# POWER of PERFORMANCE MANAGEMENT

## How Leading Companies Create Sustained Value

**André A. de Waal**

**John Wiley & Sons, 2001**

**ISBN 0-471-38347-3**

# Content

# 4 Make value-based strategies operational

**KEY POINTS**

- ☑ More and more, sources of value no longer only consist of tangible assets but increasingly also out of intangible assets. Both types of value drivers should be tracked by the information system.
- ☑ In the balanced scorecard, non-financial, leading indicators are combined with financial, lagging indicators, to get a balanced overview of the organization's performance and to check whether the organization's strategy execution is still on track.
- ☑ The development of critical success factors and key performance indicators is at the center of the effort to build a balanced scorecard. It is important to distinguish between result and effort measurements.
- ☑ In value-based management, an organization expressly looks at long-term value creation, instead of looking at short-term profit maximization.
- ☑ Value-based management is the 'glue' that binds financial objectives, strategic plans and operational performance together into an integrated framework focused on value creation. This is achieved by linking the financial value tree metrics with the strategic and operational value drivers and processes of the organization.
- ☑ To make value thinking a success, trust is needed. Trust in the value drivers, trust in causal relationships between financials and non-financials, and trust in an open culture.

## 4.1 The challenge of 'value thinking'

"Leading companies have invested time in linking strategy
with operational performance."

H. Evans et.al.

"The Balanced Scorecard is the leading strategic performance management solution for aligning strategy and more effectively measuring and managing a business."

Business Wire

In the New Economy, sources of value no longer only consist of tangible assets like financial capital and physical facilities, but increasingly out of intangible assets like brand names and human capital. In a recent research project, conducted by Arthur Andersen in cooperation with DYG, Inc. and Heathcare Forum (Boulton, 2000), a majority of the managers polled said that much of the value being created in their organizations fell outside their formal reporting systems. The respondents indicated that their reporting systems should be adapted, to capture especially a number of sources of value creation which are currently not or not sufficiently tracked (see figure 4.1):

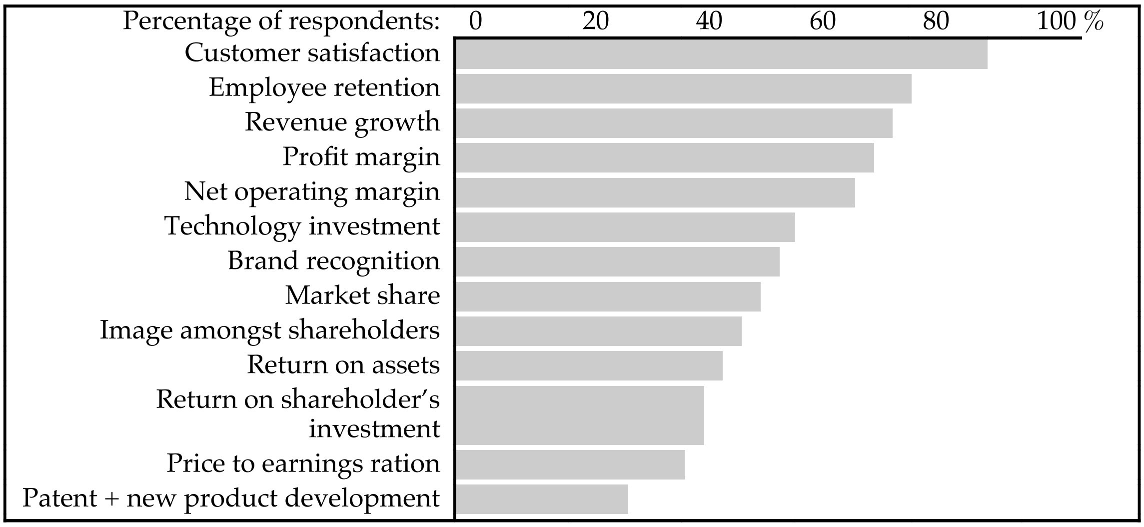



*Figure 4.1 Results of a survey indicating relative importance of indicated sources of value creation*

This picture is reinforced by research, performed by Schiemann & Linge (1999). They questioned executives to what extent their measurement systems tracked value drivers in various types of performance areas, how often these value drivers were updated to reflect changing circumstances, and the extent in which the value drivers were used in the organization's performance management process (figure 4.2). The results show a strong bias towards financial measurements.

| **Percentage of managers who believe that:** | **Performance Areas** | | | | | |
|---|---|---|---|---|---|---|
| | **Financial** | **Operating efficiency** | **Customer satisfaction** | **People performance** | **Adaptability /Innovation** | **Environment /Community** |
| Measurements are clearly defined | 92 | 68 | 48 | 17 | 13 | 25 |
| Measurements are regularly updated | 88 | 69 | 48 | 27 | 23 | 23 |
| Measurements are | 98 | 82 | 76 | 57 | 33 | 44 |

| | | | | | | |
|---|---|---|---|---|---|---|
| included in performance review | | | | | | |
| Measurements are linked to compensation | 94 | 54 | 37 | 20 | 12 | 6 |
| Measurements help drive organizational change | 80 | 62 | 48 | 29 | 23 | 9 |

*Figure 4.2 Results of a survey indicating the quality of measurement systems*

Since 1996, Arthur Andersen has been analyzing the quality of the management information process of a number of organizations, using the so-called Management Information and Reporting Analysis, or MIRA for short (De Waal et. al., 1998; De Waal and Fourman, 2000). The MIRA offers a structured approach in assessing the internal reporting system of an organization as used by its managers. External reporting as used to inform shareholders, banks, etc., is not addressed. During such a review, the management reporting system under study is analyzed on the following aspects:

! *Internal financial* - Internal financial information should provide insight into the financial state of affairs of an organization. The MIRA looks at *content* (which financial data are available, and what ends up in the internal reports), and at *users* (who receives this financial information, and is it clear and relevant for the user)
! *Non-financial* - Non-financial information should consists of data, collected in a structured manner, on strategy deployment and on the organization's critical activities. The MIRA looks at *content* (which non-financial data are available, and have these been linked to the organization's strategy and critical activities), and at *approach* (has non-financial information been developed in a structured manner).
! *Dynamics* - Management reporting should be the basis for a number of activities: analyzing the organization's results, decision-making, action taking, and evaluating the results of the actions. The MIRA looks at *structure* (can the reporting layout be used for dynamic reporting), and at *use* (how do managers use reporting).
! *Communication* - Communication should take place in an organization by people regularly sharing information on the results across horizontal and vertical organizational boundaries. The MIRA looks at *content* (which information is shared), at *approach* (is information shared regularly and in a structural manner), and at *participants* (who shares information with whom).
! *Systems support* - Information systems should provide a stable structure for quick data collection and processing, reporting of financial and non-financial information, and communication. The MIRA looks at *IT architecture* (which IT components are being used, and what is the quality of these components), and at *investments* (which IT investments have been made and are planned in the management information function).
! *User-friendliness* - The information function should generate reports and use executive information systems that are comprehensible and user-friendly. The MIRA looks at *user-friendly reporting* (are the reports easy to comprehend, and do they have the right volume), and at *user-friendliness of reporting systems* (are the information systems easy to understand and use).
! *Integrity* - The information function should provide timely, reliable and complete information, in a consistent manner. The MIRA looks at *reliability* (is the information in the reports accurate and reliable), at *completeness* (is no information missing), at *timeliness* (is information available when people need it), and at *consistency* (are there no conflicting signals in the reporting).

The results of a MIRA are depicted in a Radar Diagram, in which the above described eight aspects are rated on a scale ranging from A to E (figure 4.3). For each aspect, the organization's performance is compared to criteria, derived from best practice organizations throughout the world. If the organization meets most of these criteria, the score on this aspect is rated an A. The less 'best practice' criteria are met, the lower the score is. Score E means that the organization's reporting really needs improvement on the aspect in question. Score C means that the performance regarding this aspect meets 40 to 60 percent of the criteria.

The MIRA has until now been performed at more than fifty organizations worldwide. They varied in size (small and big), organizational structure (holdings and independent companies) and industry (profit and not-for-profit organizations). The boundary of the filled in area in figure 4.3 depicts the average score of all the MIRAs performed to date.

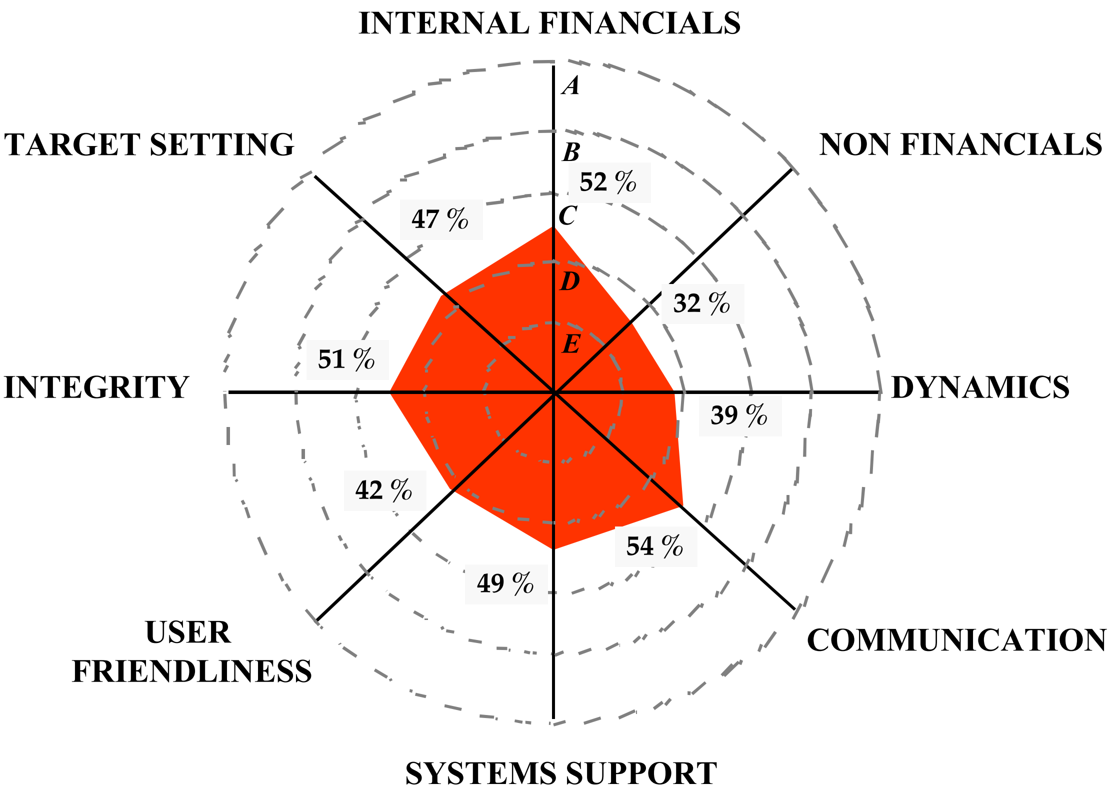



*Figure 4.3: MIRA Radar Diagram - average scores for the management reporting system analyzed to date*

Most organizations turn out to be weak on non-financials and dynamics, and only a few organizations score better than a C on more than two aspects. As positives were found that financial targets, specified to departments and products, were widely used, and were accepted by managers as evaluation tools. The management reports were in general used for making decisions and defining actions to improve future results. The figures in these reports were considered to be highly reliable. Managers were well informed about the organization's mission and strategy, and a lot of attention was being paid to optimizing the use of information technology.
As improvement opportunities were found that more non-financial information could be included. Also, accountability for the results of key performance indicators could be defined clearer, and more attention could be paid to the analysis of results and to making reports more action and future oriented. A lot could still be gained by linking the reporting system directly to the operational systems that generate the data, thereby decreasing the need for manual handling of the data. The user-friendliness of management reports could be improved, for example by decreasing the volume and using more graphics. Finally, more formal approaches could be used to set targets, for example by using benchmark figures of other organizations. In appendix B, a more detailed analysis of the MIRA results is given.

<u>A confused picture</u>

Taking together the results of the above mentioned research projects paints a confused picture. On the one hand, organizations want to move to more value-based, non-financial, leading indicators and better performance management. On the other hand, their measurement systems and performance management process are still mainly focussed on financial, lagging indicators, and organizations do not seem to be action-oriented enough!

Two recent trends that try to address this apparent conflict, are the concepts of the balanced scorecard and value-based management. In the balanced scorecard, non-financial, leading indicators are combined with financial, lagging indicators, to get a balanced overview of the organization's performance and to check whether the organization's strategy execution is still on track. In value-based management, an organization expressly looks at long-term value creation, instead of looking at short-term profit maximization.

Challenges in applying these concepts in an organization are manifold. How can we get all management levels in the organization on one page regarding the strategy? How do we make sure the strategies at the different organizational levels are aligned? Should we also align the balanced scorecards? How do we link the value-based strategy with operations, using the appropriate financial and non-financial value drivers? How do we derive concrete action plans, at lower levels of the organization, from the value-based strategy?

### 4.2 Implement the balanced scorecard

Monitoring financial figures may show that the adopted strategy has worked and that value was created in the past, but they do not show if this also will be the case in the future. Running an organization by monitoring only financial measurements is like driving a car by only looking in the rear view mirror. Financial measurements that show what happened in the past are called lagging indicators. To complement these lagging indicators, an organization also needs leading indicators that forecast future results.

The leading indicators are expressed in the form of critical success factors and key performance indicators. A critical success factor (CSF) provides a qualitative description of an element of the strategy in which the organization has to excel in order to be successful. The CSF is quantified, made measurable, by a key performance indicator (KPI). The use of critical success factors and key performance indicators enables measurement, and thus control, of strategic objectives. If performance indicators that measure the execution of the strategy and the creation of value are not included in the performance management process, it will not be transparent whether strategic objectives and value creation are being achieved. Figure 4.4 gives an example of CSFs and KPIs.

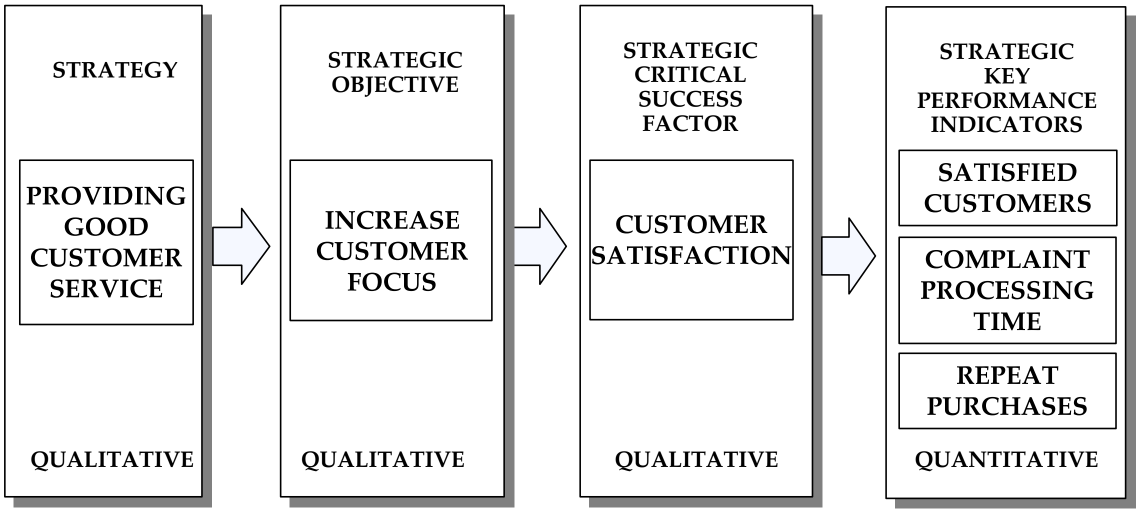



*Figure 4.4: An example of a CSF and its corresponding KPIs*

Providing good customer service is of critical importance for an organization's success. One of the ways to provide this service is by increasing the focus on the customer throughout the organization, and thereby increasing customer satisfaction. Whether customer service is satisfactory is reflected in the number of customers that repeatedly buy products or services ('repeat purchases'). Customer satisfaction can also be measured by pro-actively asking customers what they think of the services provided ('satisfied customers'). An important activity that helps to keep customers satisfied is to respond quickly to complaints ('complaint processing time').

