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Evaluating General Managers' Performances

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Choosing what measure(s) to use to monitor performance and to motivate good performance is critically important in all organizations because usually “What you measure is what you get.” If you measure profits, managers tend to focus on producing profits. If you

measure growth, they will focus on generating growth. These motivational effects exist even in the absence of formal links between the measures and the various incentives that organizations provide managers, but companies' incentive plans amplify the motivational effects.

The alternatives for measuring the performances of general managers, those located both at the corporate level (e.g., CEO) and below (e.g., division vice president) who are responsible for both revenues and expenses, can be classified into

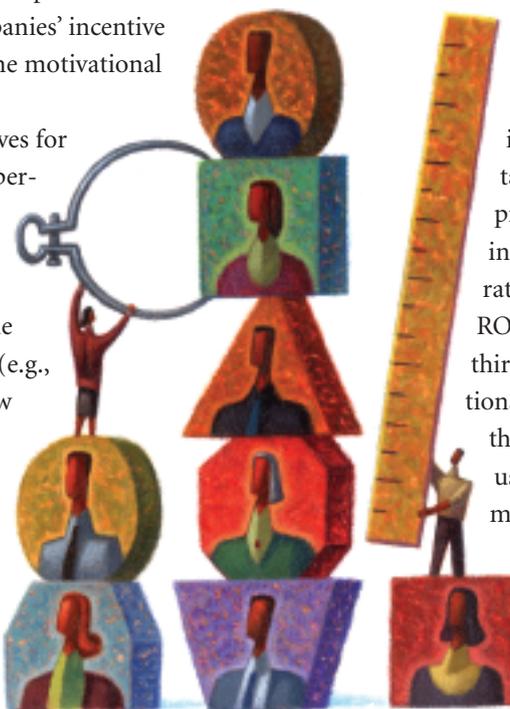
three broad categories. One is market measures, which are direct reflections of an entity's changes in value. A second includes summary accounting-based measures, which

can be defined in terms of either residuals (e.g., net income after taxes, operating profit, residual income, EVA) or ratios (e.g., ROI, ROE, RONA). A third is combinations of measures, the concurrent use of multiple measures, most often including a summary financial measure with one or

more nonfinancial measures. The balanced scorecard framework is an example of a relatively elaborate combination-of-measures system.

How should senior managers and members of compensation committees of boards of directors choose from all these possibilities? To answer this question, I use a universally applicable set of measurement evaluation criteria. Ideally, performance measures or combinations of measures should be:

- 1. Congruent** with the organization's objectives. Since the primary objective of profit-making organizations is to maximize shareholder value, the measure(s) used should increase when value is created and decrease when value is destroyed. That's the meaning of congruence.
- 2. Controllable** by the managers whose performances are being measured. Controllability isn't a concern when evaluating entity performance. But measures that aren't controllable, at least to a considerable degree, convey little or no information as to whether the manager of an entity performed well, and they provide no useful motivational effects.
- 3. Timely.** No one wants to wait years for feedback and performance-



dependent rewards.

4. Accurate. For measures to be accurate, the “noise” and bias in the measurements must be minimal.

5. Understandable. Measures that aren’t understood have no motivational effects.

6. Cost effective to produce. The benefits of the measures should exceed the costs of providing them.

If a measure (or a combination of measures) fails to satisfy any of these criteria, the company will face problems such as poor evaluations, weak or even misdirected motivations, and/or wasted performance-dependent incentives.

In the following sections, I’ll use these criteria to assess each of the three measurement alternatives available for evaluating general managers’ performances.

A. Market measures

Market measures are generally superior to the alternatives in terms of congruence. They provide direct indications of the amount of value that has been created or destroyed. What could be better than rewarding managers in direct proportion to the gains realized by the entity’s owners?

Market measures also have other advantages. For publicly traded entities, market values are available on a *timely* basis: daily or even more frequently. If the values stem from recent trades, they are *accurate*—measured precisely and not able to be manipulated by the managers whose performances are being evaluated. They are *understandable*. And because they don’t require any company measurement expense, they are extremely *cost effective*.

