The key to performance indicators

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High performance indicator reporting

There is no doubt that KPIs are one of the major challenges for reporters. We are often asked, ‘Which ones do we choose, do they give too much away, how do we present them, what if they change, what are others doing?’

Set out in this paper are ten key principles that we return to time and again when discussing this issue. As with our paper on Principal Risks, we have used the FTSE 100 as a useful data set and have not used named examples, but do give an indication of the scale of each point.

For those in a hurry, here is a short cut…

There is boundless advice about how to pick or identify the best KPIs for a business available from all quarters. We believe that there is a pretty foolproof way to identify a company's actual KPIs, either as a Reporter or as a reader – the real deal, the ones the management really focus on above all others and use to run the business.

The problem is that they might not appear in the Business Review; if it exists, this goldmine is located deep in Corporate Governance territory (see point 10).

What is a Key Performance Indicator (KPI)?

The Companies Act 2006 (CA06) is quite clear – 'Key performance indicators' are factors by reference to which the development, performance or position of the company's business can be measured effectively by its owners.

The choice and discussion of KPIs by a reporting organisation is used by various interested bodies, including the FRRP, as an indicator of clarity of Board and management thinking and focus. Many have also said they would be concerned if the KPIs are not the measures the Board uses to manage the organisation. This sort of 'management approach' thinking has been enshrined in new accounting standards, such as IFRS8.

IFRS8 generally requires the information reported to be what management, specifically the entity's chief operating decision maker, uses internally for evaluating segment performance and deciding how to allocate resources to operating segments.

Interestingly, IFRS8 information may be different from what is used to prepare the income statement and balance sheet… which suggests that KPIs don't, necessarily, have to be top level financials.

So, KPIs are not statistics or metrics, they are measures against which managers and investors can judge the business and its performance.

That is not to say that stats and metrics can’t be meaningful, if coupled to narrative:

Box ticked, job done

88% of FTSE100 companies report Key Performance Indicators. But, in the interests of speed and compliance, some of these seem to have elected to define their financial highlights and possibly some main corporate responsibility numbers as their Key Performance Indicators.

A few of these mention KPIs in either the Directors’ Report or Remuneration Report but detail is not accessible, or present, in some cases, elsewhere in the Report.

When is a KPI not a KPI?

7% don’t/won’t use the term Key Performance Indicator, or the abbreviation KPI. Many of these are dual listed UK/USA – but they will use ‘Key measures of progress’, ‘Measure performance’, ‘Financial and operational performance indicators’, ‘Performance indicators’, ‘Key financial measures’, ‘Financial performance measures’, ‘Principal performance indicators’ – why? Strangely enough, some of them are unable to use the phrase ‘Principal Risks’ either. One has to wonder if it is on legal advice or through a fit of pique over regulatory constraint.

Non-compliant

5% do not seem to identify anything approximating to a KPI.

Reporting KPIs

1. Don't overload the system – no more than 12

'Key' is the same as 'Principal' (as in Principal Risks) so there should be nearer 6 than 60. Ten to twelve is about right. State clearly what is a KPI and what's not – other measures can be 'performance indicators', it's just that they are not 'Key'.

The average number of KPIs disclosed by FTSE 100 companies is nine.

One has to feel awe (or pity) for the Board running the company with 49 KPIs. Their plea in mitigation may be they are in a highly regulated industry and have drawn no distinction between KPI and PI, but even so, those meetings must be marathons.

There are a couple of instances when an organisation in a similar predicament does draw the distinction but not often enough and, thankfully, most won't encounter the problem in the first place.

2. Provide explicit links to strategy and objectives, explaining why each measure is important as an indicator of performance

If the strategy has a logical sequence then the KPIs should flow from it and support the narrative. 47% of our sample clearly link their KPIs to their strategy and objectives.

Several companies use successful variations on the idea of an flow-chart, showing the dynamics and grouping of strategic strands, objectives, current progress and performance measurement, future priorities and, in some exceptional circumstances, Principal Risks, followed by a section expanding the KPI information.

Some 18% report financial KPIs only, which is fine if it is true. Given their scale, one would expect most FTSE100 companies to have material measures, other than purely group-level financial ones, necessary for an understanding of the development, performance or position of their businesses... Furthermore, the CA06 requires, where appropriate, analysis using other than key performance indicators, including information relating to environmental matters and employee matters. The only blanket exception is for medium-sized or smaller companies.

It is worth mentioning at this point that the average number of sustainability/ corporate responsibility KPIs reported is three. Even more interesting is the trend towards justifying the use of these KPIs by the integration of CR into the overarching corporate strategy.

For example, one company groups its KPIs under the strategic headings of Financial, Customers, Operations, and Employees, and there are several others. This is a theme we will be returning to later in this series of papers.

Reporting KPIs continued

3. Provide data and narrative to explain the measures, definitions, calculations, source, assumptions, limitations and reconciliations to financials.

This is one of the main best-practice issues that can be put down to simple laziness if it is not done. An explanation should be given of why each KPI is important to the business, and mentioned above, and how it is arrived at.

One way we liked was under the overall heading of 'Delivering our strategy' and had sections entitled 'What we measure', 'Why we measure it' and 'How we performed'.

Failing to do give the narrative is tantamount to writing, 'Dear investor, we are delighted to present our KPIs; we are sure you can work out why they are effective measures of the performance of your business'.

