The power of world-class performance management: use it!

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Introduction

In order to be successful, organizations need to become and stay world-class in everything they do. An organization needs to be able to anticipate on changing circumstances in its industry. It needs to have the right information at the right time to make the best decisions and take the best actions. It needs to know if strategic goals are going to be met and if it is able to satisfy the stakeholders of the organization. To become a world-class organization, a world-class performance management process is a must. Performance management can be defined as the process that enables an organization to deliver a predictable contribution to sustained value creation. A world-class performance management process consists of excellent strategy development, budgeting/target setting, performance measurement, performance review and incentive compensation sub-processes. These sub-processes are integrated in a simple way, to create the transparency of information needed to become and stay world-class. However, there is a growing conviction among managers that traditional performance management methods are flawed and insufficient for keeping competitive in today's technology driven information age. This article provides the framework necessary for developing a world-class performance management process. It is based on the practices of world-class corporations like Sara Lee, Emerson Electric, Philip Electronics, KLM Royal Dutch Airlines, NEC, and Xerox, who have all used techniques described in this article to improve their performance management process. The ideas described are based on a benchmark study performed by the author at these prominent, global companies.

The need for world class performance management

More and more it becomes clear that the quality of the performance management process enables companies to perform better. An increasing number of literature sources and case studies (Armstrong and Baron,1998; Schiemann and Lingle,1999) shows that companies who have implemented an excellent performance management process perform better, financially as well as non-financially, than those companies that are less performance management driven. It clearly pays of to install world-class performance management. However, an organization may expect to encounter barriers that need to be overcome on the road to world-class performance management. The benchmark results suggest an organization needs to deal with seven challenges, which are depicted in Exhibit 1.

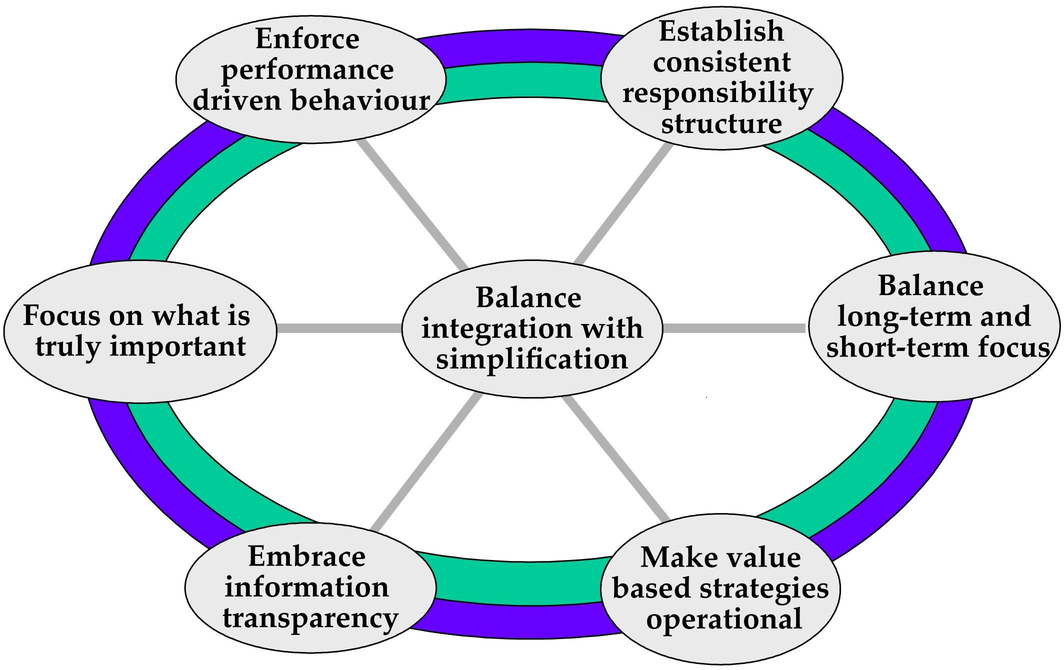

Exhibit 1: The seven performance management challenges

Challenge 1: Establish a consistent responsibility structure

Goldsmith and Clutterbuck (1997) found, in their research of the characteristics of high performing companies, several common factors: (a) clarity and consensus about the role and responsibility of corporate headquarters and business units, and (b) a balance between strategic and financial control, in which autonomy and enterpreneurship of lower levels is promoted. In this way senior management at corporate headquarters has more time for long term tasks such as strategy development and for coaching, and developing the next generation of managers they can trust. Trust in management requires consistent behavior, on all management levels. The roles and responsibilities of each management level must be crystal clear, and the chosen management style must be applied consistently throughout the organization and its the performance management process. The information requirements from management must be predictable, instead of causing a constant stream of ad-hoc information requests and regularly changing information requirements, as is customary in many organizations.

A clear management control model provides the structure for a consistent responsibility structure. This control model forces an organization to make choices about the roles and responsibilities of corporate headquarters, the divisions, and the business units. It also forces to determine how the performance management process has to function within the organization. To set-up the model, the three parenting styles as described by Goold et. al. (1994) can be used. These three styles differ in the extent in which corporate headquarters influences the strategic planning processes of lower levels in the organization and how corporate headquarters controls and manages these lower levels (Exhibit 2).

