How KPIs can help to motivate and reward the right behavior

Paper #5 – How to use KPIs to create a transparent organization

Contents

2 Transparency is the new control system

3 Six implementation guidelines

6 About the author

Most bureaucracies use standards to control people, catch them breaking the rules and punish them to get back into line. Workers feel as if they are part of a chain gang rather than a valued team. They are not trusted to use information to make decisions. In fact, decision-making is separated from the work. This creates a void that is filled with mixed messages and political behavior. To bridge this gap, firms spend huge sums on complex planning, budgeting, scheduling and control systems that program every action and activity on a daily basis at the front line.

Many of these organizations operate behind a cloak of secrecy and obfuscation. Just because leaders have the authority to make decisions they think they have the right neither to explain the reasons nor to accept the consequences. This leads to poor communication and decision-making and creates opportunities for misrepresentation and fraud. Dictating and directing information so that people only see 'what they need to know' denies people the performance insights that come from seeing the bigger picture and prevents them from raising tough questions about the performance of their peers. "The risks of having a completely open system would be too great," they say. "Anyhow, how can we trust people with sensitive information? It would reach our competitors in no time at all." In such a culture, information is restricted and with only one interpreter of that information, the potential richness is lost and creativity is stifled. It is the synthesis of information in often unique ways that leads to insight and discovery. By denying this opportunity, command and control leaders do their best to destroy innovation.

While the problem of information sharing is endemic to command and control organizations, networks thrive on openness and transparency. The main advantages of open workplaces are the speed, responsiveness, and learning capacity of their human networks. Knowledge, competence, value creation, and the capacity to influence others create power in networks.

The evolution of the Internet is making it easier to share information. In fact, such words as "freedom" and "autonomy" define what the World Wide Web is about. All attempts to "control" the Web have come unstuck. But the Web itself has moved on. If Web 1.0 was about the Web as an information source, then Web 2.0 is about the Web as a platform for participation and connectivity that includes such social networking sites as wikis and blogs that aim to facilitate creativity, collaboration and sharing among users. Web 2.0 is a dynamic peer-to-peer network with everyone potentially connected to everyone else. It is the ultimate democracy. Everyone has a voice. Innovation and change can come from anywhere at any time. Approval comes from peers rather than bosses. Information is open, transparent and accessible. Like Web 2.0, management in the networked organization is about linking (but not controlling) people and releasing their energies and capabilities for the benefit of all stakeholders.

Transparency is the new control system.

Why do so many companies spend huge sums on managing travel and entertaining expenses when just opening every manager's expenses up to scrutiny by everyone else would be the cheapest and most effective control system available? What many leaders fail to realize is that control is not only about complying with agreed-upon processes and procedures but also about building a cohesive management culture. It is difficult for one (or even two or more) people to commit a fraudulent act if their decisions are open for others to see. Of course, no one expects to spend hours poking around in other people's files, but just the fact that they *could* is enough disincentive to nip any bad thoughts in the bud. There is, of course, a trade-off between open information and leakage to undesirables. But in an age of instant copying, your most sensitive information is probably already sitting on some personal storage device ready for when people might leave the organization. That's why the option of full transparency is the best one to take. Could an Enron or WorldCom have happened with fully open systems? Unlikely is the answer.

Despite these developments, too many organizations continue to operate in a gray area between what's right or wrong and too often step over the wrong side of the ethical line. But in a world of constant digital surveillance, 24/7 media and Web-based social networks, any of which can turn an error of judgment or hidden truth into a reputation melt-down in an instant, operating in the twilight world of balancing cost/profit against what's ethically right and wrong makes no sense at all. The ethical decision is the only one to take.

While a few short-term profit opportunities might be sacrificed, there is strong evidence to suggest that "transparent" organizations attract the best people, customers and investors as well as perform better and endure longer than their rivals.[1] And because they trust people with information and give them more scope and authority to make decisions they don't need many layers of management (and the costs they incur). They also recover more quickly from economic downturns and other setbacks. Building and sustaining organizations that place transparency at the center of their management model is fast becoming a key success factor in the digital age and *the* litmus test of leadership quality.