The balanced scorecard is used to represent the financial and non-financial performance indicators in a user-friendly format. Traditionally, a balanced scorecard has four perspectives, or areas, which are: innovation of products/services or people (including learning and growth of people), effectiveness of processes, experience of customers and financial performance.

- The **Innovation** perspective measures how often an organization introduces new products, services or (production) techniques. In this way, the organization makes sure it does not become complacent but continuously renews itself. Some organizations augment this perspective with **people** aspects. These measure the well being, commitment and competence of people in the organization. The people aspects measure cultural qualities like internal partnership, teamwork, knowledge-sharing, as well as aggregate individual qualities like leadership, competency, and use of technology.
- The **Process** perspective measures the effectiveness of the processes by which the organization creates value. It follows the people aspects in the Innovation perspective because people impact the ability of the organization to create value by implementing and managing effective processes. The Process perspective measures how effectively processes operate. It precedes the Customer perspective because efficient processes make it possible for an organization to stay or become more competitive.
- The **Customer** perspective measures performance in terms of how the customer experiences the value created by the organization. It follows the Process perspective, because value created by processes is only meaningful when it is perceived by the customer as being valuable.
- The **Financial** perspective measures the 'bottom line', such as growth, return on investment and the other traditional measures of business performance. It is the last perspective because it is the final result of good, committed people, of implementing and operating effective processes, of the ability for renewal, and of creating value which customers have chosen to pay for.

In different organizations, the perspectives and the leading indicators can be different, but the idea of a balanced scorecard is to combine lagging and leading indicators, to give an understanding of where the organization was and where it is going. A 'balanced' set of measurements allows an organization to measure the cause and effect chain by which customer and shareholder value is created. If value is created by people working on and in processes to satisfy customers and to produce financial results, then managers must be able to measure and monitor all of these perspectives of value-creation to effectively manage the business.

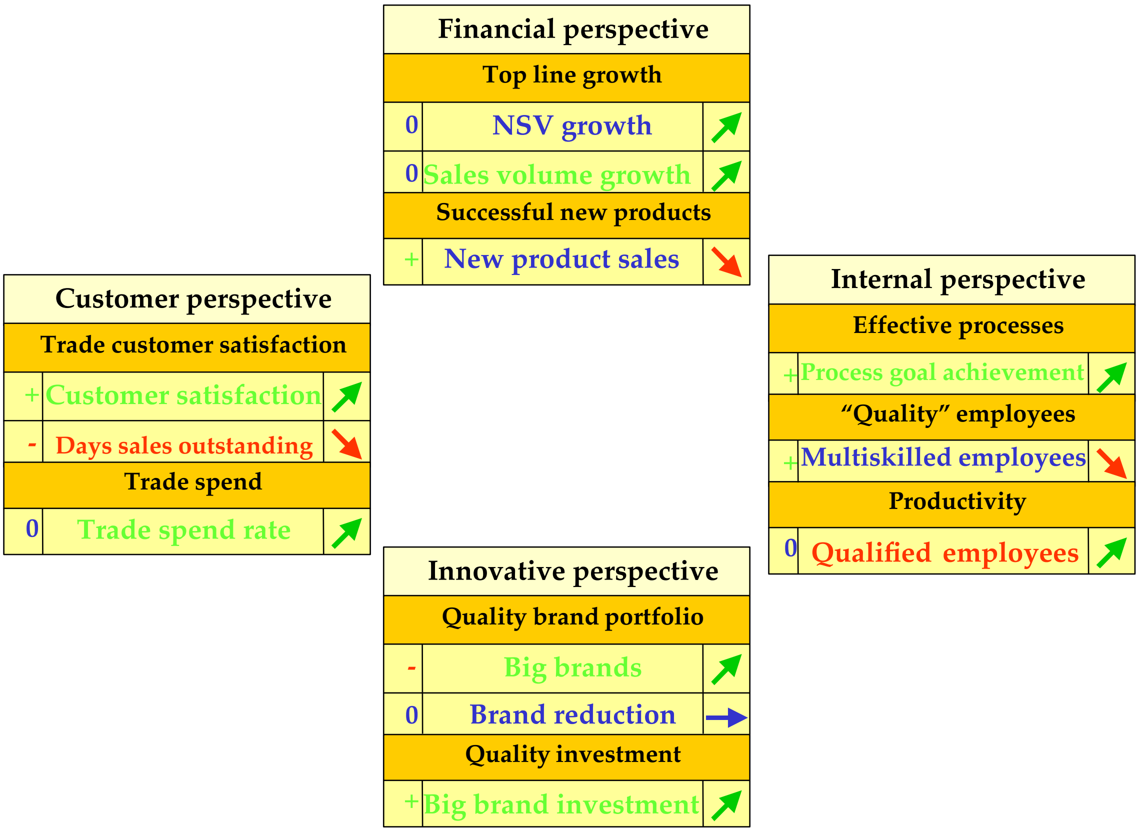



*Figure 4.5: An example of the balanced scorecard*

Figure 4.5 gives an example of the four perspectives of a balanced scorecard, which has been enhanced compared to the traditional format with some extra columns. For each of the four perspectives, it shows the actual performance compared to budget in the center column (using traffic light coloring); the change compared to history in the left hand column (indicators: +, - and 0, with traffic light coloring); and the expected future performance in the right hand column (indicators: ➚,➔ and ➘, with traffic light coloring). For instance, the KPI 'multiskilled employees', belonging to the CSF 'quality employees' in the internal perspective, could be coded blue in the middle column, meaning the actual result is equal to budget for this period. The left column could show a green +, meaning the result on this KPI was better this period than last period: the organization improved. However, there could be a red arrow pointing downward in the right column, meaning that the organization expects to do worse next period. This is a clear signal for the organization to act now, to prevent this from happening!

The main benefit of managing with a combination of financial and non-financial information is that the use of leading, non-financial indicators facilitates pro-active control and the ability to take preventive action. A balanced set of key financial and non-financial indicators enables management to focus on the really important issues that drive business performance, and to monitor the achievement of strategic goals more closely. Using non-financial information improves the analysis capabilities of managers because they can identify the root causes of financial performance. The non-financials can include external information, making it possible for management to compare the internal results with external trends and drivers.

### 4.3 Develop critical success factors and key performance indicators

The development of critical success factors and key performance indicators is at the center of the effort to build a balanced scorecard. In this section, the development process of these measurements is described, using the performance measurement pyramid (figure 4.6).


Figure 4.6: The performance measurement pyramid

The performance measurement pyramid is made up of:

*Mission and strategy*. First of all, an organization has to formulate its mission by answering the question '*What* do we, as an organization, want to accomplish: what is our mission?' To formulate a strategy, an organization has to answers the questions '*How* are we as an organization going to achieve our mission?', and '*How* can we accomplish what we want?'

Suppose an organization has the following mission: to double in size, while retaining a socially conscious image. Possible strategies for achieving such a mission might be: to make the organization focus more on customer satisfaction, to develop new environmental friendly products, and to sponsor local environmental projects.

*Strategic objectives, critical success factors and key performance indicators*. In order to make an organization's strategy tangible, strategic objectives need to be formulated. A strategy is often expressed in abstract terms. By formulating one or more strategic objectives, it becomes clear which activities have to be undertaken in order to implement the organization's strategy. If the organization's strategy is already expressed in specific, measurable terms, the strategy and the strategic objectives will be virtually the same.

Whether strategic objectives are being achieved can be monitored with strategic critical success factors and measured with strategic key performance indicators (see figure 4.4). These strategic measurements are included in the management reports which are used by the organization's board of directors or senior management team. Often, the balanced scorecard of an organization is composed of these strategic measurements. For an organization with diverse activities, a complete balanced scorecard on the corporate level may not be meaningful because the non-financial indicators cannot be meaningfully aggregated across subsidiary businesses. In that case, only a limited number of financial indicators are reported.

*Functional objectives, critical success factors and key performance indicators.* A business function or department can support an organization's mission and strategy by translating the strategic objectives into their own functional area, by defining functional objectives for that business function or department. The extent to which the functional objectives are achieved is monitored with functional critical success factors and measured with functional key performance indicators (figure 4.7). These functional measurements are used by managers of various functional disciplines or middle management. The functional measurements are included in a balanced scorecard for the department.

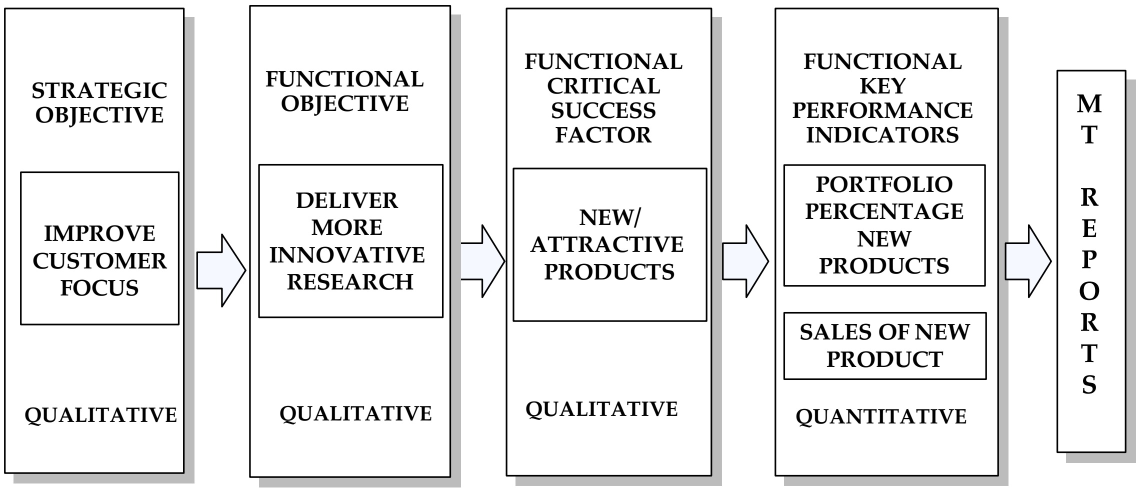



*Figure 4.7: Functional critical success factors and key performance indicators (for a R&D department)*

Suppose the Research & Development department of an organization translates the strategic objective 'Improve customer focus' into the functional objective of conducting more innovative research. After all, the more products that are developed that meet the customer's demands, the more satisfied the customer will be. It is critical to the R&D department, therefore, to monitor whether the department succeeds in developing enough new products that are attractive to customers. Whether customers appreciate these new products can be measured by the sales of new products. Whether the number of new products developed is sufficient can be measured on the basis of their share that these new products have in the product portfolio.

Because every business function or department contributes in its own way to the achievement of strategic objectives, it is essential to determine the functional objectives for each business function or department separately. Management has the responsibility to continuously monitor whether the functional objectives and the strategic objectives are aligned. If this is not or no longer the case, the functional objectives need to be reformulated. This is an effective way for the organization to maintain alignment.

*Crucial business activities, operational critical success factors and key performance indicators.* In addition to the mission and strategy, every organization has specific crucial business activities. We define a crucial business activity as an activity 'that makes the business tick' and, for this reason, must *always* be executed in order for the business to survive, regardless of the chosen mission or strategy. The execution of crucial business activities is *monitored* by means of operational critical success factors and *measured* with operational key performance indicators (figure 4.8). These operational measurements are used by managers who are directly involved in the crucial business activities. The operational measurements are included in the balanced scorecard for the department.

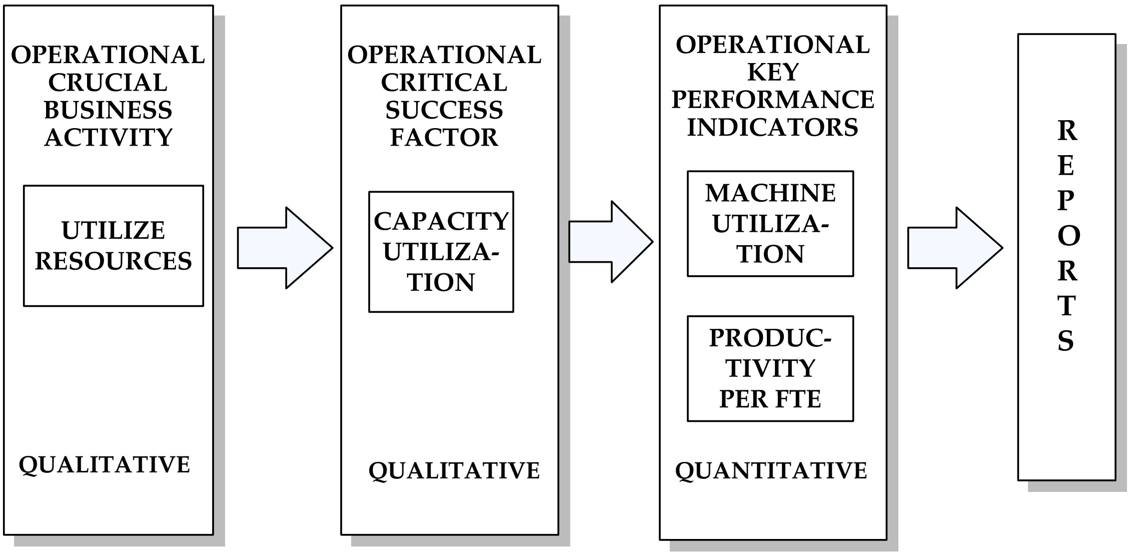



*Figure 4.8: Operational critical success factors and key performance indicators*

An organization has to make optimal use of its assets to prevent product costs becoming too high. The organization's strategy is 'to bring high-quality consumer products to the market at a low price'. The organization then has to watch the production costs closely so they do not become too high, resulting in a profit margin that is too small for the organization to be able to continue investing properly. This means one of the organization's crucial business activities is to produce as efficiently as possible, which translates into utilizing resources optimally. The capacity utilization of these resources has to be tracked, by measuring machine capacity, personnel capacity and by calculating the productivity per FTE (Full Time Equivalent).

*Environmental factors and environmental key performance indicators*. These are measurements that provide information on the environment in which an organization operates, and especially on developments that are relevant to the organization. It concerns aspects over which the organization has no or very limited control, but which may have a considerable effect on the results of the organization. This is why, especially during the target-setting process for key performance indicators, managers have to take into account the influence of environmental factors (figure 4.9). These business environment measurements should therefore be included as an extra perspective in the balanced scorecard of the organization.