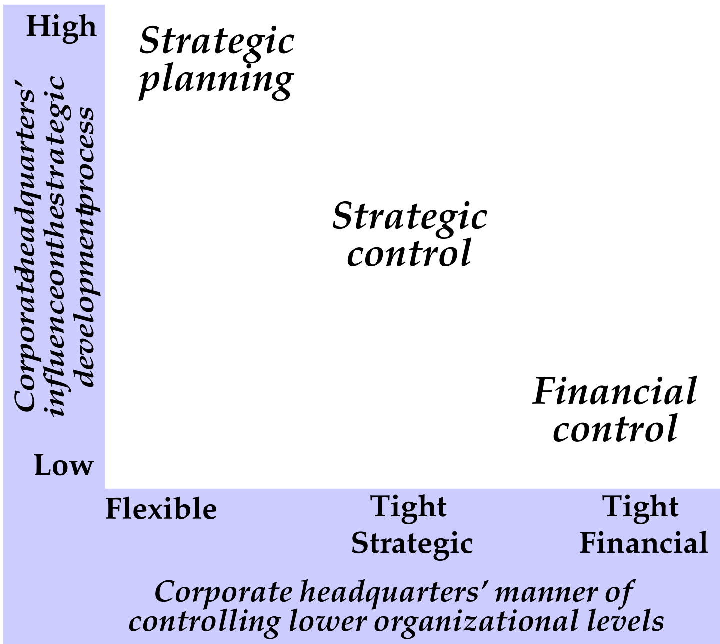

Exhibit 2: Influence of corporate headquarters on lower organizational levels, depending on the parenting style

With the *strategic planning* style, corporate headquarters plays an active part in the strategy development process of the divisions and business units. The planning process is heavy and time consuming. Because corporate headquarters is so close to the divisions and business units, it is at all times informed about their status. Therefore, the control focus lies mainly on achieving longer-term strategic objectives. Corporate headquarters will only officially react on large deviations of operational results, which makes the control process flexible, taking second stage to the planning process. With 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. Focus in the plans lies on defining both short and longer-term financial and non-financial objectives, which are regularly checked by corporate headquarters. With 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 in whether or not the divisions and business units achieve the financial targets as forecasted in their strategic plans. Corporate headquarters de facto manages a portfolio of businesses.

During the definition of a new management control model it is of the utmost importance that an organization chooses one parenting style, and applies this style consistently throughout the performance management process. Consistent application results in clarity about the roles and responsibilities that the different management levels in the organizations have, consistency in managing and controlling the various organizational levels, clear expectations about responsibilities, clarity about which strategic objectives should be achieved by whom, and consensus about when higher management levels can intervene in the management process of lower management levels. Consistency also requires that every management level sticks to the chosen and communicated style and structure: consistently 'walk the talk'!

Challenge 2: Balance the long-term and the short-term focus

Research (Redwood et.al., 1999; Drucker, 1999) indicates that organizations have difficulty in turning their strategic intent into activities that achieve strategic goals. Although they often have a good strategic plan in place, many companies are not able to articulate and communicate this plan effectively throughout the organization, and then translating it into short-term action plans. Thereby is the strategy development process too much focused on calculating future financial results in detail, instead of planning for value creation and looking at the effects of non-financial indicators on the business.
Long term plans have to be translated into realistic short-term actions. Long-term expectations should be more realistic, so that organizations deal with the 'hockey-stick' effect. This infamous effect causes organizations to make financial projections for future years that are unrealistically positive and do not have a real clear basis, therefore 'coming out of nowhere'. The increased focus on the future should also become apparent in the balance between non-financial indicators, which look to the future, and financial indicators, which look at the past.

Strategic plans often focus simultaneously on new growth opportunities (future) and on 'running business' improvement opportunities (now). However, strategic actions to achieve both types of opportunities are different in nature and require different time spans and resources. Often, it is difficult for managers to distance themselves from the day-to-day operations, causing the innovative part of the strategic plan to get short-changed. To allow an organization to better focus on each type of opportunity, the strategic planning process is split into two different processes that each addresses an opportunity separately (Exhibit 3).