But total transparency is a step-change from where most companies are today. It requires changes in how leaders think about information and how the measurement and control process works. Information systems should provide front line managers with the capability they need to "run their own business," to effectively manage project-based initiatives, and enable them to share knowledge and best practices with colleagues across the company before taking important decisions. They enable managers to get answers to such questions as:

- What do customers think about our products?
- What problems do they want us to fix?
- What new features do they want us to add?
- What problems do our distributors or resellers have and what needs to be done to correct them?
- Where and why are our competitors winning business from us?
- What are changing customer demands telling us about our core capabilities?

They also enable managers to synthesize apparently unconnected pieces of information and knit them together into flashes of insight. These "light bulb" moments might be rare but they are facilitated by having access to the whole panoply of information available rather than just seeing someone else's view of the world.

Many leaders know that the networked organization would founder on the rocks of bureaucracy. That's why none have top-down control systems that connect decisions taken at the corporate center with actions taken at the front line. They don't have, for example, targets, budgets, standard costing, batch scheduling or quality control systems (quality is in the line – not inspected for) and all their associated costs. Teams have all the information they need to complete their work. They have plans, forecasts, KPIs, and a stream of business intelligence flowing through their computer systems.

Transparent information gives leaders confidence that effective, consistent decisions will be taken by every team. It also breeds a collegiate, collaborative culture within which problems are immediately shared and dealt with before they get out of hand and lead to serious damage.

This means that many top-down controls are not required. Targets, budgets, standard costing systems, quality procedures and other control systems that exist to link high-level decisions with frontline work, are superfluous to requirements. Overheads shrink dramatically. Measurement becomes much more transparent. Measurement at Toyota is based on learning and improvement at the front line. That's why Toyota, despite having an excellent accounting system that allows it to comply with regulatory authorities and so on, actually has no standard cost accounting system. The only measures inside the plant are visual ones. They don't drive operations with the numbers. They don't measure to check where they are against some target. They follow a different logic, a deeper logic. They measure only to enhance awareness of how the work is flowing.[2]

Six implementation guidelines

1. **Make information open and transparent**. Leaders need to promote information flows to new levels of openness and transparency. They should give their people access to the sort of strategic, competitive and market-based information that was once the preserve of senior executives. And they need to understand that all the numbers in the organization should stick to "one truth" and be transparent. They should be seen by everyone in their raw state without people "treating" them or painting pictures that are designed to mislead. This gives everyone confidence in the numbers and supports devolved decision-making.

   Ken Iverson, former CEO of Nucor Steel, was a devout believer in sharing all information with employees. "Sharing information," said Iverson "is another key to treating people as equals, building trust, and destroying the hierarchy. I think there are really just two ways to go on the question of information sharing: Tell employees everything or tell them nothing. Otherwise, each time you choose to withhold information, they have reason to think you're up to something. We prefer to tell employees everything. We hold back nothing."

   President John Correnti is aware that some of this information leaks to the media but, he notes, "The value of sharing everything with our employees is much greater than any downside there might be to some information getting out."[3]

2. **Make hiding or manipulating information a firing offence.** Many leaders know that a few percent of people in every organization will abuse the freedom of information. But, like Correnti, they judge that the risk is worth taking. They realize that the benefits of providing the nourishment that everyone gets from being able to access any information when needed far outweighs the downside risks. Fast, open information is the glue that binds teams (at every level) together and enables fast, coordinated action. Everyone should get the same information at the same time (though in different degrees of aggregation). Peter Drucker likened this approach to the orchestra when he said, "The right model for the information-based organization is not the military, even in its modified form. It is the symphony orchestra, in which each player plays directly and without intermediary to the 'chief executive', the conductor, and can do so because everybody has the same 'score', that is, the same information."[4]

   At Norwegian oil and gas company Statoil, business ethics is high on the agenda. It is ruthless on policy violations that usually lead to dismissal. It has a simple "ethics test" so that people know whether or not their action is acceptable. They just need to ask the following question: Is it acceptable if the results of their actions appear on the front page of the newspaper? If yes, go ahead. If no, don't do it."

Hiding or manipulating information is endemic in many large bureaucracies. In an organization that truly believes in its core values this must be a firing offence. On the other hand, no one should ever get fired for telling the truth no matter how unpalatable it might be.

