EVALUATING FIRM PERFORMANCE : WHY FIRMS NEED TO REENGINEER THEIR PERFORMANCE MEASUREMENT SYSTEMS ?

Rickie MOORE
E.M.**LYON**
Department of Management and Strategy
23, avenue Guy de Collongue
B.P. 174
69132 ECULLY, Cedex
FRANCE

Tel : +33 4 78 33 77 54
Fax : + 33 4 78 33 79 27
Email : moore@em-lyon.com

Abstract :

One major preoccupation for just about every CEO is the appreciation of their firm's performance. In an increasingly hypercompetitive business environment, reinforced by the exigent demands and constraints of the firm's environment and the various mechanisms of the market, firms dedicate significantly resources more in cultivating the external appreciation of their performance than internally. Logically, information and data on the different indicators and creators of firm performance should thus be of critical importance to executives.

Unfortunately, because of this emphasis, firm performance measuring and reporting systems tend to be biased and can even be considered as dysfunctional. This paper argues that executives and managers need to reevaluate and to reengineer their performance measurement system to make it more pertinent so that it would serve as an effective trigger as well as a critical piloting and control mechanism for effecting strategic management intervention.

Keywords : ***Firm Performance, Performance Measurement, Performance Management***

Firm Performance

An attempt to comprehend the concept of the performance of a firm reveals a number of interesting paradoxes. The notion of firm performance is complex and eclectic in nature yet is most often reported in an 'abridged' consolidated index – financial ratios and results. Much of the corporate world bases its performance evaluation on measures such as the Economic Value Added (EVA), Earnings Before Income Taxes (EBIT), Market Share, Sales Performance, etc. But what do these numbers really say about the firm's overall performance ? What interpretation can be made about a firm based on its reported earnings per share (EPS) ? The differences in accounting practices lead to another problem concerning the financial performance of a firm – it's bottom line can be enhanced by creatively designing the contents of the P&L statement (Bittlestone, 1998). In addition, a balance sheet and a consolidated profit and loss statement are static and historical snapshots of the firm's finances at a given moment in time, and the current reality can in fact be extremely dramatic. And what about the immediate future of the firm ? There are numerous examples of firms that report 'excellent' numbers one year and then encounter great difficulty the following year. The normative reaction to consider the firm's financial performance as the firm's overall performance is at best, misleading and does not provide any indication of the threats to the firm.

While it's a widely recognized and accepted fact that the basis of any superior financial performance is the result of the combination of a number of other performances – technological, social, environmental, organizational, behavioral, etc., indicators and measures of these other performances are either brushed over (considered uninteresting) or unreported. A review of current CEO's incentive schemes clearly demonstrates that CEOs are rewarded for superior stock performance, increased market share, decreased operating costs, etc. – in short, increased financial value for the owners and stockholders (reinforced short termism) as opposed to an increase in human performance. Investment stakeholders such as Wall Street and the Stock Exchange promote short termism and narrow sightedness as they pressure company executives to center their attention on generating impressive quarterly results without necessarily worrying about the long term. Yet when crises occur, these very stakeholders criticize the executives for a lack of vision and strategy.

Much of the dialogue among business leaders concentrates on the end results and less on the processes of value creation (performance of the different segments and stages in the value creation chain). A key focal point of many corporate strategies is the reduction of costs to increase profits, however the end result is much less automatic than it can appear. In many instances, the actual cost of reducing costs can be much greater than the intended profit returns. Nevertheless, both the business and market environments encourage firms to cut costs at just about almost any price. (CEO's are rewarded when they downsize, but the evaluation of impact of the layoffs nor the costs and consequences of refocusing or redesigning the business are not part of the equation because the objective – need for an immediate boost in profits (shot in the arm), was achieved).