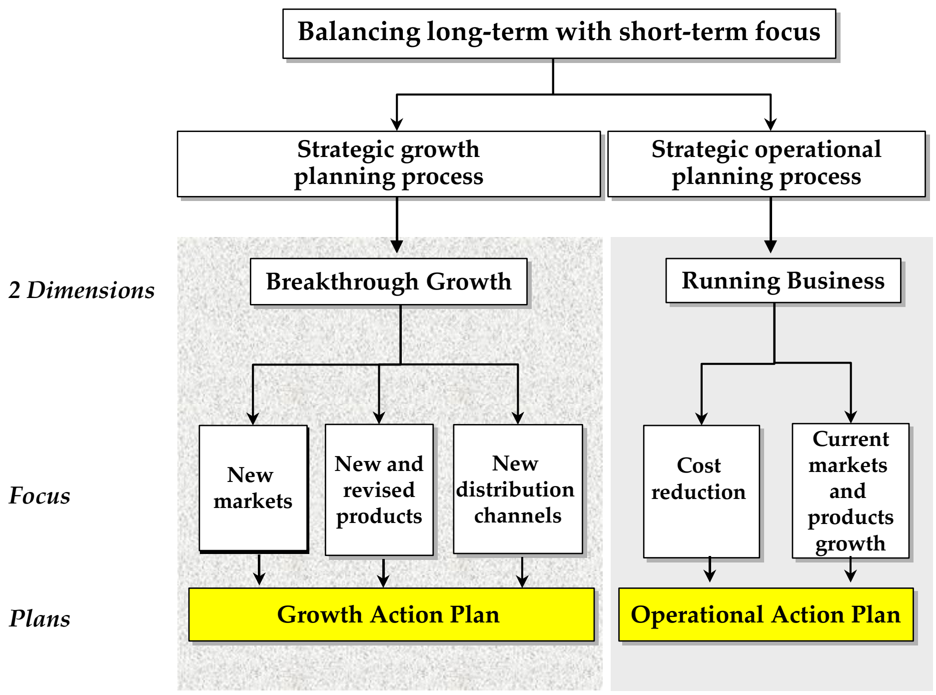

Exhibit 3: The split strategic development process

The *strategic growth planning* process is focused on actions that create breakthrough growth opportunities. The Growth Action Plan focuses on new markets, new distribution channels, and on new or revised products. The Growth Action Plan results in new sources of revenue for a organization in the next 1 to 5 years. The *strategic operational planning* process is focused on actions that improve running business, which are the current operations of an organization. The Operational Action Plan focuses on cost reductions and on sales growth with current products and current market channels. The Operational Action Plan leads to incremental improvement in the next 1 to 2 years. Splitting the strategic planning process in a profitability and a growth part entails two distinct separate processes, a different timing of the plans, involvement of different people (mainly manufacturing in the profitability part vs. mainly marketing & sales people in the growth part), and results in two distinct strategic action plans.

A split in strategic attention for improvement of the running business and for strategic growth opportunities has the benefit that the split forces management to focus more on each of the aspects of strategic planning, thus enhancing the content of these plans. Management has to think 'out-of-the-box' to look for new growth opportunities, and subsequently has to clearly articulate strategic actions solely aimed at achieving these opportunities. Underlying the split lies the requirement for an action-oriented attitude. Focus is no longer on the accuracy of the numbers in neither the strategic plan nor the forecast, nor even in the budget. Focus lies on how an organization is going to achieve the projected targets on key value drivers. This requires an attitude shift from being a 'bean counter' to being an action taker.

Challenge 3: Make value-based strategies operational

In today's 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. To effectively monitor these new sources of value, organizations have to move to more value-based, non-financial, leading indicators. However, current performance management processes are still mainly focussed on financial, lagging indicators, and organizations do not seem to be action-oriented enough. Two recent trends that address this challenge are the concepts of the *balanced scorecard* and *value-based management*. In the balanced scorecard, non-financial, leading indicators (CSFs and KPIs) are combined with financial, lagging indicators, to get a balanced overview of the organization's performance. In value-based management (VBM), an organization looks at long-term value creation, instead of looking at short-term profit maximization. In recent years both concepts have become increasingly popular (Pfeffer and Sutton, 2000; Oliver, 2000). However, many organizations find it a challenge to turn these valuable concepts into concrete techniques which can be used at all management levels.

In this article the balanced scorecard is not further described as undoubtedly the readers are already sufficiently familiar with this concept. [1] Managing an organization on the basis of value, or potential for cash generation, is known as VBM. What counts in VBM is no longer periodical profit in terms of accounting, but value created. The key performance indicator used is EVA[2], or 'economic value added'. EVA is calculated by reducing NOPAT (Net Operational Profit After Taxes) with the amount of the capital costs. 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.

The introduction of the concept 'economic value' 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 whether investments should better be done elsewhere. VBM concepts can be used to steer changes in behavior and to focus change management. The challenge now is trying to link VBM metrics to strategic and operational value drivers (Exhibit 4). This will make VBM more than just the implementation of a new financial measure, it will then be used to relate strategy with operations at all levels of the organization.

[1] For further reading, consult the books of Kaplan en Norton, the inventors of the balanced scorecard (Kaplan en Norton, 1996 en 2000).

