LINKING OPERATIONS AND STRATEGY WITH KPIs

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CPA AUSTRALIA

CONTENTS

1. INTRODUCTION TO KPIS

KEY POINT

Throughout this course, you should be using what you read to help you:

- Evaluate your current approach to reporting KPIs.
- Create a 'map' of what your new KPI reports will be.
- Identify the obstacles that may hinder your attempts.
- Develop an implementation plan.
- Successfully implement (or update) a KPI reporting system.

Most accountants spend a lot of time focusing on day-to-day issues. While these are critical to the survival of the organisation, it is easy to become distracted by the urgent, but minor issues of today and lose sight of longer-term priorities, actions and decisions that should be made. By having clear KPIs in place that are reported on regularly, the organisation is constantly reminded of what is important, what is being ignored and what needs to be improved.

KPIs are powerful tools that are able to increase intensity, accountability and results. However, there are times when employees or managers may not be fully committed to having such a level of exposure in terms of their behaviour, actions and outcomes. Successful implementation requires more than just designing a technically robust system. It also involves communicating to stakeholders, and influencing those involved so that they are able to appreciate that the benefits make KPI reporting worthwhile.

KPIs are often identified and discussed, but it is important for us to combine them into a coherent picture so that they are useful in guiding and running the organisation. In this section, we define KPIs and explain how they are useful.

1.1 REFLECTION/DISCUSSION: KPIS IN YOUR OWN ORGANISATION

REFLECTION/ DISCUSSION

Question 1.1

a) What are the KPIs used in your organisation?

b) How are they reported?

Question 1.2

a) Do you think there are any KPIs missing?

b) Do you think any of the KPIs currently used are unhelpful?

1.2 PERFORMANCE MEASURES

In order for us to understand performance measures, we first need to consider the concept of performance. Performance is typically associated with results or outcomes, as compared to a budget, a trend or other type of benchmark. Assessment of performance can be across different time spans (i.e. short or long-term). It can be based on effectiveness (i.e. the actual result) or efficiency (i.e. how the result was achieved), and can be considered in financial and/or non-financial terms. In addition, performance can be assessed at many levels (i.e. for an individual employee, for a team or department, for a particular activity or product, or for a whole organisation).

We can consider a performance measure to be any measure used within a business that is collected and reported. It may be quantitative or qualitative, focused on inputs, processes, outputs or even outcomes. Further, it may be considered leading (i.e. an indicator of future performance/results) or lagging (i.e. a measure of past performance).

EXAMPLE

Research and development effectiveness

Research and development (R&D) is a core expense for many innovative companies, especially in the technology and pharmaceutical industries. The ability to compete depends on a constant flow of innovative products and services that satisfy customer demands (or even create new desires).

R&D performance measurement typically includes measures such as:

- number of new products;
- R&D expenditure;
- number of patents registered; and
- revenue from new products.

However, we need to question whether these measures actually capture the effectiveness of the R&D activities. For example, consider the 'Sales growth percentage' for three technology companies: Apple Inc. (Apple), Microsoft Corporation (Microsoft) and Google Inc. (Google).

Sales growth %

	2011	2012	2013	2014
Apple	66.0%	44.6%	9.2%	7.0%
Microsoft	11.9%	5.4%	5.6%	11.5%
Google	29.3%	21.5%	20.6%	18.9%

We can see that Apple experienced significant sales growth between 2011 and 2012 and, given the industry Apple competes in, this could well have been related to its superior R&D effectiveness. However, sales growth has not been as rapid in recent years, indicating that there may well be a number of factors causing the single measure of sales growth (e.g. competition, marketing, input costs, acquisitions) or that R&D expenditure has been less effective than previously.

If we look at 'R&D expenditure as a percentage of sales', some intriguing results appear.

R&D expenditure as % of sales

	2011	2012	2013	2014
Apple	2.2%	2.2%	2.6%	3.3%
Microsoft	12.9%	13.3%	13.4%	13.1%
Google	13.6%	13.2%	12.9%	14.9%

Apple's R&D expenditure is significantly lower per dollar of sales than that of the other two companies. While Google and Microsoft spend about the same proportion on R&D, the sales growth for each company is significantly different, Most interestingly, in recent years, Microsoft's sales growth has continued to increase and Google's sales growth has not reduced as significantly as the sales growth reductions experienced by Apple.

While there may be some correlation between these measures and R&D effectiveness, it seems that one measure alone may be insufficient.

EXAMPLE

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Other factors that might influence R&D effectiveness are more qualitative and harder to measure objectively. These include:

- visionary leadership;
- innovative culture:
- the working environment;
- technical excellence;
- brand awareness; and
- product marketing (not forgetting good luck and good timing!).

Source: Apple Inc., Annual Reports 2012 and 2014, <http://investor.apple.com/>, accessed August 2015.