In recognizing the limitations of the concept of firm performance, many theorists and practitioners have sought to redefine it and to develop appropriate tools and methods which offer clarity and attempt to streamline the concept. Todate, a number of initiatives have been launched and tried in seeking to address this problem ; *Total Quality Management* – championed by Deming and others quickly spread in the 1980s to become a major hallmark of management, *Activity Based Costing* – where costs were tracked relative to a process and not as a consolidated or global sum, a concept called the B*alanced Scorecard* (Kaplan and Norton, 1996), that supplemented traditional financial measures with criteria that measured performance from three additional perspectives – those of customers, internal business processes and learning and growth, and which became widely adopted by many firms and organizations in the mid and late 1990s. etc.. Despite all these contributions to the development of theory and practice of performance measurement and management, there is still much to be achieved in streamlining the concept and developing more appropriate methods and practices. Respected thinkers in the field of management (Gharajahedi, Lawler et al, 1998) continue to make the argument for developing a systems view of firm performance and therefore integrating the different components – quality of work life, management practices, etc., into the concept thus creating a 'whole' concept.

Complexity and Control Information

Firms today can be compared to many devices which dominate our world – they range from the relatively simple to the highly sophisticated ones which require a great deal of control information. Even though many traditional firms tend to hang on to their initial ways of being and doing, current market forces create increasingly competitive environments that result in more complexity for all concerned. As a result, firms that fail to adapt to the new context risk loosing their market share, their competitive advantage, etc., and their existence eventually becomes threatened.

One can hardly imagine the driver of a Formula 1 racing car using the same instrument panel as that of a regular automobile, or the pilot of the Concorde using the same set of flight instruments as that of a light Cessna aircraft, even if they perform the same function. In these contexts, operators of the different devices need the data and information that will enable them to safely operate the device and assure its performance. As the degree of sophistication of the device increases, the need to monitor the multidimensional determinants and causes of its overall performance also increases. This information need has evolved beyond both endogenous and exogenous data, to include the outcomes and consequences of their interactions and combinations. In addition, many companies have operational and management information control systems that fail to integrate strategic development and strategy implementation.

Performance Measurement Systems

A study of the performance measurement system of a number of firms conducted through a survey of 169 executives and operational managers of firms in two highly developed states the USA – Georgia and California, confirmed that still today, in spite of all the debate, theory and progress that has been made, many performance measuring systems are either not aligned with the context of the firms, underdeveloped, track irrelevant data or fail to have a formalized process for monitoring key data and evaluating its elements, are redundant, are inappropriately used, are results based, do not integrate process measurement, and fail to facilitate effective strategic management intervention, etc. This alarming situation causes us to wonder how are corporate decisions make, on what basis, with what information – is it reliable or not ? Are executives enabled through their performance measurement systems to comprehensively anticipate problems, to strategically pilot and control the firms, and are they able to effect timely interventions to ensure the firm's performance ? Effective decision – making is as much a function of the capability and capacity of the decision-maker as it is of the quality of the information provided – thus the system of information.

Apart from the 'hard' production and financial control measures of a firm's operations, measures of the other performances fail to be integrated into the firm's performance measurement system and are often underemphasized in the exploitation of the information.

While many executives are increasingly conscious of the fact that non-financial data is perhaps as equal to and some times more important than the financial ones, they have great difficulty identifying appropriate indicators and measures of the data. For some firms, the situation is even worse – managers are unable to interpret the information provided by the measurement system, or some managers are unable to use the system as a means for piloting their operations.

As firms benchmark and compare their performance to that of their peers, their desire to be part of the pack can adversely and directly influence the performance measurement, performance management and performance development initiatives implemented with the firm. Sometimes the impact can be devastating and firms end up being worse of than their peers. An inappropriate measurement system is a much greater cost to the firm than is often imagined. Lack of pertinence and coherence leads to goal substitution and goal displacement, creates corporate blunders and facilitates strategic miscalculation and erroneous decision making.

Reengineering the Performance Measurement System

The performance measurement system of a firm is an integral part of its 'lifeline'. Slater et al (1997), provide the basis on which the system is part of the critical linkage between strategy execution and strategy adjustment. It is through measurement that corrective measures can be taken to ensure performance. And because the performance of the firm is a comprehensive result, its measurement and evaluation system should be equally comprehensive and multidimensional to achieve alignment and coherence with the notion of its performance.