3. **Teach people to understand the meaning of measures and reports.** While teams need KPI data on-line they also need to be able to understand it and recognize the implications it may have for further action. These are the indicators that provide real insight and early warnings of changes in the management landscape. Every team and individual at Southwest Airlines knows the few key measures that determine profit or loss. A few years ago, one of the pilots worked out a neat way of explaining to people how each flight did not make a profit until the 75th passenger was on board and that all the profit came from the last five passengers. So load factors are a critical driver of profitability. Every employee is educated in the "North Star Metric" that shows "profit per plane" (see figure 1).

$$\text{Profit per plane} = \text{Available Seat Miles per Plane} \times \left[\text{Revenue per Available Seat Mile} - \text{Cost per Available Seat Mile}\right]$$

Figure 1: Southwest's Profit per Plane Metric

4. **Ensure that data is clean and accurate.** Operating with fast, transparent information is a laudable aim, but it will be a waste of time if the data in the system is unreliable. Dirty data is endemic to most management information systems and represents an increasing cost. Research shows that around 20 percent of all data is subject to error. Missing fields, wrong coding and duplicate entries make it difficult for managers to close the books with confidence.[5]

The Data Warehousing Institute estimates that data quality problems cost U.S. businesses more than $600 billion a year. Yet, most executives are oblivious to the data quality lacerations that are slowly bleeding their companies to death. More injurious than the unnecessary printing, postage, and staffing costs is the slow but steady erosion of an organization's credibility with customers and suppliers, along with its inability to make sound decisions based on accurate information.[6]

Leaders can learn from "lean" thinking." Take the example of a U.K. local government office that was in the dreadful position of having 7,700 benefits claims waiting to be processed, twenty times the norm. The department was taking more than six months to pay a claim. When they examined the system they found that they weren't looking at the process from the claimant's point of view. There were two separate parts, inquiry and assessment, and no one was looking at it end to end, the way the customer experiences it. People were doing what the system told them to do and ignored the customer perspective. Staff were asked to study actual contacts and analyze what they meant. The results were a shock. Only around one-third of letters, phone calls and visits were new claims. All the rest were 'waste' (demand resulting from a previous failure). Only three percent of claimants had their claim settled in one visit to the office. Most came in at least three times, some up to ten. It was no wonder that staff couldn't deal with the backlog. When scanning documents, the system was designed to sort them three times and check them eight times. As realization dawned, there was a turning point when one staff member confided: "We've forgotten our purpose. We're pushing paper to satisfy official specifications, not the claimants."

After the whole team got clean information and were able to assess claims and pay them as quickly as possible to those entitled, redesigning the system (again using the frontline teams), was easy. As the call analysis had established, the real bottleneck was not assessing claims, the presumed culprit, but getting clean information in the first place. So staff formulated a bargain: if claimants provided all the right documents at the first point of contact it promised to deal with the claim immediately, or within days if it had to be referred elsewhere.

They now use measures that tell staff how well they are achieving things that matter to customers, not according to official specifications. Staff have 'good' information that enables them to keep customers informed of progress at all times. They also know that customer claims will be dealt with on a "first in, first out" basis. The result is that, because staff can confidently deal with customers, they are happier at work and therefore more caring and committed. After a three-week pilot, it was clear that redesigning the system into a single flow allowed staff to cope with claims in days if not hours. Rolled out without fanfare to cover all 60 benefits staff, it quickly began to reel in the backlog. Live claims come down to 300, and staff started coming to terms with unaccustomed gifts of flowers and cake instead of brickbats. Morale and quality were up, and extra capacity has been delivered to the front line at no extra cost.

The lesson is that all data should be entered correctly first time. Batching, scanning, archiving and retrieving consume huge amounts of time and cost as people need to reopen files many times.

5. **Operate with "one version of the truth."** Many organizations have to deal with a patchwork quilt of information systems that are difficult to stitch together. This is one of the primary causes of slow information. Not only this, but they also keep parallel sets of books, including, in some cases, one for cost accounting, one for management accounting and one for financial accounting. Some have yet another, that is, information suitable for regulators. Most managers don't know what happened last month until the second half of the following month. They typically spend the first couple of weeks joining their systems together, often re-keying information into spreadsheets to show leaders a complete picture. In a fast-changing market or in the first few months of a new product launch, this can mean the difference between taking the right and wrong decisions that, in turn, can have a major impact on the bottom line.

