Performance Measures that Drive the First Tenet of Business Strategy

By Mark L. Frigo

Businesses are driven in the direction they are steered. Performance measures provide the steering, guiding an organization into activities that are monitored in measurable results. But what's the long-term direction in which a company must be guided? The research behind the Return Driven Strategy framework (Figure 1) tells us that the highest tenet of business strategy is "Commit to Ethically Maximize Financial Value." Companies that abide by this rule show better financial results over long-term periods. Those that don't live by this guiding principle are some of the worst financial performers ever. Given the importance of this tenet to success, what are the key performance measures that can guide and drive a company's execution toward superior results?

Throughout this discussion, you'll note the use of lagging and leading indicators in strategic performance measurement. Lagging indicators help us to understand what has happened. Leading indicators provide insight as to what will happen. Attention to and balance of these types is incredibly important.

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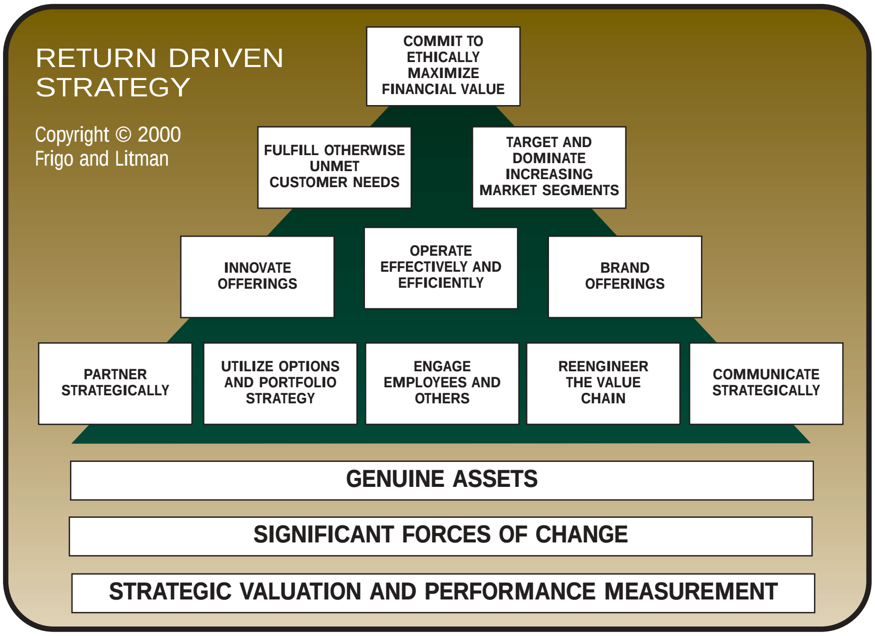
First and foremost, companies must ensure that their business activities are aligned toward maximizing financial value. This must be done within the ethical parameters of the communities in which a company operates, or the company experiences undue risk that can completely kill its valuation and ability to even stay in business. What performance measures can help ensure a company's attention to this all-important tenet of business strategy?

Financial Value and Discounted Cash Flows

If a company is committed to maximizing financial value, it must accept that valuation is a function of discounted cash flows (DCF). To this end, every business must employ metrics for tracking its ability to generate free cash flows over time to increase its DCF-based valuation. Two important financial drivers measure trend and level of cash flow performance. First, whether a company is publicly or privately owned, investors need to know how much investment is being made in it period by period, which is termed asset or investment growth. Second, the investor needs to under-



stand how much cash the firm can drive over and above the investments it is making.

Depending on the industry and nature of the business, there are various ways of measuring investment and re-investment in a firm. Similarly, there are different ways of measuring the return on those investments. The nature of these calculations must be dependent on an understanding of exactly how the metrics will be used to ensure plans are executed, not on some theoretical basis. For instance, if a company is attempting to link its activities to the embedded expectations in its stock price, it might consider the use of a measure like CSFB HOLT's Cash Flow Return on Investment, CFROI®. The measure is widely used by the institutional investor community, and, while sophisticated, it creates a level of accuracy for valuation purposes.

Ensuring Commitment

At times, metrics are needed to ensure directional accuracy, such as for creating incentives in executive or employee compensation programs. Monitoring management compensation is key to understanding whether a firm will commit to maximize financial value. In this case, simpler measures may be considered, such as an economic profit or residual income calculation. This measure appears to lend itself well to management incentive plans yet with reduced application in valuation issues. Needless to say, the accuracy of the ROI calculation and the investment measure must match the required accuracy for the use of the metrics.

In order to ethically maximize financial value, a company must use the right incentives for executives, management, and employees. Are metrics unintentionally leading to unethical activities and behaviors that ultimately lead to disaster? Is management being paid to do things that are truly in the best long-term interests of the shareholders? People do what they are paid to do. If their pay doesn't drive the first tenet of business strategy, nothing else will.

Aligning the Organization Toward the Overriding Goal

The widely used balanced scorecard framework is popular for directing management toward monitoring financial and nonfinancial measures of performance. Strategic objectives and performance measures must reflect the Commitment tenet of Return Driven Strategy. If they don't, you must question the firm's ability to produce respectable returns to its shareholders. In well-designed balanced scorecards, you can see this tenet explicitly targeted through certain measures and metrics.

The Importance of Ethics

An incredibly important consideration is missed all too often. Companies must ensure adherence to the "ethical component" of the first tenet of business strategy. A firm must develop and review performance metrics or even "markers" that indicate when activities are moving out of the bounds of ethical behavior. Companies that violate ethical behavior run the distinct risk of losing massive levels of value and even their ability to remain a going concern. Various performance metrics can help track whether or not a company is staying within the bounds of ethical behavior as its communities define. This could include tracking litigation against the firm, monitoring trends in employee grievances, or watching for excessive or obsessive interest from consumer activist groups. Each of these may alert management to unhealthy trends.

Of course, one of the major concerns today is the development of internal metrics to monitor and control financial reporting systems. When companies violate their trust with the investor markets through financial statement misreporting or fraud, they generate the ire of the Securities & Exchange Commission (SEC) and the shareholders, with drastic consequences.

Strategic Priorities Moving Forward

Management that steers a company the wrong way finds itself in a morass of poor financial performance with unhappy investors. Yet the problem may not be in the ability to steer but in choosing the wrong direction to drive in the first place. The Return Driven Strategy framework can accelerate the design and development of a performance measurement system. Remember, targeting superior financial results, the first tenet of business strategy, calls a company to Commit to Ethically Maximize Financial Value. Performance measures geared toward this goal can help drive an organization in the right direction. Consider the importance of these concepts in your organization. As a driver of your business, first ask yourself if you are truly driving in the right direction. Then focus on the performance measures that will get you there. With diligence, you'll increase your ability to steer your company on a path to a much better place, one of superior financial returns. ■

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