It is clear that conventional accounting measures are inadequate and insufficient for appropriately and pertinently measuring a firm's performance in today's environment. New aspects and elements of firm performance have made their way onto the boardroom table and managers' desks. Rightly argued by Kaplan and Norton (1996), *"as companies around the world transform themselves for competition based on information, their ability to exploit intangible assets has become far more decisive than their ability to invest in and manage physical assets*. According to the Institute of Management Accountants (1996), Sarah Mavrinac from Ernst &Young's Center for Business Innovation reported from a study of institutional investors that "analysts that focused on nonfinancial issues have increased accuracy in their earnings estimates and strong correlation with growth expectations".

Hurd (1998) wrote that performance measurement systems look backward to capture data on what has happened and they neglect to measure the factors that drive profitable growth. He further argues that for high technology firms where everything changes so quickly, performance measurement systems need to be forward looking so as to avoid being in a situation where it's too late to respond.

In developing an implementing an effective performance measurement system, a number of questions have to be asked – what to be measured, when, why, how, with what indicators, What are the links between the various measures, what problems or issues will be created, what costs are involved ? Albert Einstein is noted for saying that *"not everything that counts can be counted, and not everything that can be counted counts"*.

An effective and pertinent performance measurement system focuses the business on both those factors that are required and are relevant to compete successfully while developing its potential and capacity for the future. An appropriate performance measurement system identifies the drivers of the firms' performance and integrates process measures. It links key indicators to defined objectives. According to Rivers (1999), it would be a major disillusion to contemplate that customers purchase a firm's products because of its return on investment (ROI) or it's return on capital employed (ROCE).

An intervention on the performance measurement system alone is not sufficient to bring about superior firm performance. Executives should not however, transfer their responsibility to the performance measurement system. While the system will provide useful information, executives still need to analyze and evaluate the data for decision-making. Even though a robust performance measurement system does not translate into superior economic performance, it can serve as an early-warning device and help to pinpoint where corrective action is needed.

Theurer (1998) argues that for performance measures to be effective they must benefit from a clear commitment from the leaders of the firm, employees must have the capacity to develop measures and that the measures should not be used as a source of punishment which supports negative accountability.

A common saying in the domain of performance measurement is – "*what gets measured can be managed and what's managed can be improved*". However, we need to be guarded against an over obsession with measurement. The performance measurement and evaluation system should also be formalized to promote rigor and to allow for point-of-contact self or auto adjustment. Such a system reduces the remote and removed intervention of distant management which can create or amplify a bad situation through lack of thorough knowledge, information and understanding of the relevant process, its interactions, interdependencies and outcomes.

Once defined and implemented, revisiting and modifying the system is often an exercise in overcoming resistance especially if the system has 'proven' itself in the past. But it is necessary to review the system not only because the market environment of the firm has evolved but also because work methods, technology, competence portfolio, etc. have evolved. Failure to realign the firm and its measurement system translates into increased costs and untapped potential – the very aspects of the firm that are so critical to its survival. Failure to realign could then be considered aligning for failure.

Bibliography

DALY, Dennis C., 1996. Performance Measurement and Management, in Management Accounting, September 1996, New York.

KAPLAN, Robert S. and NORTON, David P. 1996. Using the Balances Scorecard as a Strategic Management System in Harvard Business Review, January-February 1996.

HURD, Johnathan. 1998. Tracking Tomorrow's Profits with Performance Measurement Systems, Mass High Tech, Jul 27-Aug 2.

THEURER, Jim. 1998. Seven Pitfalls to Avoid When Establishing Performance Measures in Public Management, July 1998, Washington.

BITTLESTONE, Robert. 1998. Measure Cause not Effect in Management Today, June 1998, London.

RIVERS, David, L. 1999. Proactive Performance Measures in Hospital Material Management Quarterly, Vol. 20(4), p. 60-68.

LAWLER, Edward, E. et al. 1998. Strategies For High Performance Organizations : Employee Involvement, TQM, and Reengineering Programs in Fortune 1000 corporations– The CEO Report, Jossey-Bass, San Francisco.