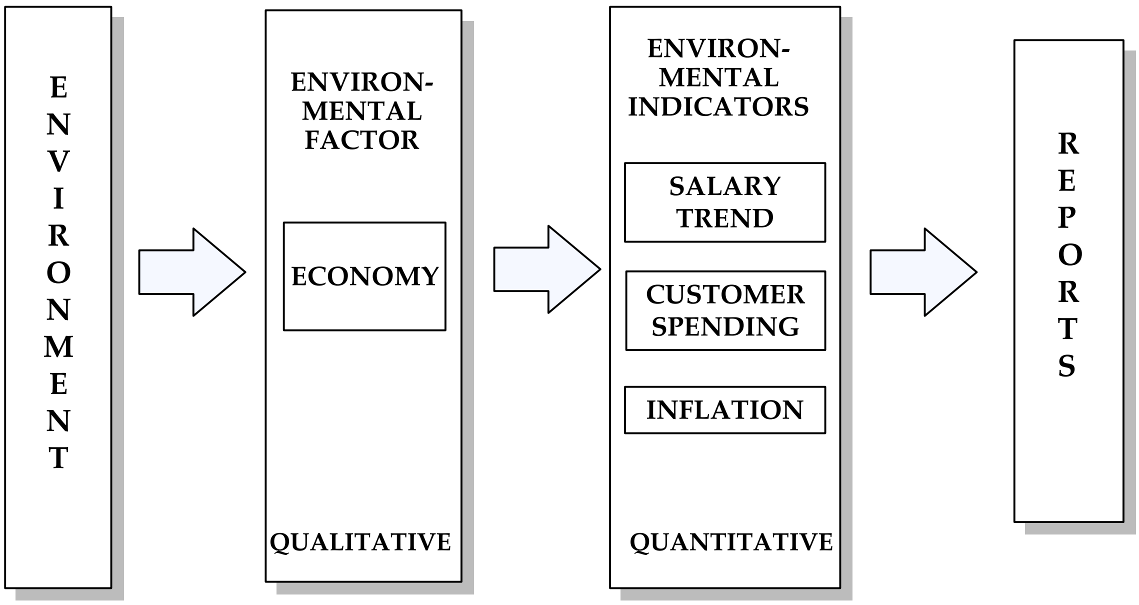



*Figure 4.9: Environmental factors and environmental key performance indicators*

Economic developments usually have a direct influence on an organization's business results and, therefore, are critical to the organization's success. Many indicators, such as salary and wage developments, inflation (and interest rates) and the accompanying consumer spending indices, provide important input for estimating the expected turnover. If the economy grows slower than expected, this phenomenon may be accounted for by adjusting the target sales budget downwards. If the sales manager does not succeed in realizing the adjusted target, the most obvious explanation ('We had a downward economic trend') cannot be used and the manager has to look for the *real* causes of not achieving the target.

<u>Result and effort measurements</u>

The critical success factors, important for tracking the results of executing an objective or a crucial business activity (the so-called result CSFs) can be determined by answering the following questions:

*'What will be the result when we achieve the objective successfully?'*
*'What will be the result when we execute the business activity successfully?'*

The critical success factors, important for tracking the efforts that are critical in executing an objective or a crucial business activity (the so-called effort CSFs) can be determined by answering the following questions:

*'What do I absolutely need to achieve the objective successfully?'*
*'What do I absolutely need to execute the crucial business activity successfully?'*

There are many efforts that may lead to achieving the final result but only those most critical need to be monitored. A 'critical effort' is that effort that is most likely to lead to achieving the desired result.

After the critical success factors have been identified, we need to answer the following questions to identify the key performance indicators for each critical success factor:

*'How do I measure the critical success factor?'*
*'How can I see the result of the critical success factor?'*

A key performance indicator is usually defined as a ratio or a percentage (the numerator and the denominator). After all, a figure of 10 for the key performance indicator 'complaints' does not mean much in itself. We can only value the result properly when it is expressed in percentages, for example: 10 complaints per 1000 customers (1%) or 10 complaints per 100 customers (10%).

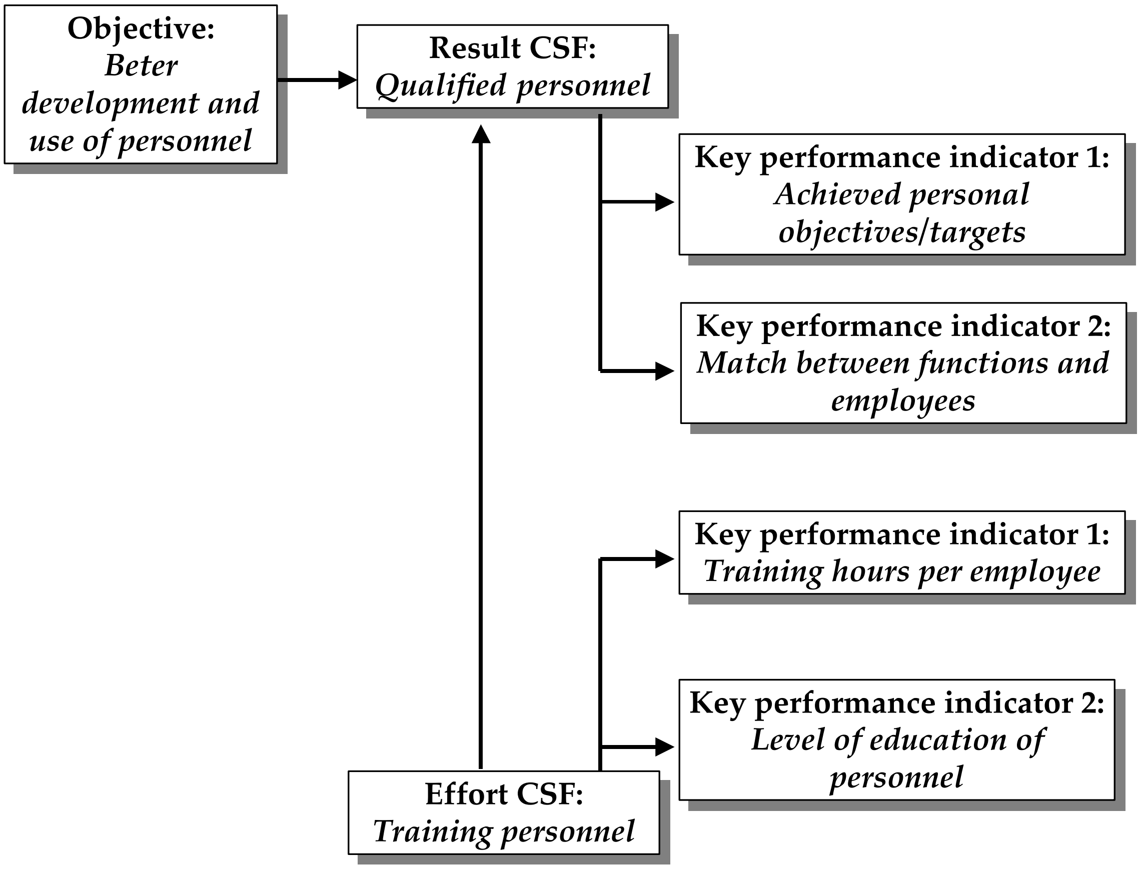



*Figure 4.10: Example of a means to track the development and use of personnel, by using result- and effort- CSFs and corresponding KPIs*

Figure 4.10 depicts the strategic objective 'better development and better use of personnel'. The final result of this objective is to have qualified personnel, which means personnel of a higher quality than before (*result CSF*). Whether the organization's personnel are indeed qualified can be measured by the number of personnel that is actually capable of achieving the agreed objectives for the current year. The number of personnel that is in the wrong job position can, for example, indicate the absence of well-qualified personnel. Whether personnel quality has improved compared to the previous year can be measured by comparing the results of the above-mentioned key performance indicators of the present and the previous year. One of the main efforts to improve personnel quality is providing training for employees (*effort CSF*). Whether employees get enough training can be measured with the number of training hours per employee and the final education or skill level achieved by an employee.

It is important to distinguish between result CSFs and effort CSFs. If only the efforts are monitored, it may happen that the wrong activities are performed very well. After all, it is not about 'doing things right' but about 'doing the *right* things right'. Therefore, managers should always keep the final result in mind, in order to be certain that their efforts lead to the desired result. But the final result is not the only thing they have to think about, as it may take quite some time before the final result is achieved. Managers have to observe if they are still on track to the final goal. They can do this by measuring whether their efforts are having the desired effect. Getting the interim results allows them to adjust their activities, if necessary.

During the development process of objectives, critical success factors, key performance indicators and targets, there are a number of quality criteria to ensure that the developed objectives, measurements and targets are specific, measurable, relevant and time-related. These criteria are listed below.

<u>Objectives</u>
- An objective has to describe an activity that leads to the desired final result.
- An objective has to be defined in concrete, not abstract terms.
- An objective must express action. This is done by using a verb with an active connotation (e.g. 'Improve …').
- An objective must relate to the area of responsibility of the manager for whom the objective is developed.
- There should be a limited number of objectives per manager (no more than 5 to 7).

<u>Critical success factors</u>
- Each objective should be measured with at least one result CSF and no more than two effort CSFs.
- For each critical success factor, no more than three key performance indicators should be developed. This is to limit the amount of information, development time and costs, and to make sure that only relevant information is included in the management reports.
- Critical success factors should not only contain financial information but also non-financial information, to ensure a well-balanced view of each objective.
- A critical success factor is a qualitative notion that describes in words how a certain objective can be measured. Thus a critical success factor is never quantitative (e.g. not 'the number of satisfied customers', but 'customer satisfaction').
- A critical success factor is clear, concise and can only be interpreted in one way.
- A critical success factor describes only what has to be measured, not what the direction or the value of the result should be (e.g. not 'high personnel quality', but 'personnel quality').

<u>Key performance indicators</u>
- The definition of a key performance indicator should be concise, easy to understand and complete (i.e. every term used in the definition is described), in such a way that the definition can only be interpreted in one way.
- A key performance indicator should be measurable in practice. An organization should have the procedures, means and (some) information systems to make this possible.
- The definition of a key performance indicator is preferably composed of a numerator and a denominator; percentages provide more valuable information than absolute numbers.
- The definition of a key performance indicator contains a reporting frequency (monthly, quarterly, yearly).

<u>Targets</u>
- The target for a key performance indicator should be realistic: a manager should consider the target to be achievable.
- The target for a key performance indicator contains a certain range. Corrective action should only be taken when the result is not within this range (positive or negative).
- The target for a key performance indicator is determined together with the manager who is responsible for the result on the indicator in question. This is to enhance support for the target within the organization.

During the development process of key performance indicators, a distinction should be made between *management* information and *operational* information (figure 4.11).

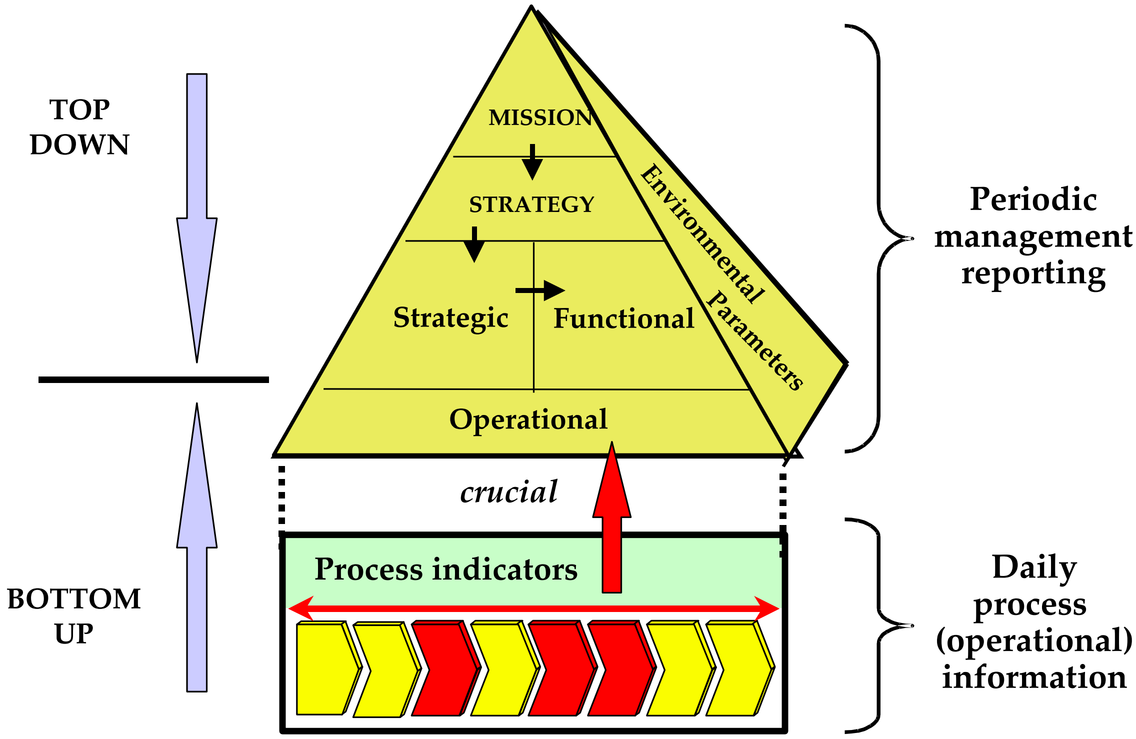



*Figure 4.11: Operational information as the basis for operational CSFs and KPIs*

*Operational information* gives an overview of the individual activities within the organization. Operational information enables an organization to decide which activities should be redirected or adjusted and which follow-up steps should be taken, showing the consequences in time and money. The process indicators that are used in operational information should not be included in management reporting. Process indicators are usually derived from detailed operational data that generally becomes available after an activity has been completed. An example of a process indicator is 'the delivery time of a *single* order'.

*Management information*, based on critical success factors and key performance indicators, is information that is generated at a higher, more abstract level than operational information. Management information has a signaling function, informing management if a certain process is heading in the right direction or not, and if performance is in accordance with agreements and targets that have been made previously. The operational key performance indicators that are used in management information are often compiled of process indicators. Management information reporting is produced periodically, usually once a month. If managers have not achieved their targets, management generally asks for an analysis of the underlying causes for the failure. For this purpose, the operational data that was mentioned earlier needs to be accessed in an ad hoc manner. An example of an operational key performance indicator that consists of process indicator data is 'the *average* delivery time of orders'.

### 4.3.1 Performance measurement in a corporate structure

In the previous section, a description was given how to develop critical success factors and key performance indicators, using the performance measurement pyramid. The pyramid methodology applies to organizations with a relatively uncomplicated organizational structure. In organizations with a corporate headquarters -- division -- business unit structure, the methodology can also be applied, with some adaptation due to the different accountability set-up in a holding structure, like f.e. a multinational (figure 4.12).

