

Purpose Driven Performance

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In recent years, academics and management consultants have argued the merit of the strategic management plan that is based upon the intelligent use of company performance data. New technologies have evolved to support the growing need for data that supports intelligent management decision making. Corporate performance management systems clearly provide a distinct competitive advantage to those with the ability to execute strategy based upon the data. However, while vigorous data analysis and reporting makes sense, the effort may be fruitless if causal factors and metrics to measure those same factors are not linked to corporate strategy. If the goal is to increase economic value, management energy must be purposefully directed toward activities that exhibit the greatest potential to influence the outcome in a positive way.

The gap between performance metrics and strategy-

Kaplan and Norton, (2005), founders of the balanced-scorecard point to the gap that exists between corporate strategy and execution stating that, "Strategy at many companies is almost completely disconnected from execution". The authors elaborate further stating that, "on average, 95% of a company's employees are unaware of, or do not understand, its strategy". Moreover, the author's considerable research reveals that the critical process of budgeting and planning is similarly disconnected from strategy and that up to 60% of organizations fail to link their financial budgets to strategic objectives. Further, more than 70% of middle managers and 90% of front-line employees have no financial incentive or link to the success or failure of strategy execution. Indeed, it would seem abundantly clear that the missing component responsible for successful execution is the ability to create clear *linkages* between the objective and the factors responsible for their success.

To illustrate this point further, Ittner and Larcker (2003) suggest that most companies fail to link metrics to strategy, creating a gap between organizational efforts and the financial objectives of the firm. Further research conducted by Ittner and Larcker (2003) of nearly 300 senior executive managers found that those "that adopted non-financial measures and then established a causal link between those measures and financial outcomes produced significantly higher returns on assets and returns on equity over a five-year period than those that did not". The most successful companies in the Ittner and Larcker (2003) study created performance metrics based upon causation, using value driver maps to lay out specific cause and effect relationships between the chosen measures and the desired outcome. The Ittner and Larcker (2003) research revealed that executive managers linking causal metrics to strategy enjoy a considerable 5.14% return on equity over those that do not.

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If such a tremendous competitive advantage exists for those that link performance metrics to strategy, why then, do so many companies fail to execute? Ittner and Larcker (2003) list four common mistakes or oversights made most often by companies that fail to execute on their strategy.

- 1) Not Linking Measures to Strategy
- 2) Not validating the Links
- 3) Not Setting the Right Performance Targets
- 4) Measuring Incorrectly

In addition, it would seem reasonable to link employee reward systems, or compensation plans directly to key elements of the strategy. Kaplan and Norton (1993) for example point out that, “some companies link compensation of senior executives to achieving stretch targets for scorecard measures.” However, it would seem sensible that all stakeholders share in a reward system that is properly aligned with corporate strategy.

Getting it right-

According to Rigoglioso (2005) citing recent research by Stanford Accounting Professor Nagar and Rajan (2005), “Data on intangibles such as customer satisfaction can yield significant forecasts of earnings only when they are analyzed in conjunction with financial statistics”. Clearly, it is critical to first isolate a desired *financial* outcome and then seek to understand the variables that cause the financial outcome to behave in the desired manner.

In order to accomplish this effectively, Kaplan and Norton (2000) emphasize the importance of creating a strategy map that essentially illustrates the cause and effect relationships between the variables. While many companies choose to rely on intuition when choosing appropriate metrics to support their financial strategy, Ittner and Larcker (2003) found that 70% of the companies in their study “employ metrics that lack statistical validity and reliability. Validity refers to the extent to which a metrics succeeds in capturing what it is supposed to capture, while reliability refers to the degree to which measurement techniques reveal actual performance changes and do not introduce errors of their own”. The important message here points to the need for a well thought- out strategy map that illustrates the causal relationships between key metrics and the desired objectives. And further, the relationships should be based upon sound statistical techniques free from bias and management assumptions.