Which having been said, 26% fail to provide even the most basic explanation of why a KPI has been selected, let alone the explanation of the basis of calculation and instead just provide graphs or charts of figures only.

The polar opposite to this approach is the 4% who bury their KPIs in the bodycopy, with purely narrative presentation of information and no tables or graphs.

4. Tailor the measures to the company and its sector, including consideration of any industry benchmark indicators and also benchmarking against peers

It should go without saying that the KPIs chosen will be tailored to the company's specific circumstances, rather than just be generically financial.

Companies and their KPI's don't, however, exist in a vacuum, so whilst careful consideration should be given to the unique set of KPIs for any particular organisation, thought should also be given to allowing comparisons to be made with relevant peers. This allows the individual performance of the company to be placed in a market context (established, one hopes, in a decent Market Overview – yet another topic we will be covering) and allow the relative performance of the competition to be understood.

This is easier said than done, due to the way metrics are calculated from company to company, and because of concerns over commercial sensitivities, but there are ways and means of sourcing and generating appropriate and comparable data, as some companies have demonstrated admirably.

Reporting KPIs continued

We have come across companies using KPIs for strategic advantage, setting standards and so challenging others to disclose similar information, and also sector grouping discussing appropriate cross-business KPIs for general use. One example of a frequently used and widely recognised measure is LTIFR (Lost time injury frequency rate) in the natural resource sector. Ones with less standardisation are customer satisfaction and staff retention.

Occasionally the company is so diverse that some of its KPIs are not applicable across the group, but are specific to each division – this can occur in a retail/wholesale business, for instance.

5. Give segmental analysis, where appropriate

A point that speaks for itself, although often honoured in the breach. IFRS8 may help in this respect, as the data will be available.

6. Give trend data and commentary

Five years is a minimum, really; found one firm giving up to ten, but had to dig for the information. There are a lot of companies that do rolling year on year comparisons that are not very helpful in judging performance in the medium term and this, of course, begs the question, 'Why?

There is a definite weakness across the entire FTSE top 100 in terms of discussing trends in their KPIs. Only three companies give some information on the positive trends in their KPIs and none comment on any negative ones.

7. Give targets

This is quite a challenge, and some figures don't lend themselves to this, but others do and giving them suggests that the organisation has a sense of defined purpose and focus. 8% report specific targets for some KPIs, but a few are not really measurable in isolation, take 'to be number one in customer service', for instance. Or the tantalising, 'The KPIs for 2008 encompassed various portfolio growth and operational performance targets, the substantial majority of which were met' with nothing else on KPIs at all!

Reporting KPIs continued

8. Clear presentation and grouping, with links and referencing to further information

Anyone who has been in a aircraft cockpit knows that all the primary dials are grouped where the pilot can monitor them easily. Three quarters of those reporting KPIs group them, often in a discrete section, so why do others (13%) disperse the details, making them inaccessible for all but the truly dedicated researcher?

The use of links and cross-referencing to other information is to be encouraged, especially in a dynamic web environment, but not if it means that the primary data is scattered.

We also see confusing presentations, where all kinds of metrics and measures run together, with no prioritisation or distinction drawn between them.

9. Explain any changes in KPI choices year-on-year

This doesn't, and probably shouldn't, happen often but, when it does, it is usually only spotted by doing a year-by-year comparison. This year we did see a company highlight a new KPI in addition to those from the previous year.

A related issue is when the only things that change in the KPI section are the dates and numbers, with the narrative being a carbon copy of the previous year. Not very helpful, even if the lawyers and accountants did sign it off last time. 1/10, must try harder.

10. The KPI/Remuneration link in the Annual Bonus section of the Remuneration Report

Given the current interest in remuneration in general, and Annual Bonuses in particular, this is a neat linkage to make, clearly aligning directors' interests with organisational performance, providing quantifiable data and explanation to support it.

It is, as one can image, not a problem-free solution. 47% of companies are ambiguous in what the measures for bonus payment are, favouring broad, catch-all terms such as 'corporate and individual objectives', 'personal objectives and financial targets' and providing no further detail. Some even deploy the ultimate get-out clause of, 'Specific targets have not been disclosed as they are considered to be commercially confidential' – the sceptics amongst us might add 'and eminently achievable'.

26% award their Directors annual bonuses based purely on the financial performance of the company, sometimes using only a single measure. Maybe their Remuneration Committee need to rethink the policies?

Reporting KPIs continued

But a laudable 20% attempt to directly link the Directors' annual bonuses to the corporate KPIs, some more successfully than others. Unfortunately, the majority fail to highlight this fact and, if interested, the keen reader has to carefully cross-refer what is stated as a bonus measure with the stated KPIs. At least one company we are aware of went the other way, starting with the established bonus criteria and identifying these as their KPIs.

Remuneration policy is beyond the scope of this paper, but the reputation management advantages are clear to see and, hopefully, this will be considered in the FRC/ASB Complexity Review when they come to consider the simplification of the Remuneration Report, and also in the concurrent Combined Code Review.

Conclusion

KPIs are on the radar screens of the regulators and are also being used as a way of benchmarking management ability. They have to be done, and they really should be done well. They provide at a glance information on how a company is performing and provide a sound way of linking this performance to remuneration.

Do get in touch do discuss this and other aspects of corporate reporting.

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