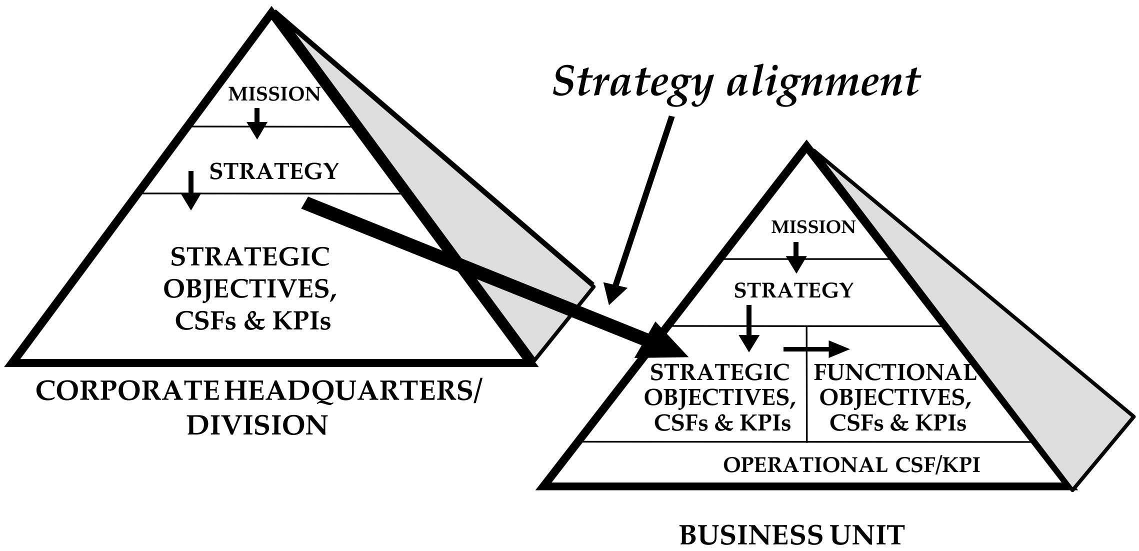



*Figure 4.12: The relationship between corporate, division and business unit measurements*

Formulating critical success factors and key performance indicators for organizations with a corporate headquarters -- division -- business unit structure takes place in almost the same way as in companies with a more simple organizational structure. First, the mission and strategy are formulated: 'What do we want to accomplish as an organization?' Then, the strategic objectives are defined: 'How are we going to accomplish our mission?' Defining the strategic measurements, however, follows a more complex methodology:

- The performance on the strategic objectives is monitored by means of strategic critical success factors and measured by means of strategic key performance indicators. These strategic measurements are developed for and used by corporate headquarters. Because the divisions and business units often have an autonomous organization, with their own mission and strategic objectives, they will have their own pyramid. Divisions and business units have their own specific strategic CSFs and KPIs, which are used by the management teams of the divisions and business units. In the case of a corporate structure, like a multinational, there are numerous pyramids: one for corporate headquarters, and one for each division and business unit.

- The strategies of the divisions and business units should be aligned with the strategy of corporate headquarters. In the same manner, alignment is needed between the measurements developed at corporate headquarters level and the measurements developed at the divisional and business unit levels.

In summary, the strategic objectives of corporate headquarters determine the direction of the divisional objectives. Between a division and its business units a similar relationship exists. Objectives of business units should therefore be derived from divisional objectives, which are derived from corporate objectives. In a similar way, the different sets of critical success factors and key performance indicators are aligned: the corporate CSFs/KPIs determine the direction for the CSFs/KPIs of the division, which in turn determine the direction for the CSFs/KPIs of the business units (figure 4.13).

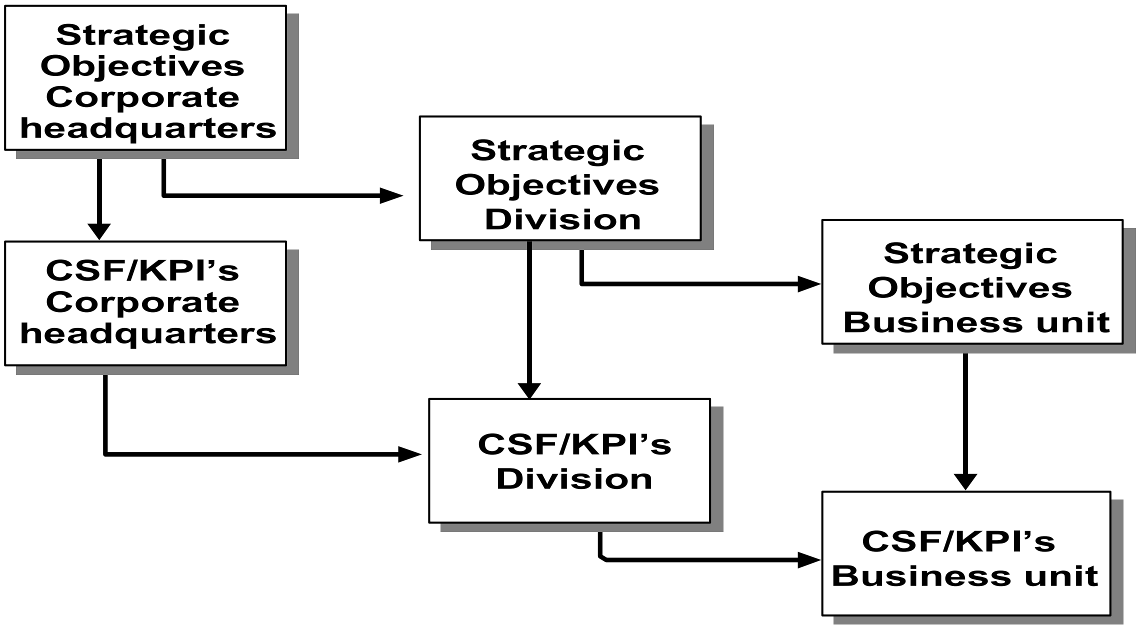



*Figure 4.13: A coherent cascade of strategy and strategic measurements in a multinational*

If the above-described methodology is used, every division will have its own set of critical success factors and key performance indicators, to track its strategy and crucial business processes (1 and 2 in figure 4.14). These measurements are then input for the management report of the division (3) and used by divisional management to steer and control the division (4). In addition to the regular financial reporting of the division to corporate headquarters (5), only the most important indicators, those that give the best insight into the status of the division and that are regularly used by divisional management, are reported on a regular basis to corporate headquarters (6). In this way, corporate headquarters only receives the most important information. Corporate headquarters then uses this information to supervise the division (7). Only when the division does not meet its targets, will corporate headquarters step in and start coaching and controlling the division (8). In the same manner, the division can supervise its business units.

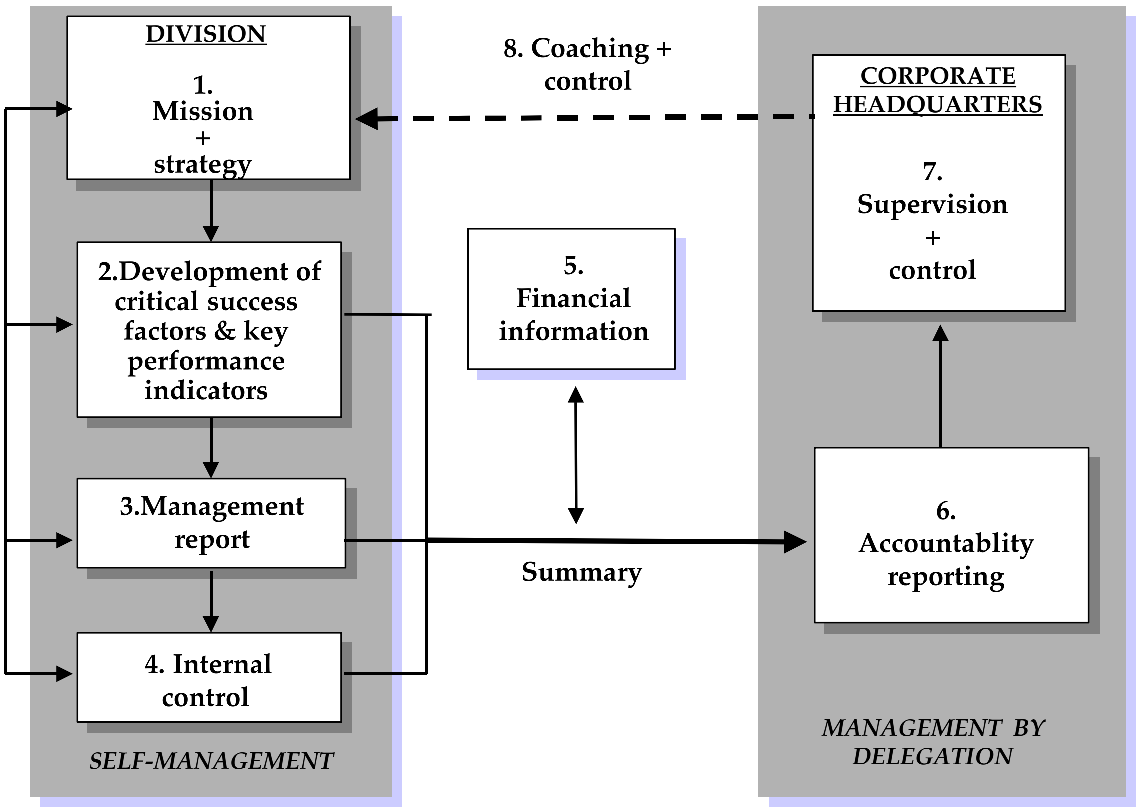



*Figure 4.14: An overview of the reporting flow,*
*from lower to higher management levels in the organization*

### 4.3.2 The link between parenting styles and the balanced scorecard

As described in chapter 3, there are three main parenting styles: financial control, strategic control and strategic planning. The choice of parenting style dictates the influence corporate headquarters has on the strategic planning and operational control processes of the divisions and business units. This in turn dictates the content and level of detail of the information flow going from these divisions and business units to corporate headquarters. To make a link between a specific parenting style and the shape of a matching balanced scorecard, we can adapt the model of Weber (Weber, 1999), which matches types of corporate structures with types of balanced scorecards by putting in the types of parenting styles and adapting the types of control (figure 4.15).

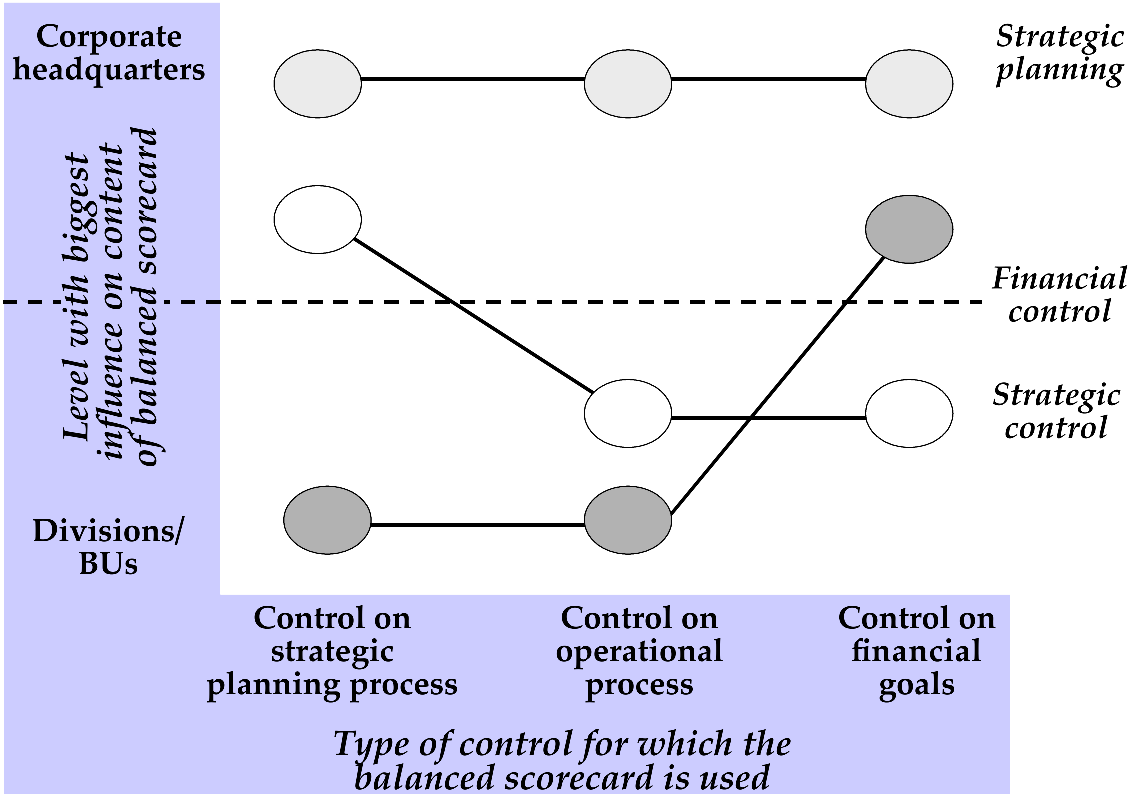



*Figure 4.15: Influence of corporate headquarters' on the content and use of the balanced scorecard, depending on the parenting style*

In the strategic planning style, corporate headquarters plays an active and dominant part in the strategy development process of the divisions and business units. It is also heavily involved in deploying and monitoring (the execution of) the strategy. Because corporate headquarters has to stand close to the divisions and business units, it needs the same type of information from all the lower organizational units. The scorecard indicators of the divisions, business units and corporate headquarters are so similar that these can be consolidated into one balanced scorecard. This consolidated scorecard is checked in detail by corporate headquarters, which makes it possible to intervene on lower levels. In the strategic planning style, corporate headquarters has the dominant influence on the development and use of the balanced scorecard.

In the strategic control style, corporate headquarters issues strategic guidelines but the divisions and business units make their own strategic plans independently. These plans are evaluated and prioritized by corporate headquarters. The divisions and business units define both short and longer-term financial and non-financial objectives, which are put in 'local' balanced scorecards. These indicators are then collected (but not consolidated!) into one scorecard, and complemented with indicators which show the added value of corporate headquarters. This scorecard is checked on a high level by corporate headquarters. In the strategic control style, corporate headquarters has the dominant influence on the development  of the scorecard. The divisions and business units have the dominant influence on the use of the balanced scorecard.

In the financial control style, the responsibility and authority to develop strategic plans is totally delegated to the divisions and business units. Corporate headquarters in principle does not evaluate these plans, but is only interested whether or not the divisions and business units are achieving the financial targets as forecasted in the strategic plans. Corporate headquarters manages a portfolio of businesses and does not need complete balanced scorecards from the divisions and business units nor from itself. Corporate headquarters can use the financial indicators in the 'local' scorecards as input to evaluate the portfolio. In the financial control style, the divisions and business units have the dominant influence on the strategic and the operational use of the balanced scorecard. Corporate headquarters uses part of the balanced scorecard for financial control purposes.

The above-described links between parenting styles and types of use of the balanced scorecard should be regarded as guidelines. Every organization has to decide if a particular link indeed fits with its management style and with the guidelines and agreements made between the various organizational levels.

## 4.4 Link quality frameworks with performance measurements

In the past few years, many organizations have started total quality management projects. The purpose of these projects is to improve the organization's overall quality with respect to operational processes, procedures, standards and documentation. In many cases, quality frameworks provide, as it were, a manual in which areas are indicated that need to get structural attention to improve the organization's quality permanently. The best known quality frameworks are the European Foundation for Quality Management model (EFQM) and the Baldridge model. The challenge organizations are facing is how to link these quality frameworks with the critical success factors, key performance indicators and the balanced scorecard.