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

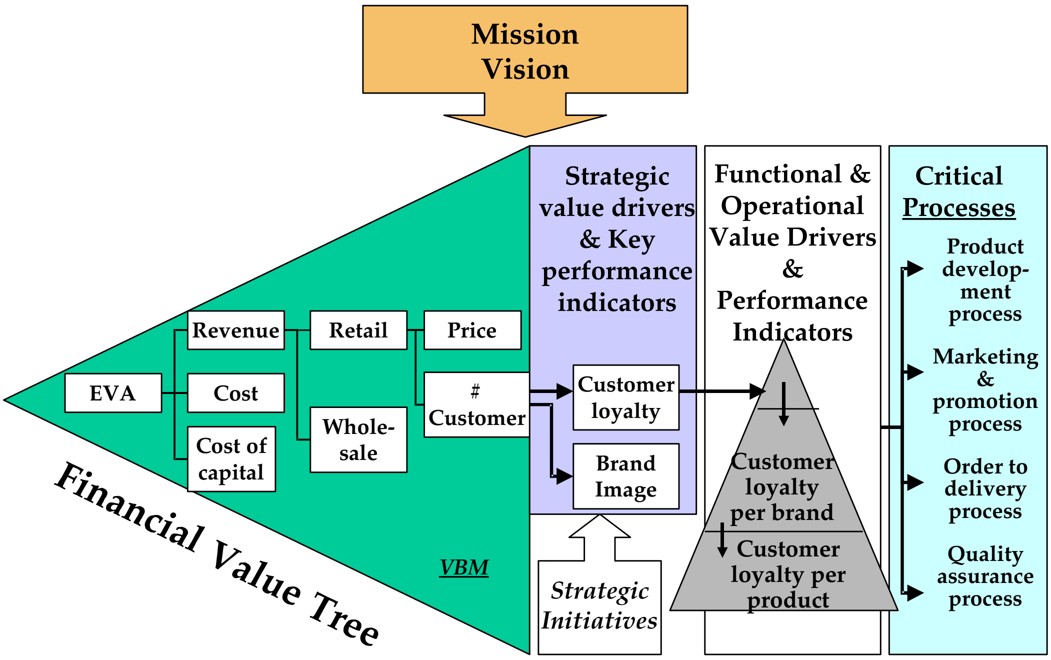

Exhibit 4: Linking VBM with CSFs and KPIs

Based on its vision and mission, the organization builds a *financial value tree* that encompasses the key financial value drivers of the organization (in Exhibit 4). 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 (   ). The financial value tree has now been further extended to include non-financial value drivers, which are linked to the financial value drivers as much as possible. The strategic value drivers and performance indicators are then translated for the lower organizational levels (   ). 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 (   ). The strategic, functional and operational value drivers and performance indicators (both financial and non-financial) measure the key value creation processes of the organization and all its processes.

A focus on value creation increases the overall value creation ability of an organization. This is because everyone in the organization 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. Value-based management is the 'glue' that binds financial objectives, strategic plans and operational performance together into an integrated framework focused on value creation. 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.

Challenge 4: Embrace information transparency

Making information transparent means that everybody in the organization can see the information they need and are entitled to, when they want, in the format that best suits them. In this way, everybody is at all times informed about the status and developments of the organization. Thus everybody can react fast and efficiently on warning signals. To obtain this, the effort it takes to collect, report, process and digest information has to be reduced. An organization has to strive for efficient data collection and reporting processes. This entails fast collection of data from different sources and the ability to efficiently generate reports, containing relevant information compiled from that data. This means sufficient information technology (IT) support is needed for reporting, measurement and analysis. IT support plays a crucial role in enabling users to easily access information on a 'when needed' basis. Information transparency can be accomplished through the use of one centralized, corporate data warehouse, which collects and stores management information from all organizational levels. However, one central warehouse is often not considered to be a cost-effective and viable option for large, global companies. The main reason is the significant effort needed to obtain the high level of data standardization and commonality that is required to establish and maintain such a warehouse.

Consequently, each management level has to find a balance between the information collected and stored structurally and regularly on its own level (the so-called 'information push'), and the information that has to be available on lower management levels and which can accessed on an ad-hoc basis by higher management levels (the so-called 'information pull'). This entails a minimum of information goes automatically to the top of the corporation, and at the same time more detailed information is made retrievable at lower levels for the top level to get it themselves if they want to (Exhibit 5).