With all these advantages, what’s not to like? Actually, market measures do have some severe limitations and problems. One is a severe

feasibility constraint. The market measures having the advantages listed above are readily available only for the small minority of business entities whose shares are actively traded in public markets. Except in highly unusual cases, market measures aren’t available for either privately held corporations or wholly owned subsidiaries or divisions, and they aren’t applicable to not-for-profit organizations. Value changes can be assessed in private entities, such as through appraisals, but those assessments are generally less precise, less cost effective, and possibly less objective and/or less timely.

A second problem is that market measures present two types of *controllability* problems. Generally, they can be influenced to a significant extent by only the top few managers in the entity, those who have the power to make decisions of major importance. They say little about the performances of individuals lower in the organizational hierarchy, even those with significant general manager responsibilities, except in a collective sense. Thus, market measures provide meaningful indications about the individual performances of the top management team only.

Even for the top management team, market measures may be far from totally controllable. Market prices are affected by many factors that the managers can’t control, such as changes in macroeconomic activity, interest rates, factor prices, exchange rates, and the actions of competitors. Research has shown that the proportion of stock price changes that can be “explained” by macroeconomic and competitive factors is high, in some markets and situations perhaps as high as 98%. When this “noise-to-performance signal” ratio is high, stock prices

don’t provide much information about even top-level managers’ performances.

In addition, despite the fact that market measures provide direct, objective measures of shareholder realizable value, they can present some *congruence* problems. For a number of reasons, they don’t always reflect the “true intrinsic value” of the entity. First, markets aren’t always well informed. For confidentiality and competitive reasons, not everything that managers know is disclosed to the market. Managers who want to do so can manipulate stock prices in the short run through the timing of disclosures. The market valuations can’t reflect information that isn’t available to it.

Second, even market valuations with well-informed participants might not be correct, and even large, actively traded markets exhibit what seem to be biases, mood swings, and other imperfections. Markets seem to overreact to earnings developments in both the up and down directions, so it’s difficult to explain all market valuations without considering some behavioral (noneconomic) factors. For example, it’s difficult to explain the rapid stock market decline of 22.7% in the crash of 1987 within the theoretical framework of economists’ efficient markets theory without considering behavioral factors.

Third, market valuations in less-active markets, such as those in developing countries, are known to suffer a number of significant imperfections and lags, so they can be used for evaluation/motivation purposes only with extreme caution.

Finally, market values aren’t always reflective of *realized* performance. In some situations, the val-

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ues are heavily influenced by future expectations that will never be realized. I could cite many examples of stock prices jumping on reports of a promising new development in an R&D laboratory or the hiring of an important new executive only to have the stock drop back quickly to prior levels when the R&D development proves to have no commercial value or when the new executive leaves without any real accomplishments. Thus, paying bonuses based on market performance is risky. Real payments may be made for results that are never realized.

B. Accounting-based measures

Standard accounting-based, summary financial measures satisfy many measurement criteria:

- They can be measured on a *timely* basis. Net income and accounting returns are regularly measured on a quarterly and monthly basis.
- They are relatively *accurate*. Accounting rules are described in great detail, and auditors provide a valuable objectivity check.
- They are *understandable*. Virtually every manager who rises to a general management level knows through formal education or experience what the accounting measures represent.
- They are *cost effective*. Firms are required to produce the measures for financial reporting purposes, so there is little or no incremental cost.

Summary financial performance measures also provide some *controllability* advantages. They can be tailored to match the levels of authority of any manager. And although they are affected by many of the same uncontrollable macroeconomic distortions that influence the market

performance measures, some of these distortions can be removed with standard management accounting techniques such as variance analysis, flexible performance standards, and/or relative performance evaluation.