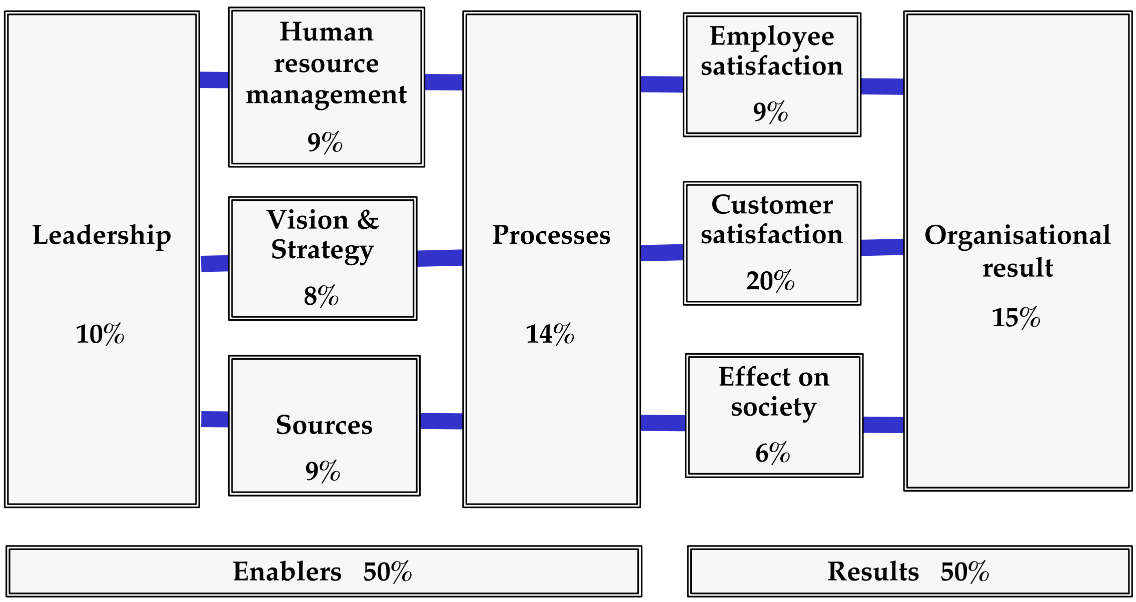



*Figure 4.16: The EFQM model*

The EFQM model (figure 4.16) provides a tool, firstly for determining where the organization stands at a certain moment in time with its actual results in comparison to its quality targets, and secondly for indicating how these results can be improved. The model has nine components that are divided into two categories. The first category consists of the results that the organization has achieved with respect to employee satisfaction, customer satisfaction, the effect on society, and the overall (financial) results. The second category includes the so-called enablers, i.e. the activities that have enabled the organization to achieve results. Examples of enablers are: good leadership and good human resource management, a clear vision and strategy, availability of resources (such as financing) and efficient processes. The degree of alignment between the enablers and results categories determines the success of the organization. The idea behind the EFQM model is that an organization should pay attention in various degrees to the components of the model (in figure 4.16 shown as percentages).

The components of the enablers category determine *how* the results are achieved. Leaders should inspire people in the organization to strive for continuous improvement, by showing their dedication to establishing an improvement culture. Human resource management strives for making optimal use of employees' knowledge and motivation. The use of other assets (financial, technological, and physical) should also be optimized. All processes should be managed and controlled well, and should be continuously improved. As a starting-point for this, the organization's vision and strategy have to be clearly formulated.
The components of the results category determine *what* the organization has achieved or is about to achieve. It should be clear what employees, customers and the society think about the organization, and how satisfied they are. The results of an organization have both a financial and a non-financial aspect.

The Baldridge model (figure 4.17) is composed of seven related areas that influence each other in different ways. Good leadership is followed by development of clear customer and market focuses and strategic plans. Processes are carried out and managed and people are trained and developed. This entire process is supported by sufficient information and analysis in order to lead to good organizational results. Just like in the EFQM model, the idea behind the Baldridge model is that attention should be paid to all components of the model. If this is not done structurally, an organization cannot consistently achieve good results.

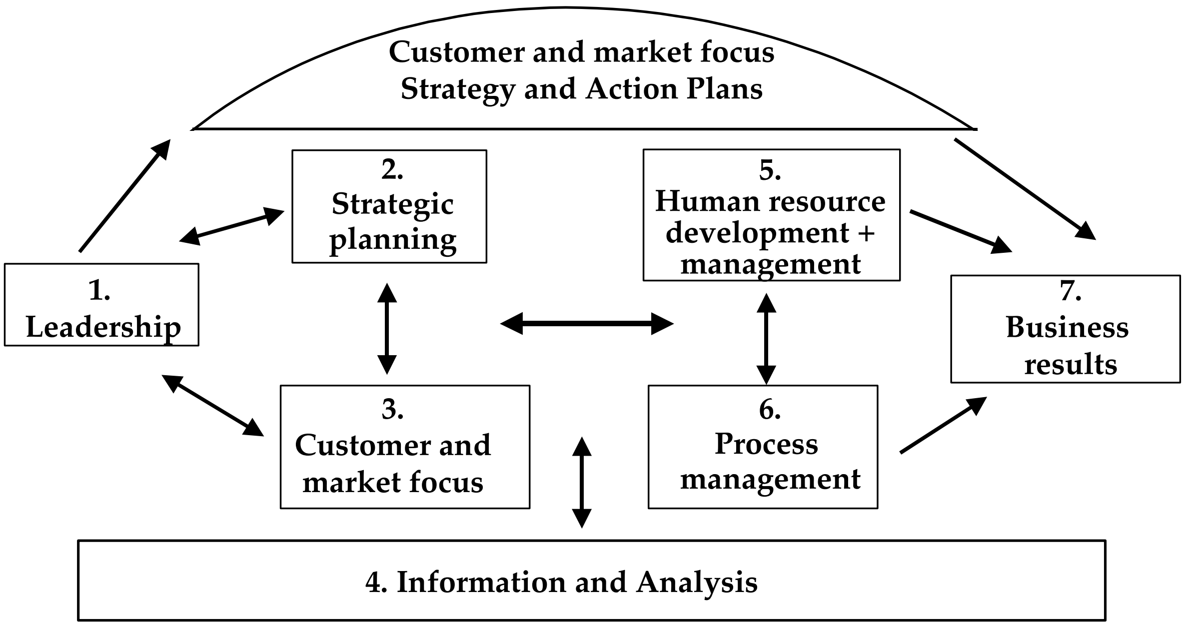



*Figure 4.17: The Baldridge model*

Organizations that have implemented one of these frameworks have an urgent need for good information about each of the components of the framework. They want to have answers to questions like 'Do we have good human resource management?', or 'Do we have the right customer focus?'. To answer these questions, many organizations decide to link the development project of critical success factors and key performance indicators to the implementation project of a quality framework. To do this, specific indicators are developed for each component of the model and are subsequently included in the management reports. Only this way, management can be ensured of a good implementation of the quality framework and also, more importantly, that the organization and employees follow the lines that were set out by the quality framework.

When making the link between a quality framework and a balanced scorecard, it is important to keep in mind the different focuses they have. A quality framework asks for measurements, the balanced scorecard provides the development method for these measurements. A quality framework takes an integral look at an organization and does not have a specific focus, the balanced scorecard focuses specifically on the strategy and can miss other, often operational issues. The areas in the quality framework and the perspectives of the balanced scorecard overlap partly but also supplement each other. A quality framework gives high-level relationships between organizational areas, the balanced scorecard looks for specific cause-and-effect relationships. The balanced scorecard follows the execution of the strategy, a quality framework follows the development of an organization to 'total quality'. Some observers state that quality of leadership will make the big difference between the success and failure of an organization (American Productivity & Quality Center, 1998). Therefore, they are of the opinion that the quality frameworks have to be complementary to the balanced scorecard, because these frameworks explicitly focus attention on the category 'leadership', which the balanced scorecard does not. This mix of overlap and supplementation makes a joint implementation of a quality framework and the balanced scorecard exceedingly suitable to improve the overall management information function of an organization.

### 4.5 Focus on value creation

Managing an organization on the basis of value, or potential for cash generation, is known as 'value-based management' (VBM). What counts in value-based management is no longer periodical profit in terms of accounting, but value created. The key performance indicator used is EVA[1], or 'economic value added'. EVA is calculated by reducing the so-called NOPAT (Net Operational Profit After Taxes) with the amount of the capital costs. If the balance is positive, value has been created; if the balance is negative, value has been destroyed (figure 4.18). NOPAT is found by performing a, often considerable, number of corrections on the calculated margin in order to link the margin to the organization's cash flow. The capital costs are the weighed average costs of capital (equity and debt). The latter is found by performing a number of corrections on the corresponding accounting amounts. One can say that value is created or destroyed when the return, made with the organization's capital, is higher or lower than the costs associated with this capital.

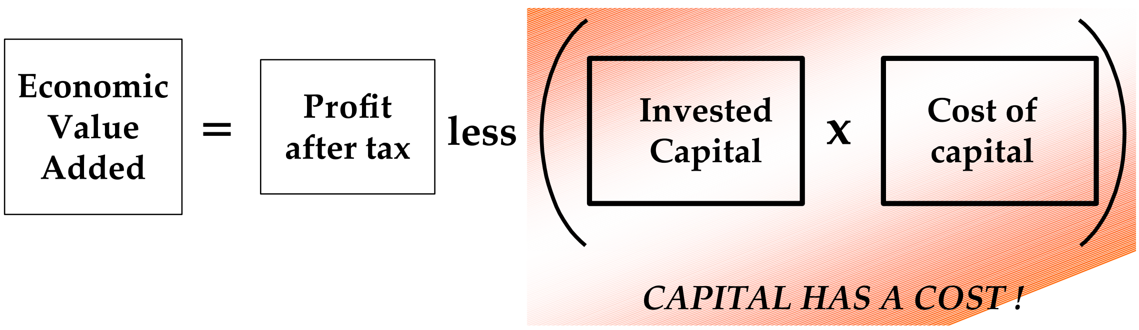


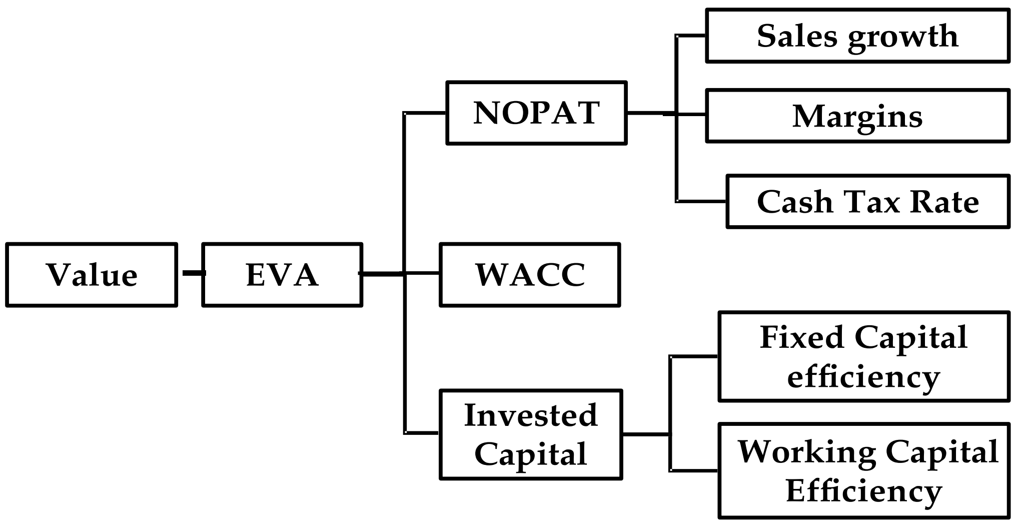

*Figure 4.18: The economic profit calculation*

The main benefits of EVA are the introduction of the concept 'economic value' and the fact that it makes managers more aware of the costs of capital. EVA can be applied to all activities and investments of an organization. It can be used to evaluate if the various activities and participations add enough value to the organization, or that investments should better be done elsewhere. Used at the corporate level, this measure is valuable in portfolio management by identifying the businesses to divest or invest in.

[1] TM Stern Stewart & Co.

EVA is also used at lower management levels. At these levels, the measure is the key financial value driver for a division or business unit measuring their own performance and evaluating their own strategic alternatives. When VBM is used at all management levels, the concepts of VBM are truly embedded in the organization. VBM concepts can be used to steer changes in behavior and to focus change management.

Value creation is 'high' on the agenda of top management. Financial value creation has been measured and consequently management's focus and behavior is changing. The next challenge to further extend value-based management is trying to link the financial value tree metrics to the strategic and operational value drivers(figure 4.19). This will make VBM more than just the implementation of a new financial measure, it will then be used to relate strategy and operations at all levels of the organization.




**EVA = economic value added**
**NOPA = net operational profit after tax**
**WACC = weighted average cost of capital**

*Figure 4.19: The financial value tree*

The first step in value-based management is the calculation of EVA, because this enhances managers' awareness of capital costs. However, it takes more than this to manage an organization on value creation: managers also have to gain insight into the factors that determine value. These factors are not automatically generated by EVA. It takes a second step: linking EVA to value creation factors.

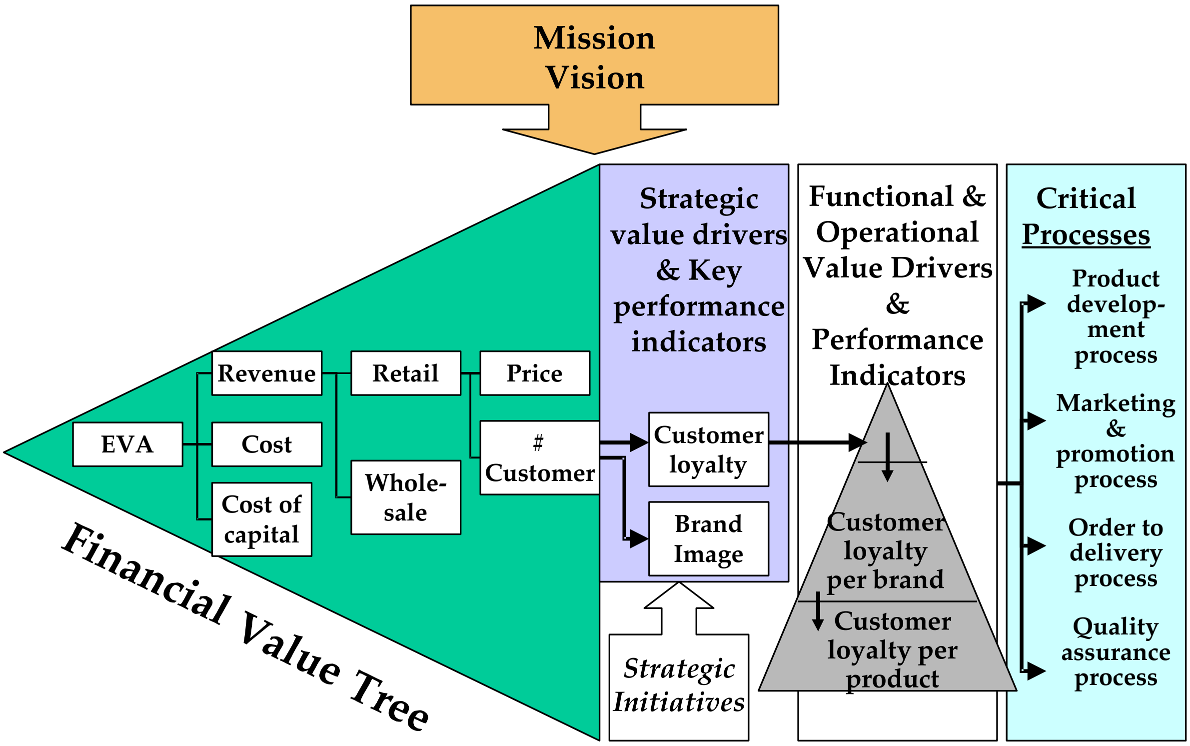



*Figure 4.20: Linking the financial value tree with CSFs and KPIs*

Figure 4.20 shows how this link can be made in a practical way. The trick is to keep it simple and easy to understand for everyone. Based on its vision and mission, the organization is able to build a financial value tree. This value tree encompasses the key financial value drivers of the organization. The ultimate value driver in the financial value tree, Economic Value Added (EVA™) [2], needs to be defined in a way that is easy to understand (  in figure 4.20).