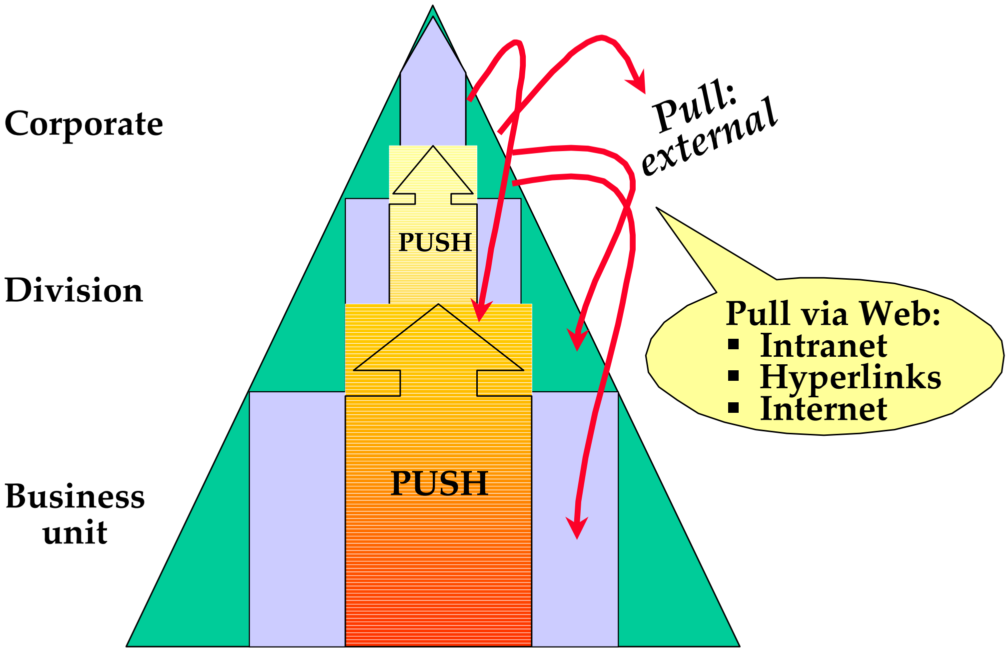

Exhibit 5: Information push en pull

Each management level determines its own set of standardized management information: data (f.e. key financial ratios) that this level wants to receive from all lower levels that report to this level. This date can be different for each level (in Exhibit 5). The remainder of the management information is not standardized. This means the lower level organizational units can define information items that are specific to them. Examples are adding specific accounts to the standardized chart of accounts, to be able to capture extra, unit specific information (   ). Each management level requests from lower management levels a certain amount of data and information that is needed on a regular basis. This data is common for all these lower levels and is pushed upwards. The higher the management level, the less information is needed. The information is collected and consolidated in an efficient and timely manner. This is possible when strict agreements have been made concerning the data items to be pushed upward and the data definitions that have to be standardized across the organizations for these specific data items. Precondition for this is a standard chart of accounts, which should not have too many accounts (   ). Each management level is able to access, on its own and on an ad-hoc basis, management information as well as non-standard data from lower level organizational units. This information is pulled out of the local systems, which reside at these lower levels (   ).

Information transparency is obtained by storing 'pushed' information in a data warehouse, maintained at the management level that collects the information. Business intelligence tools (e.g. Executive Information Systems) allow user-friendly drill-down and 'slice & dice' capabilities on the data in the warehouse, thus allowing information to be viewed and analyzed from different perspectives. Management information is made transparently available via the Intranet. A standard web browser provides access to management information at each organizational level, by providing access to standard homepages containing periodic management information such as balanced scorecards, financial (traffic light) reporting, forecasts, analysis, action reporting and strategic plans. These homepages can be standardized across the organization to create a common, consistent and thereby user-friendly view of periodic management information. 'Hyperlinks' can be added to the homepages. These provide links to other web pages on the Intranet and Internet, thereby connecting related data and enhancing the overall value of the information.

When information transparency is obtained, time is created for added-value activities. Because it will take users less time to hunt for and collect needed data, managers have more time to actually process the information and to take action. A mindset which is able to deal with information transparency is needed. Managers have to be able to deal with 'management by exception': they will get less information (both in volume and in detail level) automatically delivered to them. And they need to find additional information *only* when this is needed to do their job. Managers also need to acquire the skills to be able to manage by surfing around on their Intranet and on the Internet.

Challenge 5: Focus on what is truly important

Management today is dealing with many different information needs. The traditional way of dealing with these needs was by adding new information to the old stack. This resulted in reports getting more voluminous, many reports still being delivered on paper, and information systems that did not yet comply to the new information needs. However, it is a challenge to not try to know every detail. The art of management is not to know everything that is happening in a organization, but to know what the key issues of the business are. The trick is to focus on critical business issues, on key value drivers that are crucial to the business, on exceptional events or figures, on analyzing financial and non-financial results, and take action on these. Reports should function as an enabler for action-taking.

One way of doing this is by using contingencies in the budgeting process. Because budgets are a 'snapshot in time', management can never fully guarantee that budgets will be achieved exactly as planned. Contingencies can be defined (① in Exhibit 6), that constitute performance ranges representing acceptable deviations from the budget. Only if business performance is outside the agreed contingency area will corporate or divisions intervene and take on a more active (coaching) role, conducting more frequent performance reviews and requiring more detailed reporting.