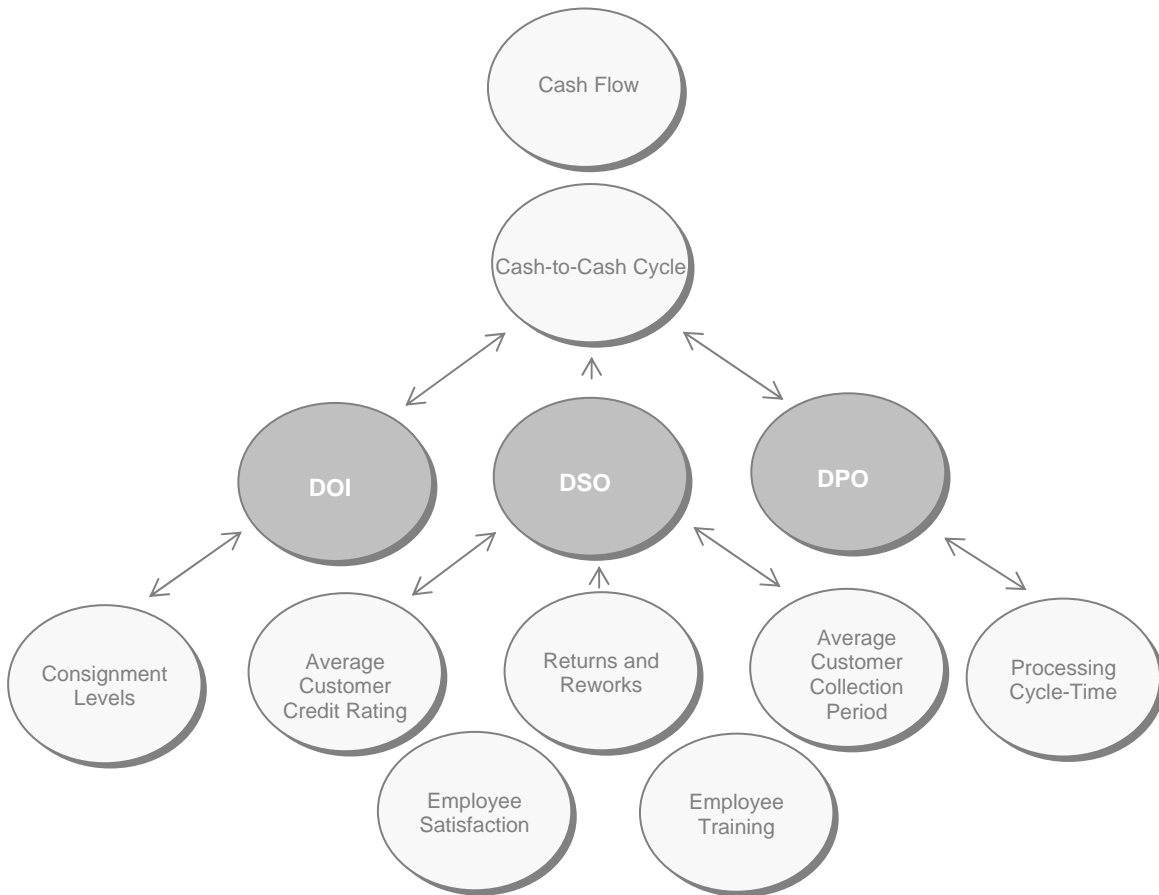
For example, a sound mapping process might start with the creation of a list containing all possible variables thought to influence the desired objective. Hypothesis’ may be created based upon management assumptions and experience and will form the basis for the descriptive analysis of the data. After the list is compiled, scatter and box plots, correlation and covariance tables can be used to hone-in on variables suspected to possess the most influence on the desired outcome, in this case, the dependent variable. Upon completion of a descriptive presentation of the variables, an *inferential* model using linear regression techniques can be developed to prove or disprove causation between the variables and provide a sound basis for measurement and KPI choices going forward.

Begin with the financial objective-

As emphasized by Kaplan and Norton (2000), “the best way to build strategy maps is from the top down, starting with the destination and then charting the routes that will lead there”. Formulating the strategy from the top-down means one must first consider and then decide upon the desired financial objective. For example, let’s say that the executive manager determines that improving cash flow to a certain level is a primary objective of the firm. Upon a descriptive and inferential analysis, we may learn that improving cash flow depends first upon improving the firm’s cash-to-cash cycle which is in turn dependent upon days-sales-outstanding, days of on-hand inventory and days- payable outstanding. In turn, days-on-hand inventory is dependent upon supplier responsiveness and so on. Table 1 illustrates a hierarchical representation of the variables that impact cash flow for a hypothetical electronics firm. It should be noted that the list is by no means exhaustive and a typical firm may contain many additional variables.