Next, the strategic initiatives and plans are evaluated and prioritized according to their contribution to value creation. The organization then identifies a limited set of key strategic value drivers and performance indicators to measure these value-based initiatives (  in figure 4. 20). The financial value tree has now been further extended to include non-financial value drivers. These non-financial drivers are linked to the financial value drivers as much as possible. The causal relationships are often indirect or even systemic in nature (causal loops), and might be difficult to calculate mathematically. The challenge for management is to either quantify or qualify the relationships between leading non-financial and lagging financial value drivers, to have confidence in these links and at the same time to keep it simple.

The strategic value drivers and performance indicators are then translated into the lower organizational levels (  in figure 4. 20). It is important to align the drivers and indicators with each other at all levels and with the respective strategic plans and initiatives at these levels.

Ultimately, VBM creates a link between financial value and the true drivers of value: business processes (  in figure 4. 20). The strategic, functional and operational value drivers and performance indicators (both financial and non-financial) measure the key value creation processes of the organization. By selecting the appropriate value drivers and performance indicators for each process, these processes can be measured on operational excellence and value creation.

[2] EVA is a trademark of Stern Stewart & Co.

A focus on value creation increases the overall performance and value creation ability of an organization. This is because everyone in the organization, management as well as employees, sees and understands the link between their activities and their contribution to both the financial results and strategic objectives of the total organization. Also, value creation becomes measurable at every level of the organization, giving it the focus and attention that it deserves from management at all levels. Value-based management is the 'glue' that binds financial objectives, strategic plans and operational performance together into an integrated framework focused on value creation.

When the development of key performance indicators and the determination process of value drivers takes place at the same time, linkages or overlaps may be identified. As a result, the value-based management model can be used during the development process of critical success factors and key performance indicators to determine the possible effects that key performance indicators may have on EVA. This also works the other way round. During the EVA determination and analysis process, key performance indicators can explain how the formulated strategies and critical success factors have lead to a certain performance.

Information technology can assist organizations in their efforts to create and sustain value. The support for value creation is realized by an integrated set of applications, as well as using an underlying data warehouse structure that provides the required information. An integrated data warehouse should be fed by Enterprise Resource Planning systems (ERP) and other sources. Based on a consistent set of common data, the ERP system and data warehouses are fully integrated across the organization. The integrated set of applications on top of this structure should provide the information and analysis capabilities that enable value-based management practices. These applications include advanced simulation and scenario modeling tools, risk management applications, a consolidation tool, a corporate performance monitor, and mechanisms for communicating more effectively with stakeholders.

The use of a key financial metric, like EVA, at lower management levels might not result in the expected increase in value creation. The (accompanying) terminology of the measurement often proves hard to understand and apply to every-day business by operational managers (e.g. weighted average costs of capital). Another reason EVA might not be used at the business unit level is that the use of shared resources across business units results in allocation efforts and ownership problems, as business unit management cannot be held responsible for a lot of these allocations. This may result in business units focussing too much on allocation issues instead of on value creation. In that case, the desired change in management behavior, that has been realized at corporate and division levels, will not occur at business unit level, thereby discouraging the use of EVA at this level.

## 4.6 Behavioral implications of value thinking

Focussing on value creation requires a real shift in thinking. No more only focussing on the profit and loss account, but looking everywhere all the time for possibilities to add real value to the organization. Trust is the keyword here! Trust in the value drivers, trust in causal relationships between financials and non-financials, and trust in each other.

Being the owner of a set of value drivers, and being trusted by management and colleagues that you can indeed be trusted to determine, define and revise actions that should create value. Being the owner of a set of value drivers, and trusting that the actions you define for the non financial value drivers will indeed, through causal relationships, improve the financial value drivers, thereby adding value. After all, not all relations between value drivers can be mathematically calculated. And finally, being the owner of a set of value drivers that really show what you are doing, making your performance transparent, requires an open culture and trust in each other that the results on the key value drivers will be used to manage, not to control and punish.

## 4.7 Case: Improving value thinking worldwide at Sara Lee/DE

This case study describes how Sara Lee/DE improved its value thinking by implementing key value drivers, in the shape of critical success factors (CSFs) and key performance indicators (KPIs), worldwide. Arthur Andersen Business Consulting supported the company during the roll-out by providing the methodology and training to the controllers. As part of the project, Sara Lee/DE and Arthur Andersen Business Consulting conducted a pilot at the business unit Kiwi Brands in Australia. The most interesting aspect of this case is the way in which the 'train-the-trainer' concept can be used to implement performance management, and thereby value thinking, fast and efficiently worldwide.

### 4.7.1 Organization's background

Sara Lee/DE is a subsidiary of Sara Lee Corporation, which is domiciled in Chicago, USA. The main activity of Sara Lee Corporation is developing and selling branded products worldwide. In 1978, the company acquired a 65% share in Douwe Egberts, a family-owned coffee-roasting firm from The Netherlands. In 1984, Sara Lee Corporation obtained complete ownership and created the subsidiary Sara Lee/DE (SL/DE). Nowadays, SL/DE is responsible for the divisions of coffee & tea, household & bodycare, direct selling and the region Asia. Sara Lee Corporation's organizational structure is illustrated in figure 4.21. SL/DE, based in Utrecht, The Netherlands, has sales exceeding U.S.$6.6 billion, with a net profit exceeding U.S.$500 million, and is employing more than 27,000 people.

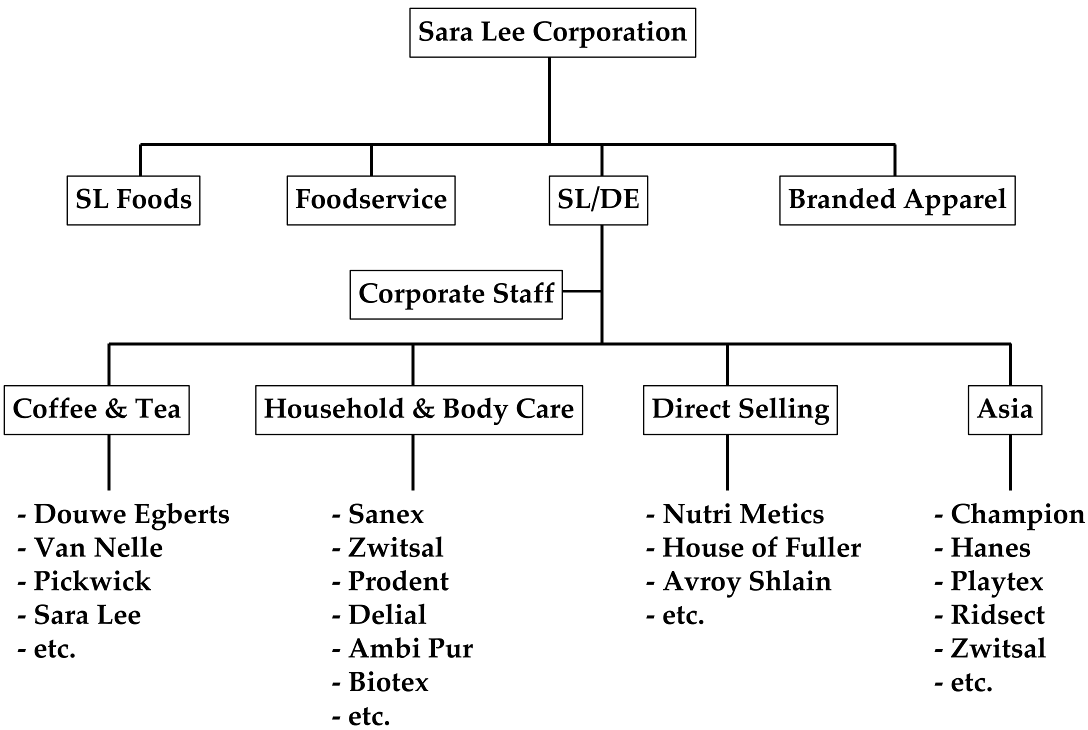



*Figure 4.21: Simplified organizational chart of Sara Lee Corporation and SL/DE*

Sara Lee Corporation does not see itself as a manufacturing or distributing company but rather as a collector of brands, focusing its attention on the marketing of finished products. The company has worldwide more than 100 brands, including Douwe Egberts coffee, Kiwi shoe polish, Stegeman meat products, Ambi Pur air freshener, Sanex body care, Hanes clothes, and Coach leather products. Eight of these brands have a worldwide revenue each exceeding U.S.$500 million. The main strategy of the organization is to create and maintain brands with the highest added value and return against the lowest costs. In addition to this, Sara Lee Corporation focuses on optimizing its profits, while using a minimal investment. For this reason, the company has divested in recent years by selling off production plants and outsourcing transportation. It is expected that this will continue in the near future as the company strives for a return on investment of 20%, up from the current 16%.

### 4.7.2 Establish a clear responsibility structure: a decentralized management style

SL/DE competes in a wide range of industries. The coffee & tea division operates in a stable, mature industry with a limited number of strong competitors. The household & body care division and region Asia have to cope with fierce competition from several strong multinational companies. The direct selling division operates in a relatively young industry with, until now, a limited number of major international players. Therefore, corporate headquarters employs a decentralized managing style so that management of the various divisions can deal freely with the different industry characteristics they encounter (figure 4.22). In an interview, SL/DE's chief executive officer (CEO) described this managing style in the following way: "Our brand managers do not have to execute directive number 225 from headquarters when they are launching a new product. We, the board of management, give them a framework. We manage the process a little by saying: 'this flavor or trend is in hot demand in the market this year'. But as long as sales are up 12% every year and value is consistently added, every manager has complete freedom. A significant part of their reward is based on incentives, in bonuses and share options".

| Definition | Strategic planning | Strategic control | Financial control |
|---|---|---|---|
| Type of industry | ✓ Rapidly changing, fast growing or fiercely competitive industries. | ✓ Mature industries and stable competitive situations. | ✓ Wide variety of industries. |
| Parent role | Closely involved with business unit in formulation of plans and decisions. Clear sense of direction. | ✓ Planning decentralized to business units. Parent role is checking, assessing, and sponsoring. | Insists that all decisions are 'owned' by the business units themselves. |
| Business role | Seeks consensus with head-quarters and other units for business initiatives (in line with strategic targets). | ✓ Own responsibility for strategies, plans, and proposals. | Independent entities, sometimes working together to achieve mutual benefits. |
| Organizatio-nal structure | Large or powerful functional staffs at center. Shared service departments (marketing, R&D, etc.) | ✓ Decentralized with focus on individual business unit's performance. Headquarters operates as strategic controller. | Minimal staff at the headquarter level, focused on headquarters' support and financial control. |
| Planning process | Resource allocation driven by requirements of long-term strategies. Planning influence of headquarters is high. | ✓ Negotiation of financial and strategic performance targets. Planning influence of headquarters is medium. | No formal strategic planning, process focuses on business unit annual budget and financial targets. Planning influence of headquarters is low. |
| Control process | Low priority on monitoring monthly financial results. Control by headquarters is flexible. | ✓ Regular monitoring of actuals against planned, on financial and non-financial targets. Control by headquarters is strategic. | ✓ Concentrates on financial targets and results (contracting). Control by headquarters is strictly financial. |
| Value creation focus | Creation of new business units for long-term business development. | ✓ Long-term strategies and goals of the business units (facilitating + coordinating). | ✓ Operating improvements and financial control. |

*Figure 4.22: SL/DE's parenting style*

This means that the dominant management style in SL/DE is that of strategic controller. The Board of Management (BoM) has decentralized the strategic planning process to the divisions but delivers strategic guidelines to which divisions have to adhere. The monthly and quarterly reviews by the BoM focus on the financial performance of the business units, although non-financial performance is becoming more important. The divisions and business units are responsible for the content and execution of the strategic plans. Large investments by business units have to be submitted to the BoM, by way of a capital expenditure request. Approved investments are often aimed at improvements in the operational processes, but can also be used for long-term strategic investments.

### 4.7.3 Focus on what is truly important: global roll-out of performance management

Management at SL/DE in general is quite satisfied with the management information function at the company. The corporate reporting set, called the corporate headquarters' barrel report, is delivered to the board members, according to strict due dates in a predefined format with all the needed financials. The report set is discussed with the divisions during regular meetings, called barrel meetings. However, management recently feels there is important management information missing. The reports contain mainly financial status information on a detailed level. They do not contain enough information about the execution of SL/DE's growth strategies, which are:

(1) to build brands in new channels and in new ways;
(2) to achieve and maintain low-cost production worldwide;
(3) to make acquisitions that are strategic and complementary;
(4) to concentrate investments behind high-margin, value-added products; and
(5) to increase business internationally by focusing on growing economies.

Also, general managers from the divisions and business units are asking for more information about customer profitability, product profitability, operational and process bottlenecks, key performance indicators (KPIs), and future-oriented information. This gave the chief financial officer (CFO) of SL/DE enough reason to start an improvement project. This project consisted of three parts that would be (partially) executed concurrently (figure 4.23).

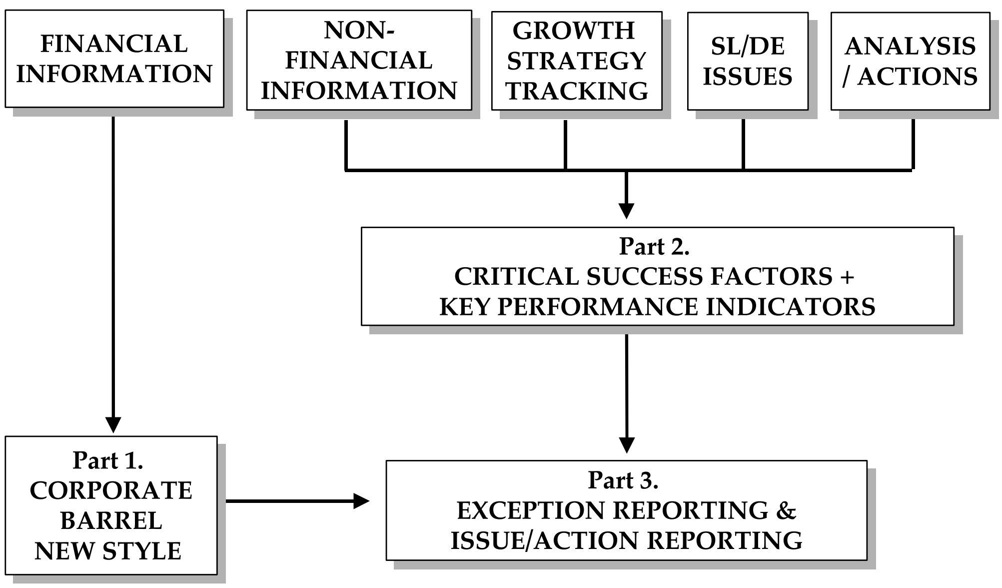



*Figure 4.23: Overview of the parts in SL/DE's management information improvement project*

In part one of the improvement project, the key financials which every division and business have to report to corporate headquarters, are reviewed on relevance. A summary of these financials, augmented with key ratios like treasury information and cash flow ratios, is put in a new corporate barrel report. In a dedicated narrative part of the report, the general manager from the division or business unit must describe important analyses and actions in a free format. The financial details of the business unit are put in an appendix.