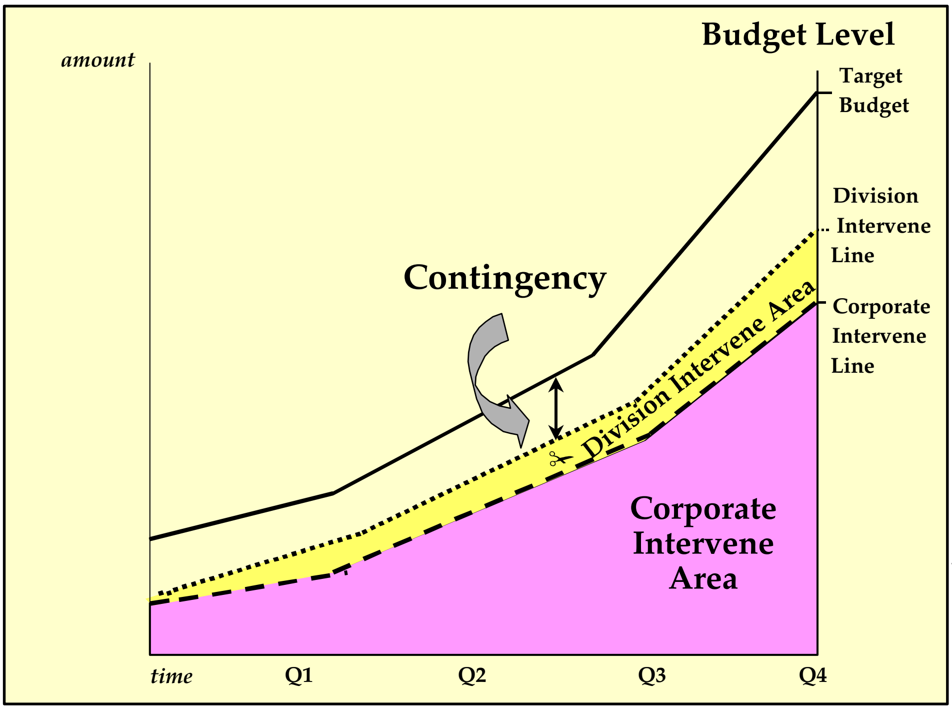

Exhibit 6: The budget, set out over the year, with the contingency area and the two intervene areas

In order to implement this type of 'management by exception', target budgets are agreed at the business unit level for a limited set of key performance indicators and contingencies are set between each unit and corporate headquarters, as well as between the unit and the division. The contingencies are based on sensitivity analyses performed during the strategy development process. Management reports include traffic lights that visualize if actual or forecasted performances on the key financial indicators need divisional intervention (f.i. by using yellow to indicate the results are in the division intervene area, in Exhibit 6), or corporate headquarters intervention (f.i. by using red to indicate the results are in the corporate intervene area,). Performance reviews take place on an exception basis, as corporate headquarters or division management only intervenes if performance is outside the contingency areas.

Using budget contingencies means the budget setting process will take less time because it is performed only with key financials, and because there are clear targets and contingency areas with which lower levels can work. Defining the contingency areas requires business unit management to know its industry and market very well. Discussions about the achievability of the budget are held only during the budget setting process and no longer during the year. There is no need to talk about or renegotiate the budget every time changes occur, because the boundaries between which the business unit can operate are clear.
Because contingency areas have been defined, the absolute accuracy of the forecast is no longer relevant. Control is no longer aimed at the forecast accuracy, but at drafting preventive actions aimed at obtaining the budget. These preventive actions are based on a rigorous analysis of cause-and-effect relationships, thereby increasing the knowledge of managers about their business.
An important behavioral implication is that managers have to learn to deal with 'uncertainty' because they receive less details. This can create an uncomfortable feeling, because they feel they do not known everything and therefore are not fully in control. However, learning to deal with this feeling will enable managers to focus on the 'big picture'.

Challenge 6: Enforce performance-driven behavior

For an organization to thrive, managers must be able to get things done, to deliver on commitments, to follow up on critical assignments and to support and hold people accountable to their promises. Managers need to replace passive *performance measurement* with pro-active, results-oriented *performance management*. In order to create performance-driven behavior: (a) the objectives of all management levels have to be aligned with the mission and strategy of the organization; (b) these objectives are translated into clear expectations regarding the performance of employees; (c) employees know how to fulfill the expectations and they know what kind of support they can expect from management; and (d) the set of human resource instruments (performance review, incentives, training, and development) is attuned to the realization of the organization's objectives. Then, people should act on what was agreed. Management should set the right example by 'walking the talk', consistently delivering on what was promised. This walk-the-talk culture should be focused on actions and follow-up on these actions: did they deliver the results expected from them. For this, management has to give employees not only the responsibilities and the tools to achieve agreed upon results, but also the freedom to achieve these results in the manner they see fit. These requirements can be put in the so-called Performance Alignment Model (Exhibit 7).

