Performance Measurement: Key Performance Indicators

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This is the second in a series of articles focused on best practices for the implementation of strategic planning and performance measurement. Such methodologies are integral to the success of all kinds of businesses, from small-scale enterprises to multinational corporations.

This piece will endeavor to further clarify the initiatives necessary for comprehensive performance measurement by explaining the second of four best-practice initiatives: key performance indicators.

What Are Key Performance Indicators?
KPIs are measurements that quantify objectives, thus making it possible to assess performance and gauge success. While critical success factors (which were covered in our first piece) are defined specifically as activities or elements, key performance indicators are measurements that support critical success factors.

KPI measurements must meet certain criteria as set forth in the "SMART" acronym: specific, measurable, achievable, results-oriented, and time-based.

Why Are Key Performance Indicators Necessary?
Key performance indicators are essential to ensuring proper focus on the most vital metrics. Under normal circumstances, it is not uncommon for complex and huge volumes of data to obscure the most important metrics, thus making it difficult to appropriately quantify company successes. But the process of linking KPIs to critical success factors and critical success factors to strategic objectives ensures the continuity of strategic intent from the boardroom down to the shop floor.

In addition, outside the financial arena, there may not be clear and concise reporting on non-financial metrics. In such companies, a high-level view of key indicators is missing. Without key indicators, responsibility and accountability cannot possibly be optimized. Key performance indicators are therefore crucial as a means of filling this void and providing a means of analyzing both financial and non-financial operations, with a view toward managing activities so that they are both strategically aligned and performed efficiently.

What Are the Benefits of Key Performance Indicators?
As previously mentioned, key performance indicators are integral to the successful translation of high-level objectives into day-to-day activities. However, they also carry a number of other potential benefits for the company.

With KPIs, management can easily determine if operational results are aligned with target metrics. Secondly, comparing actual results to planned performance provides insight into the many factors affecting business performance that may have been overlooked. And finally, quick, easy access to data also improves competitiveness by improving company response time. Decision making is better and more quickly informed, meaning that any necessary corrective action can be taken swiftly and confidently to ensure optimum effect.

How Do You Develop Key Performance Indicators?
Key performance indicators are straightforward to produce. It only takes a few simple steps to create a series of relevant indicators. First and foremost, use critical success factors to generate quantifiable KPIs. Consult the first article in this series for more information regarding the development of critical success factors.

Next, determine the data sources, data format, and method of gathering data for all identified KPIs. The data sources for such KPIs might include databases, data translation, or data aggregation, to name a few. It is also useful at this stage to determine the desired target KPI values. Consider not only the low and high values in the range, but also variance values and alert levels if required. Also ascertain if the value will be measured or calculated and determine formulas for any necessary calculations.

The third phase requires you to make decisions regarding the reporting of the KPIs. First, decide what frequency will be required in reporting. Some KPIs will require real-time reporting, while others will only need near real-time. Then, determine which KPIs will be high-level only, and which will require drill-down capability in the dashboard.

Finally, regularly review KPIs to assure that they are still the most relevant metrics for measuring your critical success factors. Also, during the review process, determine if any, and what kind of, corrective actions will be taken in response to KPIs not meeting target goals.

Examples of Key Performance Indicators
Here are a few useful examples of common KPIs. Our previous article used the example of a hypothetical manufacturing company. This article will build off this example by providing KPIs for critical success factors.

First, we mentioned that a company might list “maintain ample inventory levels to ensure line fill rates remain at or above 99.5%” as a possible critical success factor. For this factor, the primary KPI would be the line fill rate. However, it would also be important to consider forecast accuracy, which measures the sales volume provided by comparing marketing sales projections to actual results, as well as product backorders, which represent the value of backorder products at standard cost. It would also be useful to consider order fulfilment cycle time, which is the time measured from receipt of customer order to order receipt by customer.

Second, we listed “as part of a plan required to generate cash for a new product launch, improve inventory turns 10%, from 3.0 times per year to 3.3 times per year by year end” as a potential critical success factor. For this factor the primary measure would be the inventory turns. However, it would also be useful to examine excess and obsolete inventory level, which is defined as the need to define and measure excess inventory. Also, with this factor, an important KPI would be key product cycle times, which measures the time required to produce the most popular or highest volume products. This measure is of particular use as shortening cycle times can improve inventory turns.

In Summary
In conclusion, the definition of key performance indicators is an integral step in the effective analysis of your critical success factors.

- KPIs are measurements that quantify objectives and enable the effective assessment of company performance. Through the application of KPIs, executives can properly assess the performance of their critical success factors and apply necessary corrective action.

- Without KPI metrics, it is nearly impossible to translate high-level company objectives into day-to-day operations.

- KPIs can be developed through a few simple steps. Just generate metrics in relation to your critical success factors, assign corresponding values, and determine the method and frequency with which those metrics ought to be reported.

If you do not feel equipped to assign metrics internally it can be useful to consult with an external service provider. An outside professional can provide an objective, dedicated eye that is difficult to find internally.

The next piece in this series will focus on the reporting of KPIs through the use of dashboards.

About CFO Edge

CFO Edge, LLC is a leading Southern California provider of outsourced CFO services. Based in Los Angeles, we are a group of experienced chief financial officers who engage with CEOs and CFOs on demand to address strategic planning, business management, and day-to-day financial operations challenges. Our seasoned professionals deliver services as interim CFOs, part-time CFOs, project-based CFOs, recruitment-to-permanent CFOs and interim-to-permanent CFOs. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 626.683.8840.

About Resource Planning Solutions

Chase Morrison is the Managing Director for Resource Planning Solutions Corporation. As the firm's Chief Financial Consultant, he combines extensive experience as a director of financial planning and analysis with his passion and knowledge for innovative IT solutions. While much of his career has been working with Fortune 500 companies, Mr. Morrison is now focused on using those same performance management tools to help small-to-mid-sized companies, mostly in the manufacturing and distribution industries. For more information, visit www.rpscgi.com or call 818.436.0781.