In part two of the project, every business unit has to identify and consequently report to corporate headquarters three financial and nine non-financial CSFs, in a balanced scorecard format. The business unit has to make sure that the accompanying KPIs, two per CSF, measure how the business unit supports the achievement of SL/DE's growth strategies.

Finally, in part three, the layout and content of the management reports are further refined. A critical budget range is set for each KPI. If the actuals are outside this range, the business unit needs to include an analysis, description of the proposed actions and expected results in its report to headquarters. Special issues that affect more than one division are then included in the barrel report. The financial information from part one and the non-financial information  from part two are now integrated into one barrel report.

This case study concentrates on parts two and three of the project. A phased approach was taken to these parts. In stage one, a pilot was performed at one of the business units to test the viability and enthusiasm for the concept of CSFs and KPIs. During stage two, a workshop was conducted with all of the members of the BoM to discuss the findings of the pilot, to test their enthusiasm for the concept, and to agree on the roll-out approach. Stage three is focused on a "train-the-trainer" session with the CFOs of the 50 largest business units, so they can develop and implement CSFs and KPIs with their own management teams. Finally, in stage four all of the CSFs and KPIs developed at the business unit level are collected to perform a quality check on them and to standardize them for the complete organization.

### 4.7.4 Stage one: the pilot at Kiwi Brands Australia

Kiwi Brands Australia is part of the household & bodycare division of SL/DE. The division's main products are air fresheners, shoe polish, foot care and toiletries. It employs 350 people and has good revenue and margin. Kiwi Brand is based in Melbourne.

The reason Kiwi Australia volunteered as a pilot site is that the company had just developed a new mission and strategy. The new mission 'To achieve sustainable profitable growth' was translated into the new strategies:

(1) to obtain top line growth,
(2) to focus on customer and end consumer,
(3) to consolidate Kiwi's portfolio of brands, and
(4) to strive for organizational effectiveness.

As a next step, the management team wanted to improve the management information so that it better reflects the new mission and strategy. The pilot, conducted in one week by a team of SL/DE and Arthur Andersen Business Consulting consultants, consisted of interviews with all management team members, covering quality and content aspects of internal (within Kiwi Australia) and external reporting (to corporate headquarters). After the interviews, a workshop was conducted with the entire management team about the current quality of reporting at Kiwi Australia, the concept and development of CSFs and KPIs, the development of action-oriented reporting and the DOs and DON'Ts in relation to the implementation of CSFs and KPIs. Finally, the facilitators processed the workshop results and feedback was given to the CEO and CFO.

The first activity during the workshop was to evaluate which of SL/DE's growth strategies were aligned with and, thus, supported by Kiwi Australia's strategies. Possible mismatches between the strategies were resolved by either rewording or by (slightly) changing the business unit's strategy (figure 4.24). If this was not possible, the management team discussed whether Kiwi Brands Australia should support the growth strategy in question. Subsequently, CSFs and KPIs were developed for these strategies.

| **Kiwi Brands Australia strategy** | **SL/DE growth strategy** | | | | |
|---|---|---|---|---|---|
| | **Build brands in new channels and in new ways** | **Achieve and maintain low-cost production worldwide** | **Make strategic and complementary acquisitions** | **Concentrate investment behind high-margin products** | **Increase business internationally** |
| **Obtain top line growth** | ✓ | | | | |
| **Focus on customer** | ✓ | | | | |
| **Consolidate Kiwi's brand portfolio** | | ✓ | | ✓ | |
| **Strive for organization effectiveness** | | | | | |

*Figure 4.24: Matching SL/DE's growth strategies with the strategies of Kiwi Brand Australia, using the strategy alignment matrix*

For example, the 'concentrate investment behind high-margin, value added products' growth strategy is translated into specific CSFs and KPIs for Kiwi Australia, as shown in figure 4.24. The growth strategy stipulates that Kiwi Australia should only invest in those products in its portfolio which have a high margin and add value to the business. This means that Kiwi Australia first has to remove low margin products, which do not add enough value, from its brand portfolio. The business unit's portfolio has to be trimmed down and consolidated.

**SL/DE GROWTH STRATEGY: Concentrate investment behind high-margin, value added products** → **KIWI AUSTRALIA GROWTH STRATEGY: Consolidation of Kiwi Australia's brand portfolio** →

- **CSF =Quality brand portfolio**
- **KPI = Brand reduction**
- **KPI = Brand leadership**

*Figure 4.25: Translating a SL/DE growth strategy, via a business unit strategy, into business unit measurements*

If Kiwi Australia wants to offer a portfolio of strong brands, the quality of the portfolio is very important and needs to be monitored continuously. This important CSF for the company can be tracked with the KPI "Brand reduction", which measurements how well the company is able to remove low-margin brands from its portfolio so that only the high-margin brands remain. Another KPI that can be used is "Brand leadership", which measures how many of the brands in the portfolio have a strong position in the market. After all, the more brands that have a first or second position in the market, the stronger Kiwi Australia's portfolio becomes.

Some of Kiwi Australia's strategies do not directly support SL/DE's growth strategies. However, these internal strategies are important for the company to improve its position in the market or to become more effective and efficient. For example, Kiwi Australia's strategy "Organizational effectiveness", is translated into CSFs and KPIs (figure 4.26).

**KIWI AUSTRALIA INTERNAL STRATEGY: Organizational effectiveness**

- **CSF =Satisfied people**
- **KPI = Employee satisfaction**
- **KPI = Employee turnover**

*Figure 4.26: Translating a business unit's internal strategy into measurements*

At the time of the pilot, Kiwi Australia experienced some difficulties due to a series of reorganizations. Therefore, an important objective was to strive for an effective organization. A precondition for this was a high-quality workforce. From a long-term perspective, 'happy employees are better employees'. Thus, creating a satisfied workforce was critical to Kiwi Australia.

The following table shows a selection of the CSFs and KPIs developed during the workshop (figure 4.27):

| Strategies | CSF | KPI | Definition of KPI |
|---|---|---|---|
| Obtain top line growth | Sales growth | Net sales volume (NSV) growth | Difference between NSV this period and NSV last period |
| | | Market share trend | Change in market share vs last period |
| | New products | New product sales | New product sales vs total sales |
| | | Successful new products | Number of successful new products vs total new products |
| Focus on customers & end consumers | Trade customer satisfaction | Customer satisfaction | Number of satisfied trade customers vs total trade customers surveyed |
| | | Days with sales outstanding | Total debtors divided by annual sales, multiplied by number of sales days |
| | Products ranged | Timely new product acceptance | Number of product acceptances in less then x weeks vs total new product acceptances |
| | Satisfied end-consumers | End-consumer satisfaction | Number of satisfied end-consumers vs total number of end-consumers surveyed |
| | | Complaints | Number of serious complaints |
| | | Repeat sales | Number of "loyal" consumers vs total consumers surveyed |
| Consolidation of brand portfolios | Quality of brand portfolio | Big brands | Number of big brands (U.S.$10m earnings or more) vs total number of brands in portfolio |
| | | Brand reduction | Number of brands currently vs number of brands last year |
| | | Brand leadership | Number of "Top 3" brands vs total number of brands |
| | Quality Investments | Big brand investments | Investments in big brands vs total investments |
| Strive for organizational effectiveness | Satisfied People | Employee satisfaction | Number of satisfied employee vs total number of employees |
| | | Employee turnover | Number of employees leaving vs total number of employees |
| | | Absenteeism | Average number of days absent per employee |
| | Effective | Process goals | Number of process improvement goals |

| Strategies | CSF | KPI | Definition of KPI |
|---|---|---|---|
| | Processes | achievement | achieved vs total number of goals set |
| | Quality workforce | Multiskilled employees | Number of multiskilled (proven to be capable of more than one job) employees vs total number of employees |
| | | Employee promotional capacity | Number of job vacancies filled internally vs total number of job vacancies |

*Figure 4.27: A selection of Kiwi Brands Australia's measurements*

During the evaluation of the workshop, the management team agreed that it was possible to develop CSFs and KPIs which are not only relevant to Kiwi Australia but also give both the household & body care division and corporate headquarters enough information to supervise this business unit. There also existed great enthusiasm in the management team to roll out the CSF/KPI methodology to lower management levels in their organization.

### 4.7.5 Stage 2: the Board of Management workshop

Not all SL/DE growth strategies can be influenced and supported by an individual Business. For instance the growth strategy '*Increase business internationally, focusing on growth in strongly developing economies*', is a strategy which is directed by corporate headquarters, not by a single division or business unit. During the workshop with all the board members of SL/DE, CSFs and KPIs were developed for these growth strategies as shown in figure 4.28. In this case, the number of growing economies in which SL/DE has business units is measured.

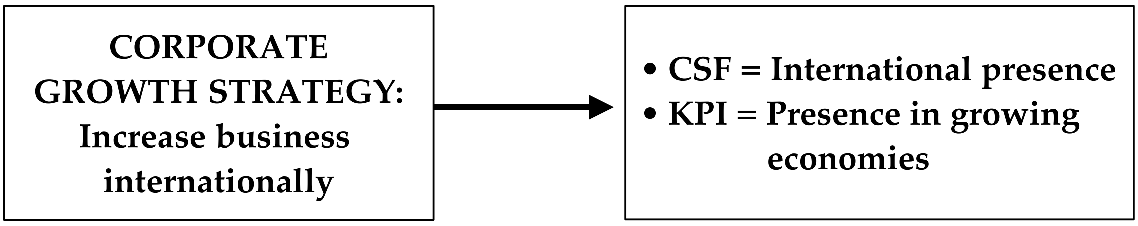



*Figure 4.28: Translating a SL/DE growth strategy into corporate measurements*

During the workshop, a discussion took place about the manner in which the BoM wants to receive KPI information from a division and a business unit. An option was to only use exception reporting. This means that the BoM would receive consolidated information from the division and only detailed information from a business unit when the results of a business unit's indicator was below target. In the (fictitious) example given in figure 4.29, Kiwi Australia's indicator 'brand leadership' was below the target of 75%. This is important information that will appear, not only in Kiwi's management report, but also in the divisional report in the barrel report of the BoM.

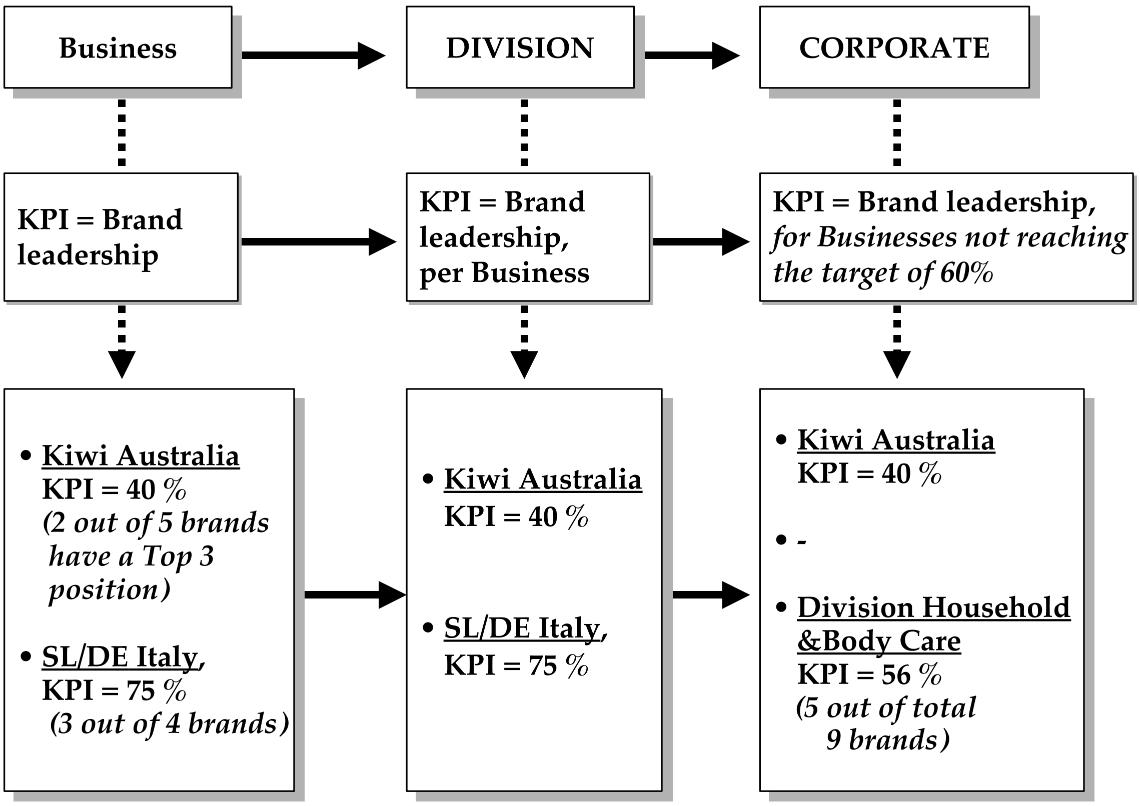



*Figure 4.29: Consolidation of business units' measurements for corporate headquarters use (f.e. 40% means 2 out of 5 brands have a top 3 position)*

### 4.7.6 Stage 3: Train-the-trainer sessions

After the pilot and the workshop, the 30 largest business units started developing CSFs and KPIs to improve both their internal reporting and reporting to corporate headquarters. To support the business units, SL/DE and Arthur Andersen Business Consulting consultants organized 'train-the-trainer' sessions. In these sessions the business unit CFOs were trained in the development technique of CSFs and KPIs and were given support tools (a training manual and a list with examples of CSFs and KPIs). After the sessions, the CFOs together with the local management team then developed their own set of measurements. All business units, thus, could deliver the required set of CSFs/KPIs to corporate headquarters.

In preparation for the sessions, several newsletters were sent out. The purpose of this was to make the controllers more familiar with the concept of CSFs, KPIs, and the balanced scorecard. One of the newsletters contained a case study, which prepared the CFOs for the kind of project that awaited them after the sessions (figure 4.30).

In the newsletter of June we have informed you about the status, progress and planned activities with respect to the improvement of the reports used at SL/DE. In this newsletter, as part of the preparation for the Advanced CFO Training in September, we will focus on a case description of a CSF/KPI project. The objective of this case is to give you a feeling of what actually takes place during such a project. The case is partially based on the Kiwi Australia pilot. The evaluation at the end of the case was obtained from the Kiwi Brands Australia management team.

# Newsletter

Finance · Vision 2000

SARA LEE | D·E

***'What gets measured gets done!'*** **August**

**Introduction**

Fred Data, CFO of Household Improvement Ltd (H.I.), an operating company within the Household & Body Care division, returned from the Advanced CFO Training in Utrecht where he had been further trained in the CSF/ KPI development method and in dealing with possible issues which might come up during the development process. He had also received the assignment of the Board of Management to develop and present, during the LRP-meeting in December, critical success factors (CSFs) and key performance indicators (KPIs) which would give the Board a good insight into his company.

**Phase 1. Project preparation**

Fred started with drafting an activity plan for the project. The plan contained 8 phases:

1. *Project preparation* - setting up a project team and informing the organization about the project.
2. *Strategy Alignment* - articulating the strategic objectives of the company and aligning them with divisional and SL/DE's growth strategies.
3. *Development of strategic CSFs/KPIs* - identifying, in a workshop with the management team, indicators which measure the company's strategic objectives.
4. *Development of functional & operational CSFs/KPIs* - identifying, in a workshop with the functions, indicators which measure the function's objectives & critical business activities.
4. *Prioritization of CSFs/KPIs* - reducing the developed indicators into a manageable set, to be used in the first year.
6. *Development of CSF/KPI definitions* - drafting detailed definitions and delivery procedures and targets for the chosen indicators.
7. *Development of report formats* - devising layouts in which to report the indicators.
8. *Implementation* - start measuring and reporting indicators, and taking action on these.

