussion with management about what is happening and what actions need to be taken. To be effective, this reporting system requires that similar teams use the same KPIs (otherwise peer comparison reporting will not work) and that viewers of the database will be able to sort KPIs by team, KPI, and history (trends over, for example, the previous 3 months, 6 months, 12 months and 24 months).

Each team can, of course, set their own goals for each KPI, but these goals will not be the ones that performance will be reported against on the system. The power in the system is in the peer pressure that results from comparisons and this can only be achieved if all similar teams share common KPIs. Also, as we will see shortly, KPI scores are only one part of the evaluation and rewards process.

Six implementation guidelines

1. **Eliminate unnecessary reports.** The number of reports seems to grow year after year. I heard in one large organization that they produced around 750 reports every month whereas only a fraction was reckoned to be of value. According to one report, companies often find that 50 percent of reports can be eliminated, and 20 to 50 percent of what remains can be consolidated. Many of those consolidated reports can be automated and a smaller number of people can generate what remains.[5] A few CFOs have conducted their own value analysis and without consulting potential users have just stopped producing large numbers of reports and then waited for the complaining phone calls and e-mails to arrive. But they seldom came. Sony Pictures Entertainment is adopting such an approach. According to Irwin Jacobson, the company's VP and controller of the Studio services division, "We're constantly pushing back to corporate to see if the things that they're requesting are: one, truly needed; two, being looked at; three, are useful; and four, could be done in a different way altogether."[6]

2. **Avoid negotiated fixed targets and find other ways of providing 'context' for reports**. Short-term fixed targets are more trouble than they are worth. Yet reports require a context for performance. Designers have a number of options. They can use ranges derived from estimates of best practice rather that fixed point targets. They can use prior years and just show trends. And they can show rankings lists using either external or internal peer performance comparisons.

3. **Design reports that are fast, frequent and relevant.** Many organizations now use KPI dashboards to show managers where they are on key indicators each day or week. A CFO of a major software company describes the system he uses in this way: "I come in every morning, turn on my computer and go straight to my BI [business intelligence] environment where I see five different reports. The first report tells me every deal that we've closed in the last 24 hours. The second report tells me about any deals in the pipeline that have changed in the last 24 hours with some threshold. The third report tells me about any deals that have slipped from one quarter to the next. The fourth report tells me about all the big deals that we are tracking in a quarter so I know to whom we're selling on an ongoing basis. And the fifth report is a summary that basically tells me where we are from a revenue point of view. That takes me only 10-15 minutes because when you're used to the reporting framework you're just looking for the changes and the exceptions."

4. **Look at reports through a lens of patterns, trends and abnormalities.** Measures and reports should not just tell a story about what has happened over a single period of a week, month or year. They should also paint a picture of performance over an extended period of time (for example, a rolling three year period). Often single-period and multi-period results are shown as trends and moving averages. Trends show performance directions and tell managers something about likely outcomes and whether further action is necessary for improvement. Trends also show a more complete picture of performance evaluation. Many strategic decisions take a year or more to have any effect. So judging a team on one year alone cannot take into account the full impact of their strategies. Also if the management has changed, the new team's first year performance may well be based on the decisions of the previous team.

5. **Monitor how you're doing versus peers and best practices.** When considering how to compile lists of peers, most managers think of external competitors and the difficulties of accessing useful and timely comparative data. But most practitioners of relative performance measures focus much more on internal peers where comparative data is readily available. There are many ways to slice and dice an organization to facilitate internal comparisons that drive continuous improvement. The objective is to enable everyone to see the performance of everyone else. One way to do this is to create a 'performance league table' at every level. Another way is to just publish all results and let each team work out where it stands relative to others. Either way, it is the pressure that arises from a unit's position in the league table that drives performance improvement. External comparisons, however, are still used at the whole company or large divisional level.

6. **Reduce the dependency on spreadsheets and use dedicated systems.** While spreadsheets are fine for local requirements, they can cause problems when they need to be aggregated up and across the organization. It is also apparent that in large organizations, different units use different assumptions, algorithms and software. This makes it difficult to combine and consolidate forecasts. A number of software companies now offer dedicated planning, forecasting, scorecarding and reporting software known variously as Corporate Performance Management (CPM), Business Performance Management (BPM) and Business Intelligence (BI).

The aim is to create a real-time, forward-looking organization. Most companies will tell you it takes months—even up to a year—to get an up-to-date full view of their business today. But this is no way to compete in today's tough, dynamic environment. Managers need fast, high quality actual numbers and equally fast and high quality forecasts. Then they will be in control. Then they can make fast and effective decisions. Teams are expected to learn as they go and improve their work processes when appropriate.

The finance team has a major responsibility to explain the meaning of measures at every level of the organization. This is a key educational role of finance and one that must not be shirked. But it requires communication skills of the highest order. The key message is that measures paint a picture of a performance trajectory that leads in a particular direction. The skill is to interpret what that direction is and what action should be taken to change it for the better.

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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March 2010
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Endnotes

[1] David A. J. Axson *Best Practices in Planning and Management Reporting* John Wiley & Sons, New Jersey, 2003, 59

[2] David A. J. Axson *Best Practices in Planning and Management Reporting* John Wiley & Sons, New Jersey, 2003, 59

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