But summary financial performance measures generally have one major flaw—a lack of *congruence* with changes in value. Many research studies have shown that the correlations between annual accounting income and annual market value changes are typically in the range of 0.1 to 0.3. So annual earnings don't tell an evaluator whether value has been created

or not. Over longer measurement windows, the correlations do increase. One large-sample study found that the correlation between profits and market value changes over a 10-year period was 0.79. (See Peter D. Easton, Trevor S. Harris, and James A. Ohlson, "Aggregate Accounting Earnings Can Explain Most of Security Returns: The Case of Long Return Intervals," *Journal of Accounting and Economics*, No. 2/3, 1992, pp. 119-142.) This finding clearly shows the trade-off between congruence and timeliness. But no managers will be willing to wait 10 years for their reliable performance feedback and performance-dependent rewards.

Primarily to improve congruence, some consulting firms have proposed new, "improved" summary bottom-line financial performance measures. These include measures with labels such as economic value added (EVA®) or economic profit. But these measures are derived from accounting

numbers. They still focus on the past, not the future, while value changes are often largely caused by changing expectations about the future. Not surprisingly, then, academic tests on broad samples of firms haven't found that the new measures provide improved congruence. (See Gary C. Bidle, Robert M. Bowen, and James S. Wallace, "Does EVA beat earnings?

Evidence on associations with stock returns and firm values," *Journal of Accounting and Economics*, No. 3, 1997, pp. 301-336, and Gerald T. Garvey and Todd T. Milbourn, "EVA versus Earnings: Does It Matter Which Is More Highly Correlated with Stock Returns?" *Journal of Accounting Research*, 2000, pp. 209-245.)



C. Combinations of measures

What about combinations of measures? The additional complexity of considering multiple measures concurrently can cause some cost and understandability concerns. But because the combinations are almost infinitely flexible, they seem to provide advantages in terms of congruence and controllability, and the measures can usually be made to satisfy the accuracy and timeliness concerns.

One of the primary arguments supporting the use of a combination of measures is that no single measure, no matter how good it is, can reflect organizational performance well enough to motivate optimal management decision making. Multiple measures might improve congruence by providing a more *complete* reflection of performance by capturing aspects of performance that aren't reflected or aren't weighted highly enough in

importance in a summary financial performance measure. If managers perceive that a financial performance measure has a weakness (e.g., too short-term oriented), they can add another measure that compensates for that weakness (e.g., one that emphasizes returns in the future, such as new product development successes or the building of market share). If the combination of those two measures leaves out a concern deemed to be important, such as safety, quality, or concern for the environment, managers can add measures that direct attention to those areas. And so on.

Measurement combinations can help address a major weakness of accounting measures, namely that they are backward looking and, hence, excessively short-term oriented. The accounting measures' short-term, completed-transaction orientation can be balanced by concurrently using other measures that are more future oriented. Market valuations are future oriented because markets base their values on estimates of future cash flows. Similarly, some non-financial measures are future oriented. Performance in areas such as market share, new product development, product quality, and customer satisfaction are often the drivers of future financial performance. Supplementing the accounting measures with some combination of these value drivers can ensure that managers don't maximize the short-term financial measures at the expense of future performance.

This balancing of short-term and long-term concerns can also be seen as an attempt to make the perfor-

mance indicators more *timely*. Including some drivers of future performance in a measurement system provides more timely indications of problems that might be forthcoming.

Because the weightings of the various measures can be varied, combinations of measures are nearly infinitely flexible. For example, with summary financial measures, every dollar of inflows (revenues) and outflows (expenses) is weighted the same in importance. As a consequence, valuable information can be lost in the aggregation. Small but critical performance elements can get lost in the measurement error of larger quantities, but if the summary measures are decomposed, different financial elements can be given different importance weightings. For example, revenues from new products can be weighted more highly than those from old products, and, if appropriate, controlling general and administrative expenses can be given more importance than controlling raw material costs.

But managers using combinations of measures must answer many questions. What dimensions of performance should be measured, and how many measures are needed to define performance "completely," or at least completely enough? Some companies use 20 or more measures to track the performance of some individuals, but that's probably too many. When this many measures are used, none of the measures is particularly important. One rule of thumb that some compensation consultants use is that the payoffs related to each measure included in a bonus plan must be worth a minimum of 5%-10% of

base salary. If the potential payouts are less than this, managers won't pay attention to that measure. But that high a weighting is impossible unless the total potential bonus payment is higher than is promised by the vast majority of compensation plans, even for the highest-level managers.