Effective leaders believe in only one set of numbers that are transparent throughout the whole organization. Maintaining one set of books, or one 'truth' is the key to high levels of ethical practice. This is exactly what such firms as ALDI, Handelsbanken and Ahlsell do. Indeed, Ahlsell, a major Swedish distributor, has an information system based on the highest ethical values. Finance director, Gunnar Haglund, explains its principles, "We established at the outset that one of our key principles was self-management and internal competition based on free access to information. We reduce all management reports to the simplest and most relevant content and format. Our reporting system has no 'middlemen' and thus there only one 'truth'. This is really important. No one is 'treating' the information or giving it some particular 'spin'. Performance is transparent. We only use real numbers. There are no profits taken on transfer prices, for example. Everyone can see relative success or failure. It drives knowledge sharing and the transfer of best practices."

6. **Don't force-feed performance comparisons.** Provided performance measures are seen to be fair, league tables produced on a regular basis can be a powerful force for improvement. The problem, of course, is designing them to be fair. This was a real problem for the U.K. public sector office when it used league tables to spur improvements in the National Health Service hospitals. It picked upon Accident and Emergency (A&E) units to make its point. Unfortunately, it committed its first mistake in selecting just one from a range of important indicators of a hospital's performance, thinking it could isolate it from what happened elsewhere. But Deming's law of "unknowable consequences" came into play as hospital managers pulled resources from trauma clinics and cancer wards in their efforts to reduce A&E waiting lists (the league table measure). Non-critical patients were left in ambulances and in corridors because the "waiting time" didn't officially start until they were registered. The U.K. tabloids had a field day. League tables, particularly in the public sector, should also reflect the *rate of improvement* rather than just present a crude snapshot of different units at one point in time. It should not just compare one school's exam results or inspection reports against another but instead look at how well they improved with the inputs as their disposal. Done well, they do create real peer pressure to perform and, in some cases, lead to the sharing of insights and knowledge.

Ahlsell knows how to do it well. Ahlsell moved rapidly from only 14 profit centers to over 200, including acquisitions. Each business-area team (for example, heating and plumbing) in each local unit is now a separate profit center. With so many profit centers, the system of using performance league tables (based on measures of return on sales and profits growth) to drive continuous improvement in front line units has grown even stronger. The impact on performance can best be seen when new acquisitions are exposed to the league tables for the first time. Managers new to the culture who previously thought they were performing reasonably well are both surprised and shocked as to why they should be so far behind existing Ahlsell units. This drives them forward. "If they can do it, so can we" is their response. They are driven to find out what they need to do to improve and work their way up the league tables.

Peer pressure is often at its most powerful when not force-fed in published league tables. Just publishing all internal performance results is sufficient for teams to see where they are in the performance rankings and how much more they need to do to improve. Total transparency is the way forward.

Building league tables can be a sensitive issue and can easily torpedo the implementation of relative measures. The trick is just to publish all performance results. In other words, make them completely transparent so that every manager can see the performance of those teams they compare themselves with. The power of the system works on its own.

Handelsbanken reports the results of each region and branch every month. Each team can see how it has performed versus its peers (although no comments are made on performance by senior managers). Comparisons cover cost-to-income ratio, return-on-equity, customer satisfaction (and complaints) and credit ratings. With no quotas or short-term targets to reach, managers are free to set medium-term stretch goals and take the appropriate actions to improve faster than others. Of course, even at Handelsbanken 25 percent of branches will be in the fourth quartile! The difference is that the performance of these branches is likely to be higher than top quartile branches in rival banks.

Many leaders and most middle managers will be uncomfortable (and many will be cynical) with this new model. But according to many thought leaders such as Gary Hamel and Richard Florida, we are heading for organizations without many managers. In his latest book *The Future of Management*, Hamel uses the Internet as a model of how management is evolving. He sees the Web as an "all-channel," end-to-end network where everyone is (potentially) connected to everyone else and where horizontal processes for control and coordination largely substitute for vertical processes. He believes the battles ahead will be less about competitors and ecosystems and more about the creative class versus the management class. Whereas the creative class (now over 30 percent of workers and 50 percent of salaries in America) hope to build less structured and less tightly managed organizations, the management class want to preserve their privileges and power. They believe that these culture clashes will be played out over the next few decades. If Hamel and Florida are right, then traditional hierarchies and their suffocating control systems will gradually disappear because one thing is certain, the creative class will demand truth, transparency and trust. Everything else is a distraction and a drain on their energy.

But why wait when you can get there now? Much of the agenda is as much about stopping what you do now as about implementing new ways of working. That is the challenge and the opportunity. I hope that these papers will give you the encouragement to begin the journey and act as your guide.

About the author

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Endnotes

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