Table 1

Example of a casual factors that influence *Cash Flow*



Source: Grabski (2007) Example of causal factors that influence cash flow

Creating a clear and *achievable* strategy-

Using the electronics company as our example, company managers may determine that cash flow must be increased by \$1,000,000 for the remaining six months of the year. A look at the strategy map reveals that cash flow can be impacted significantly by executing the following strategy:

Step 1) Using a predictive model, company executives learn that the \$1,000,000 objective can be reached if the company's *cash-to-cash cycle* can be improved by *six-days*.

Step 2) The strategy map reveals that the cash-to-cash cycle is most heavily influenced by DSO or days sales outstanding, DOI or days-on-hand inventory and DPO days-payable outstanding.

Step 3) Using the predictive model, company executives solve for the optimal mix of improvements necessary to achieve a six-day improvement in the cash-to-cash-cycle.

Step 4) In this case, a two day reduction in DSO, a one day increase in DPO and a nine day decrease in DOI will reduce the company's cash-to cash cycle by *six-days*.

Step 5) Add Stakeholder objectives to individual dashboards:

-Accounts Receivable Manager - Reduce company DSO from 47 to 45 days

-Accounts Payable Manager - Increase DPO from 35 to 36 days

-Materials Manager - Reduce DOI from 120 to 111 days

Step 6) Cash flow objectives secure.

Step 7) Initiate long term changes for sustainability.

Longer term-

In order to achieve long term sustainable improvement to cash flow, a holistic approach that recognizes variables that influence DPO, DOI and DSO throughout the organization must be initiated. For example, while improvements to DSO might be achieved by more vigorous follow-up on past due invoices to achieve short term goals, meaningful long term and sustainable improvements might include a focus on returns and re-works that are in turn influenced by employee satisfaction, which may in turn be influenced by employee training. Companies that wish to develop more holistic-company wide strategy may adopt frameworks such as the balanced scorecard to view the organization from the financial, customer, process and learning perspectives of their organization and identify the causal variables that contribute to long term gain.

Clearly, the cash-flow example shown above meets but one highly specific objective and is designed to execute one specific goal. Indeed, business managers often find themselves in such positions with the need to achieve short-term objectives such as meeting cash flow requirements or meeting debt to equity covenants. The key is to achieve short term success while implementing a strategy that sustainable over the long term and considers other important elements of the company. A single minded focus on inventory turnover to achieve cash flow goals for example may eventually impact customer satisfaction if inventory falls to a level that compromises customer service.

Linking Objectives to Rewards-

Once objectives are attached to performance drivers, and performance drivers are attached to stakeholders, a reward system that makes sense for the stakeholder and the company may galvanizes the commitment to reaching and maintaining the objective. Table 2 summarizes the strategic plan to increase cash flow by \$1 Million dollars for the remaining six months of the year for the electronics company used in our example. Table 2 includes the four primary performance drivers that influence cash flow along with their respective performance objectives, responsible stakeholders and their respective rewards.

Ideally, the performance driver, objective and progress toward the goal should be delivered directly to each individual stakeholder's dashboard.

Table 2

Objective	Performance Driver	Objective	Stakeholder
Increase Cash Flow by \$1M	Cash to Cash Cycle	< 6 days	Samantha D.
Increase Cash Flow by \$1M	DPO	> 1 day	Sam O.
Increase Cash Flow by \$1M	DSO	< 2 days	Oliver G.
Increase Cash Flow by \$1M	DOI	< 9 days	Anne T.

Conclusion-

This paper illustrates the enormous opportunity available to company managers that wish to embrace a purpose driven approach to facilitate the execution of corporate strategy. And while the benefits of such an approach may be significant, it is important to dig deeply into the organization to determine specific cause and effect relationships to uncover the variables that are most likely to lead to the intended result.

Further, this paper seeks to illustrate the value of approaching the objective with a clear understanding of the causal factors that exhibit the greatest potential to influence the outcome. Breaking down the long-term objective into smaller achievable strategies in order to direct scarce management resources to activities that matter is a strategy that clearly makes sense.

Reference List

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