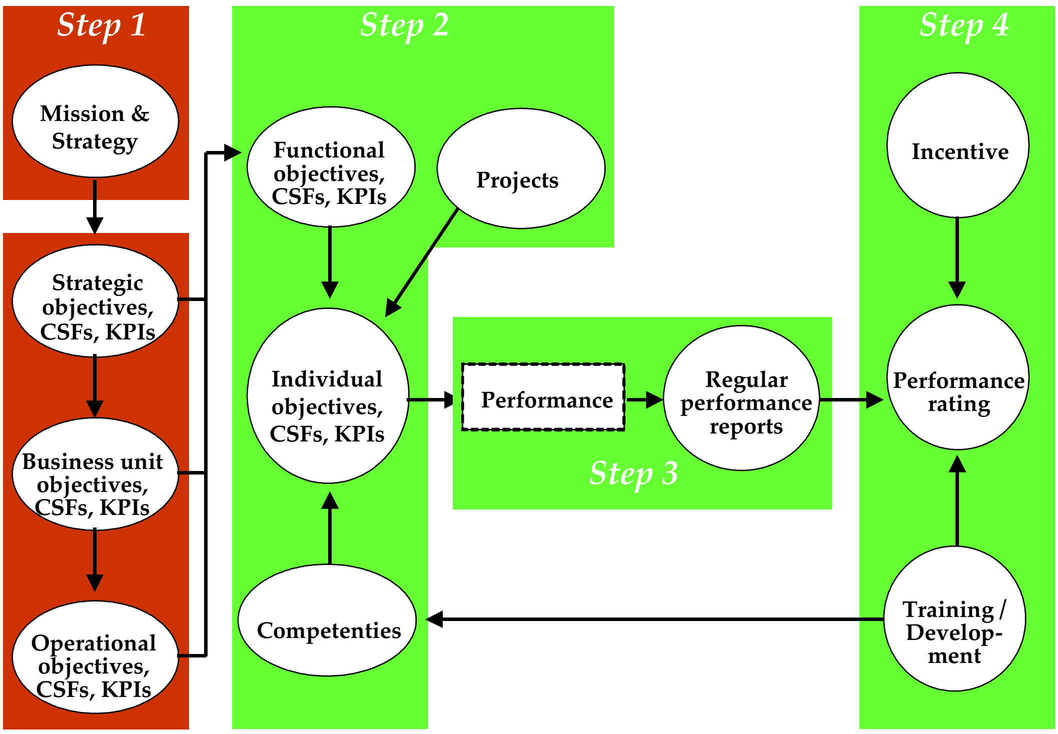

Exhibit 7: The steps in the performance alignment model, needed to develop individual measurements

Starting point are the mission and strategic objectives of the organization. These are formulated by answering the questions: 'What does the organization want to achieve?' and 'How does the organization want to achieve this?' (in Exhibit 7). In order to make the strategy as tangible as possible, concrete strategic objectives are formulated, which are measured with strategic critical success factors (CSFs) and strategic key performance indicators (KPIs). A business unit can support the execution of the strategy by translating the strategic objectives in objectives for the unit, and then working towards achieving these business unit objectives. How successful the business unit is with this, is measured by unit CSFs and KPIs, which are specific for each business unit (   ). Finally, the operational objectives are identified, based on the crucial activities of the business unit. A crucial activity is a business activity which the organization, no matter which mission and strategy have been chosen, always has to perform well in order to survive and thrive. The achievement of the operational objectives is measured by operational CSFs and operational KPIs.

Functional objectives for the various positions are set. These functional objectives are in fact the requirements that an organization places on a certain position, so that it adds value to the organization. The functional objectives are translated in functional CSFs and functional KPIs (   ). For every functional objective, the competencies are identified which the individual needs in order to achieve that objective successful. 'Success' means that the average target set for the functional KPI is achieved. The competencies are expressed in the knowledge and skills a person has (   ). Often, an employee participates in ad-hoc, special projects. Therefore, project objectives also exist. For this type of objective average targets and needed competencies are identified (   ). Functional and project objectives become individual objectives, after individual targets have been set for the person in question (   ). When setting these targets, the competencies the person currently has are taken into account. For instance, when the employee has just started in this function, the target will probably be set lower than average, to give the employee time to adjust and settle in. If the employee is very experienced, with many working years in this or in similar functions, the individual target may be set higher than the average target for this function.

After the individual objectives and targets have been defined, the employee can start working at achieving these. Through regular, periodic performance reports the employee gets feedback whether the achievement of the individual objectives is still on track (   ). If performance is slacking, the employee can define, together with the superior, corrective actions.

During an annual review, the performance of the employee is officially discussed (   ). On the basis of this review, an adjustment of the salary and bonus can be made (   ). The amount of adjustment depends on the incentive structure of the organization. Also, during the review, the individual objectives and targets for next year are discussed and agreed upon by the manager and the employee. The formal review gives important input for the development plan, which is made for every employee (   ). This plan includes activities to improve the knowledge and skills of the individual, to improve performance in the current function or to prepare the individual for the next function.

The chance of actually achieving the objectives of the organization are considerable improved by using the performance alignment model, because the objectives of all management levels are aligned with each other, so all employees know what is important for the organization and what is expected from them. The assessment and reward criteria are related with the strategic objectives of the organization, which causes these human resource tools to directly support the achievement of the strategy.

A new mindset of management is required to make performance alignment possible. This style entails letting go of strict control measurements and guidelines, and trusting the ability of lower management levels and employees to achieve their targets. It also entails trusting the information one receives from lower levels.

Challenge 7: Balance integration with simplification

In many organizations there is a tendency to make the performance management process too complicated: the long term focus has to be balanced with the short-term, financial information has to be supplemented with non-financial information, strategy has to be linked with operations, individual objectives have to be aligned with organizational objectives, and a clear parenting style and structure have to be defined. It is not easy to devise a clear, simple, practical and concise performance management process that works. But it can be done, using many of the ideas described (Exhibit 8).