How should each performance dimension be measured? For example, should accounting profits be measured using straight-line or accelerated depreciation? This single choice could have dramatic effects on reported profits. In a retail environment, should customer satisfaction be measured by a survey of customers; by a survey of patrons, some of whom did not buy anything; in terms of a measure of customer retention; or by a rating assigned by a mystery shopper? If customers are surveyed, should the measuring be done by the company or by an independent party? Should the survey be conducted soon after the time of purchase or after the consumer has had a chance to use the product for some time? Different measurement methods can yield quite different answers.

And what relative-importance weightings are optimal? Defining overall performance as 90% ROI and 10% sales growth is quite different from defining it as 10% ROI and 90% sales growth. Ideally, the choices of measures and their weights should be derived from an explicit articulation of a business model or strategy that describes the hypothesized drivers of the desired business results. And then those hypotheses should be *tested* empirically. Is the chosen strategy based on reality or merely assumptions?

Managers tend to build their combination-of-measures systems intuitively, which can cause prob-

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lems. Research has shown that some companies' systems aren't effective. Some managers implement boilerplate frameworks of measures without much thought and don't test whether those frameworks fit the specific situations in which they are being used. And some managers focus on the wrong measures. They choose measures that they assume are indicative of good future performance, but their assumptions are later proven to be incorrect. For example, instead of being bad, employee turnover might turn out to be good because it keeps labor costs low, or perhaps only turnover of supervisors, not lower-level employees, is indicative of forthcoming problems. And improving overall customer satisfaction isn't nearly as important as satisfying "good" customers.

Choosing the Measures

Table 1 provides a partial summary of the preceding analysis. It shows that market measures generally satisfy all the evaluation criteria, but their application is limited because they are controllable by only a few managers at the very top of firms whose stock is publicly traded. Summary financial measures satisfy most of the measurement criteria, but they generally fail significantly on the congruence dimension. Systems that combine measures come in great variety. It's impossible to generalize about their advantages and disadvantages in specific settings, and, in fact, we still have much to learn about them.

While we await further research findings, what advice might be given to managers making performance measurement choices? Here is some tentative advice for choosing measures to evaluate:

A. The top management team

Table 1 **Summary Evaluation of Measurement Alternatives**

CRITERION	Measurement Alternative		
	Market measures	Summary, financial measures	Combinations of measures
Congruence	Generally high	Low	Unknown
Controllability	Generally acceptable for top management team Negligible for all others	Can probably be made acceptable	Varies
Timeliness	High	High	Varies
Accuracy	High	High	Varies
Understandability	High	High	Probably high in most situations
Cost effective	Yes	Yes	Varies

(the "C-suite") of firms whose shares are actively traded

Unless market valuations are based heavily on expectations of the future that might not be realized, evaluate this top management team in terms of market performance. Market measures provide the best single indicator of value creation (or destruction). But to improve controllability, eliminate as much macroeconomic "noise" as possible by judging market performance as compared to that of the overall market or, even better, if possible, the market performance of the closest peer group of firms.

B. All other general managers

Evaluate all other general managers in terms of combinations of measures tailored to reflect value creation (or destruction) in the specific setting in which they are operating. As strategies detail managers' beliefs about the optimal ways in which to create value, the tailoring of measures should be done by choosing measures that reflect the key elements of the strategy being

followed. If the entity is following an innovation/product differentiation strategy, then innovation/product differentiation measures should be featured prominently in the measurement system. If cost efficiency and price leadership is the chosen strategy, then efficiency and cost reductions should be featured prominently. These key strategic elements are sometimes referred to as the business's *critical success factors*.

To maintain focus, improve understandability, and minimize costs, limit the total number of measures included in incentive plans, perhaps to just a few. Other measures can be monitored as potential indicators of performance problems, but including too many measures in incentive plans is more distracting than useful. ■

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