Remembering the importance of good and timely communication, to obtain commitment from the people involved, Fred immediately dispatched an information memo, which described the project's goals.

**Phase 2. Strategy alignment**

The first activity of the activity plan was to describe H.I.'s strategic objectives. The information Fred used for this was the strategic business plan and the annual operating plans of the last two years.

Because during the last year the strategy had hardly been discussed, Fred also conducted several short interviews with the management team. From these, he gathered from the managers the latest viewpoints, regarding the strategic direction of H.I. Putting all the mentioned objectives in categories, Fred was able to condense these into one strategic objective per category.

He decided to put these strategic objectives to the test in a strategy alignment meeting with the management team. John Jones, CEO of H.I., opened the meeting as Fred had asked him to.
John explained to the group: *'Management reports are a major instrument in managing our company. One of the main purposes of these reports is to provide managers with feedback on the fulfillment of H.I.'s strategic objectives and the way in which critical business activities are performed'.*
To this Fred added: *'The reports should contain not only financial but also non-financial information and should be future and action oriented. In any way, the strategic objectives of H.I. are the starting point. Let's discuss the material I have prepared'.*

The management team discussed each of the strategic objectives, which Fred had put on the flip-over. The group concentrated on what each objective meant for the future direction of H.I. and whether or not it was in line with the SL/DE growth strategies. They finally wound up with four strategic objectives which they all fully understood and had reached consensus on:

1. Top Line Growth
2. Customer & End Consumer Focus
3. Cost Focus
4. Personnel Effectiveness

The first three were in line with the SL/DE growth strategies. The fourth was special to H.I. because they experienced last year increasing difficulties in attracting and retaining good quality personnel. The group decided to have a separate meeting to discuss one of the growth strategies, which was not currently covered by one of H.I.'s objectives.

**Phase 3. Development of strategic CSFs/KPIs**

A week later the group met again. Fred Data started the workshop with explaining the advantages of applying CSFs and KPIs in management reports:

*'Firstly, they translate strategic objectives into qualitative and quantifiable units throughout the entire organization and management structure. Secondly, they signal at an early stage, even before the results appear in financial reports, areas and business activities which may be heading for trouble. Thirdly, they provide a univocal and common ground for cross-departmental discussion within the company. Fourthly, they direct employees' behavior into the desired direction. And finally, they enable a company to improve its performance continuously.'*

*'Let's start with the first objective: Top Line Growth'*, Fred continued. '*We first have to decide what the result is of this objective. In other words: with which desired result do we end up if we were successful in fulfilling the objective?'*
*'Well, of course with sales growth'*, Brian Jones, COO of H.I., answered.
*'Excellent'*, Fred praises him. *'We call this a result-CSF. And what do we need to do to achieve this result?'*
*'There are so many things we can do, what do you mean exactly?'* Mick Fontaine asked.
*'I mean that we have to select the most critical efforts we put in to achieve the desired result. It is true that we can do many things but we, as a management team, cannot focus on everything. We need to focus on the most critical items'*, Fred replied.
John spoke up: *'It should be the number of new products we introduce every year, and this should be at least 20% of our product portfolio'.*
Fred formulated his answer carefully: *'I think you are on the right track, John. However, there are some quality criteria you should keep in mind. I think you already formulated a KPI, the unit of measurement.*

*Critical should be 'new products' which you can measure with more than one KPI'.*
*'Yes'*, Brian chipped in. *'Next to 'number of new products' we should also measure 'new product sales' to see if the new products were really successful. And we should also know the number of trade customers, which put the new products on the shelf: 'the customer listing''.*
*'Shouldn't then the effort-CSF be better formulated as 'successful new products''*, Mick asked.

On this, the complete group agreed.
*'Another thing you have to keep in mind'*, Fred resumed, *'Is that the target should not be formulated in either the CSF or KPI. Because the target can change every year it should be separate. Finally, I want to stress that you always have to keep track of the result. You might do all the things right, but if you did not do the right things you still do not fulfil the objective!'*

After four hours of brainstorming and discussion, the group had identified result- and effort-CSFs and KPI's for each objective. They also already formulated draft definitions and reporting frequencies for the KPIs. They parted with a satisfied feeling. After the workshop Fred Data went back to his office, where he worked out the flip-over sheets. He sent the results back to the management team for comments:

| **Strategic Objective** : Top Line Growth | | |
|---|---|---|
| **CSF** : Sales Growth (R) | | |
| **KPI** | **Definition** | **Freq** |
| NSV growth | Difference NSV this period vs. last period | month |
| Market share trend | Change in market share | quart. |
| Sales volume growth | Difference in SV this period vs. last period | month |
| **CSF** : Successful new products (I) | | |
| **KPI** | **Definition** | **Freq** |
| New products | Number of introduced products | quart. |
| New product sales | New product sales vs. total sales | month |
| Successful new products | Number of successful new products vs. total new products | year |
| Customer listing | Number of new product customer listings achieved vs. total new listings sought | quart. |

It was decided to first finish the remaining phases for the strategic CSFs/KPIs before starting phase 4 (development of functional & operational CSFs/KPIs).

**Phase 4. Prioritization of CSFs/KPIs**

The next activity was to make a selection of the CSFs/ KPIs, which best measured H.I.'s strategic objectives. For this, Fred asked each management team member to rate the CSFs/KPIs, developed during last week's workshop, on a scale of 1 (high) to 5 (low). Fred collected the average score per CSF and KPI in a table, which he sent to the management team as input for the meeting.

During the prioritization meeting, the managers discussed only those CSFs/KPIs with a score of 3 or 4. Indicators with a score of 2 or higher were accepted right away; those with scores less than 4 were rejected. They had to make sure that each objective was measured by at least one result-CSF and no more than two effort-CSFs. Also, the managers could chose a maximum of two KPIs per CSF.

If someone had a strong feeling about a particular indicator, he could try to convince the others that this indicator should be included. In this way, the management team was able to reach consensus on a manageable set of indicators. This set was going to be measured and reported during the first year.

## Phase 6. Development of CSF/KPI definitions

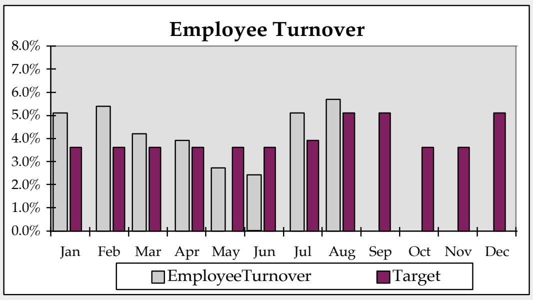
The prioritization meeting went very well. However, Fred knew the most time-consuming activity of the project still lay ahead: the development of detailed definitions for the prioritized KPIs. He also knew this was a very important activity. If good and accurate definitions were not developed, H.I. would never be able to obtain the sought after common ground for discussion and would not be able to accurately and efficiently measure the indicators with information systems. He decided to organize another one-day workshop in which the managers, in pairs of two, worked on KPIs assigned to them. For each KPI, they developed a detailed definition, a delivery procedure (the way in which to measure the KPI), a graph (the way in which to depict the KPI in the report), set a target, and assigned a person to be held accountable for the result of the KPI.
During the workshop, regular discussion took place among the group about the developed material. An argument erupted between Brian and Mick about the definition of 'employee'. Brain wanted to count only contractors while Mick had always thought temporary workers were also included. Fred settled the argument, and pointed out that the two men had in the past always interpreted the figures differently. This is a partial example of the definition document they made:

**Household Improvement definition Document**

**CSF:** Satisfied People
**KPI:** Employee Turnover

**KPI Def:** Number of contract terminations during a specific month versus the total number of employees at the end of that same month (excluded new hires)

| *Month* | *Total number terminations* | *Total number of employees* | *Employee Turnover* | *Target* |
|---|---|---|---|---|
| Jan | 30 | 557 | 5.3% | 3.5% |
| Feb | 30 | 540 | 5.5% | 3.5% |
| Mar | 22 | 543 | 4.0% | 3.5% |
| Apr | 21 | 552 | 3.8% | 3.5% |
| May | 15 | 562 | 2.6% | 3.5% |
| Jun | 13 | 556 | 2.3% | 3.5% |
| Jul | 28 | 548 | 5.1% | 4.0% |
| Aug | 31 | 530 | 5.8% | 5.0% |
| Sep | | | | 5.0% |
| Oct | | | | 3.5% |
| Nov | | | | 3.5% |
| Dec | | | | 5.0% |

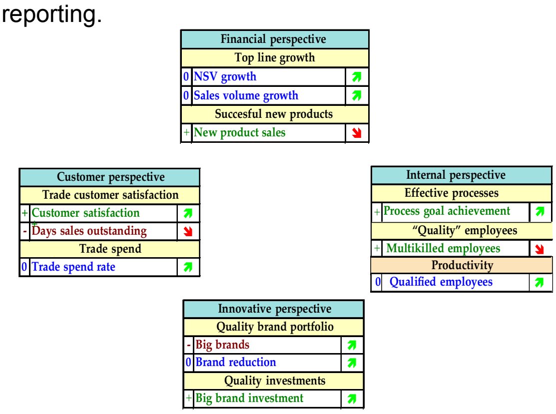



## Phase 7. Development of report formats

Three weeks later Fred Data presented the complete CSF/KPI definition document. He also showed the group examples of the layouts in which the indicators were going to be reported. The layout consisted of two parts:

- a CSF/KPI summary, giving a quick overview of the results, and
- an exception & action report, giving analysis and actions for KPIs with results below target.

The management team reacted enthusiastically and decided to use the same lay-out for its own internal reporting.




## Phase 8. Implementation

Fred asked Jennifer Lee, information manager of H.I., to review the current systems to see if they contained the information needed to calculate the KPIs. After a few days Jennifer came back with answers. Many KPIs could be measured with the current systems although some modification was needed in certain programs. The KPIs that had to do with personnel could be generated by the system of the Human Resource department. For the remaining KPIs, the management team had to decide if new systems were going to be implemented.

Now everything was ready to start using the new reports with CSFs and KPIs. The management team chose a full roll-out with a phased approach. First familiarize managers with the new reports (without projections and actions), and later incorporate projections and necessary actions. The management team also conducted an evaluation of the project, with the following results:

- The process provided a useful forum to indirectly revisit strategy for the business and reflect on whether modifications were required or not. The management team soon discovered it was an important building block to ensure strategy was up to date, understood and accepted by the entire team.

- The management team saw that it would give them

| | |
|---|---|
| ▪ The strategy alignment process gave them opportunity to ensure H.I. was focusing on things which corporate also felt were important, but also gave visibility to CSFs which were unique to H.I.'s local situation.<br>• The management team also saw this as a tool to achieve a more integrated business plan within H.I. and for managers/staff at all levels to see the linkages from mission all the way to action plans.<br>• When trying to establish CSFs it made the team think very hard about things that were truly vital (critical) to the success of the business. This would certainly help move businesses towards doing 'first things first'. | the ability to focus on a number of important non-financial performance measurements which in most cases were a measure of the quality of key processes.<br>• There was also a strong feeling that KPIs would achieve all the accepted benefits of 'what gets measured gets done'. |

*Figure 4.30: Example of a newsletter*

### 4.7.7 Stage 4: Quality check

During the roll-out of the CSF/KPI development project across the SL/DE divisions and business units, a CSF/KPI implementation team (CIT), consisting of SL/DE and Arthur Andersen Business Consulting consultants, was set up. This team supported the divisions and business units by answering functional questions and by reviewing and aligning the KPI definitions. This was done by collecting all the CSFs/KPIs developed by the business units, divisions, and the BoM. Then a consistency check of the indicator definitions was made; identical indicators needed to have identical definitions. The CIT subsequently gave feedback to the CFOs on the alignment check and, if necessary, proposed changes to certain KPI definitions. Initially, the CIT received well over 800 different KPIs. After the alignment and quality check, approximately 400 indicators remained. These indicators are now incorporated into the different long-term plans of the divisions and business units, which are sent to corporate headquarters. The CIT also collected information on the reporting capacity of current information systems of corporate headquarters, divisions, and business units to make sure that the developed indicators could indeed be measured, collected and reported.

Finally, the CIT made layouts for the CSFs/KPIs summary in the balanced scorecard format, and the exception/action report. These layouts and the final CSFs/KPIs sets were then approved by the BoM. From then on, the CSFs and KPIs from the business units were discussed during the barrel reviews.

### 4.7.8 Learning experiences

After a year of developing and using CSFs and KPIs, several interesting learning experiences were identified.

The train-the-trainer approach turned out to be a cost-effective method of disseminating the knowledge of developing CSFs, KPIs, and the balanced scorecard to a large group of people simultaneously. However, guarding the quality of the developed indicators as well as limiting their number proved rather difficult. Having business units develop their own measurements decentrally fits right in with the culture at SL/DE. This culture is driven by entrepreneurs, who first have to be convinced of the value of a new concept before committing to it. Trying to force a new concept on the business units from headquarters almost always fails due to lack of commitment. So using the train-the-trainer approach on the one hand meant a longer development project, but on the other hand led to greater acceptance of the new measurements. Still, it might have been better to manage the results of this project from the start centrally. The quality of the CSFs/KPIs would then not have differed so much over the business units and the number of developed indicators could have been limited right from the start.

During the long-range strategic planning sessions, the BoM initially did not pay very much attention to the new measurements incorporated into the strategic plans of the business units. This resulted in business unit management becoming disenchanted with the new measurements. The business units failed to realize that the CSFs and KPIs were not meant to be a control instrument for the BoM. Instead, they were intended as a steering mechanism for business unit management itself. SL/DE learned that visible support of the BoM is crucial for the successful use of the new measurements. Therefore, it was decided to start every quarterly performance review by the BoM of the divisions and business units with a discussion of the results on the performance indicators. This method drew better attention to the new measurements. It has also resulted in a stronger focus on strategic trends and developments of the business unit. Attention to strategy is no longer an annual exercise. The extent that the business units use the new measurements depends upon the interest and commitment of the board member responsible for the division. Eventually, in some divisions the indicators are again reported and reviewed monthly, in other divisions they are also reported monthly but less frequently (officially) discussed.

Another learning experience of the project is that it takes quite a long time to embed the concept of CSFs, KPIs, and the balanced scorecard in a multinational environment. Although the development process itself took less than a year, it required two complete planning cycles or two years to really get the business unit management teams and the BoM to start working with the new measurements. Also, the development project was executed in English, which sometimes turned out to be difficult for people from different backgrounds, nationalities, education levels and languages. A more regional approach with local examples in the local language might have helped.

An added advantage of introducing CSFs and KPIs turned out to be the warning signs that the divisions receive about the future profitability problems of a business unit. Business units could increase their operating margin by cutting back on advertising and promotion expenses. This is fairly easy to identify. However, delaying maintenance expenditures to raise profitability is easy to hide. These techniques are now much more visible with the non-financial indicators. Divisional management can react more swiftly and steer the business unit back to the right track. It can also better discuss with business unit management the long-term problems that are caused by going for short-term profit.

The BoM itself is better able to track whether SL/DE growth strategies are executed properly and successfully. Important indications in this respect, like "Branded share" and "New management recruits" are regularly reviewed and discussed by senior management.