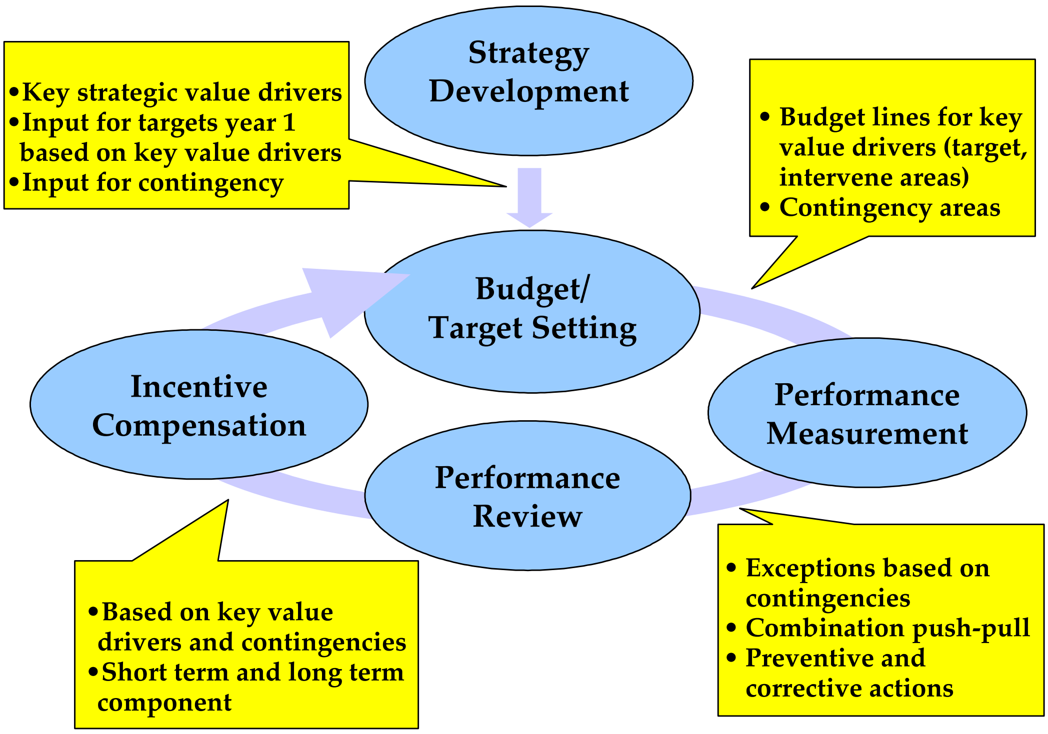

Exhibit 8: The integrated performance management process

The key concept is that a limited number of key strategic value drivers provide the link between the stages in the performance management process. These key value drivers, which include lagging financial and leading non-financial value drivers, are identified during the strategy development process as being the most important, critical items on which the organization has to focus to achieve success and create value. The strategic action plans are centered around these key value drivers.
For each key value driver, targets are set for all the years in the strategic horizon. The financial budget is made only for the limited number of key financial drivers. A complete, detailed budget is not needed. The financial targets for year one of the strategic plan make up the budget for the coming year (in Exhibit 8). For each key value driver the contingency areas are defined, based on the sensitivity analysis made during the strategy development process. With the targets and the contingency areas, the budget lines and intervene areas can be constructed. Contingency areas only need to be established for the key value drivers. The lines and areas determine what kind of information has to be reported when and to whom ( ). Management only needs information about results and forecasts for the key value drivers, and can, therefore, strictly focus on exceptional results (positive or negative). When the results wind up in one of the intervene areas, exception reports are delivered to higher management levels (push). These management levels can obtain, if needed, additional information by surfing around on the management web (pull). Corrective and preventive actions are formulated for the exceptions ( ). Managers are rewarded on the results they obtained for the key value drivers. They are evaluated on the short term (lagging financial) and long term (leading non-financial) components of organizational performance. The deviation of the actual results versus the targets on the budget lines stipulates the amount of bonus and compensation ( ).

There are developments which take the integration and simplification of the performance management process even further. An important one is abandoning the traditional budgeting process which is considered too detailed, only financial, setting boundaries on performance, and always outdated. In the contact of this article it goes to far how this can be achieved; I refer you to the articles of Hope and Fraser (1999) or to my book *Power of Performance Management* where you can find more details.

Implementing world-class performance management

It is obvious that implementing the ideas to improve the performance management process is not done overnight. It is a gradual process in which managers, who are often reluctant to change, need to be convinced of the merits of the ideas and of the new process. Fortunately, during the global benchmark, several guidelines were found that can help your organization.

- *Make sure your organization understands the objective of the improvement project.* Before starting the project ask yourself: Are improvements necessary? What do we want to accomplish? Who have to partake in it? How much time and money is it going to cost? Is it the right time to start the project? Decide which improvement initiatives will be implemented first, and the order of implementation.
- *Evaluate the performance improvement potential.* Map the expectations of senior management in regard to the desired performance improvements, and compare these with the performance improvement potential of the organization and its business units. At the same time, map the organization's key value drivers. Also map the willingness of senior management to act as sponsor of the improvement project and their willingness to be actively involved in the project.
- *Determine improvement targets.* Determine the targets and reasonable expectations for the improvement project, given the organization's current situation and its improvement potential. Agree on these targets. Determine the gap between the current and the desired performance levels, and discuss the time and resources required to bridge this gap. Set the starting date and the end date of the improvement project.
- *Set up a strong project organization.* Appoint project managers and establish cross-functional teams. Provide these with connections to the electronic network, for swift information exchange. Make detailed action plans. Determine relevant KPIs, timing, and milestones of the project, and identify required information systems. Determine the when, how and who for the evaluation of the improvement project results.

With the ideas described in this article and the implementation guidelines it should be well feasible to develop and implement a world class performance management process in your organization. Such a process is an unbelievable strong weapon against the competition: use it!

This article is a summary of the book* Power of Performance Management, how leading companies create sustained value *(John Wiley & Sons, 2001)