Source: Microsoft Corporation., Annual Reports 2012 and 2014, <http://www.microsoft.com/>, accessed August 2015.

Source: Google Inc., Annual Reports 2012 and 2014, <https://investor.google.com>, accessed August 2015.

1.3 KEY PERFORMANCE INDICATORS

It is important to note that a KPI should focus on a critical component of the business. While there are many useful and necessary activities occurring within the organisation, we need to ask ourselves:

Which of these activities are critical and need to be carefully monitored, separated from the rest, to provide a snapshot of whether the organisation is going to achieve its critical success factors and be 'successful'?

It is the monitoring of these activities, via the use of KPIs that achieves this need.

KPIs may be regarded as a sub-set of all performance measures available to an organisation, and, as the name suggests, they are key indicators of the performance of the organisation.

EXAMPLE

Marketing KPIs

Three widely used KPIs for measuring the performance of a marketing function are:

1. % brand awareness.
2. % customer retention.
3. $ customer acquisition cost.

It is fairly straightforward to see that these are key indicators of how well a marketing function is performing and contributing to an organisation's success.

There is no single definition for KPIs. Some definitions, and many annual reports and investor briefings provided by listed companies, focus more specifically on financial results, while others take more of a balanced scorecard approach and consider many measures, both financial and non-financial, within the organisation to be KPIs. Another approach is to really focus on the word 'indicator', which implies that the measure should indicate future performance, rather than report results of the past. An example of this latter definition is provided by Parmenter (2007), who argues strongly about separating financial measures (which provide results) from non-financial indicators (which point to future performance).

For our purposes, we will use a broader definition of KPIs, which incorporates measures that demonstrate past success, as well as measures that indicate future success.

DEFINITION

KPIs are a measure within an organisation that is important because achieving desired outcomes in this area is necessary for success or to prevent failure.

Many measures and indicators are useful throughout an organisation, but achieving KPI targets should be critical to the success of the organisation.

TIP

KPI test

A simple test for determining whether a measure is a KPI is to ask:

What will be the outcome of failing to achieve the desired result in this area?

- If the answer is that it will result in frustration or annoyance, or a slight decline in results, then it is not a KPI.
- If the answer is that the organisation will start experiencing significant financial difficulty, or that it will lose a large amount of market share, then the measure is a KPI.

KPIs often exist at a level that considers a much broader viewpoint than very specific measures focused on specific tasks or activities within the entity. In any organisation there will be a list of critical or key success factors that must be achieved for successful performance to be attained. Examples may include economies of scale, low cost structure, exceptional customer service, rapid and flexible delivery, and high quality raw materials. Once we can identify these factors, we can start considering which performance measures we can use to actively evaluate our progress towards achieving them.

The examples below reveal performance measures for two Australian listed companies, the Office of a state-based Auditor General, as well as CPA Australia. As you read these examples, consider whether the measures meet our definition of KPIs.

EXAMPLE

Qantas Limited

Qantas, the company, has a two-brand strategy. Qantas is the premium airline targeting the time-conscious business market while Jetstar, its subsidiary, is the low fares airline which targets the more cost-conscious holiday market. As a company, Qantas has safety as a first priority, with efficiency being achieved through having the right aircraft on the right routes with optimum capacity utilisation (i.e. seats filled with passengers).

Financial performance is naturally highlighted in the annual report to shareholders. Qantas draws particular attention in its annual reports to profit before tax, revenue, operating cash flow, and cash held at year end. Qantas reports its results for its major business segments, where it focuses on underlying earnings before income tax (before interest costs).

Qantas also notes it has established three financial priorities which it has aligned with its objectives. These are:

- Maintain an optimal capital structure, with a target to minimise weighted-average cost of capital (WACC).
- Deliver Return on Invested Capital (ROIC) greater than WACC through the cycle …
- Disciplined allocation of capital, with the aim of growing Invested Capital with disciplined investment.

Naturally, financial performance is a central part of the annual report. However, Qantas also includes a broad range of other measures of performance in its annual report.

The *Qantas Preliminary Final Report 2015* also reports performance in relation to:

- available seat kilometres (ASKs – a measure of airline capacity defined as the total number of seats available for passengers multiplied by the number of kilometres flown);

EXAMPLE

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- revenue passenger kilometres (RPKs – the total number of paying passengers carried, multiplied by the number of kilometres flown);
- number of passengers carried;
- revenue seat factor – seat utilisation (percentage of available seats booked);
- yield (passenger revenue divided by RPK);
- net underlying unit cost (as defined by Qantas); and
- revenue tonne kilometres (RTKs – the total number of tonnes of paying passengers, freight and mail carried, multiplied by the number of kilometres flown).

Clearly these performance indicators link back to Qantas' efficiency focus, and performance in these areas will drive financial performance of the group.

Source: Qantas Airways Limited, Preliminary Final Report for the Financial Year ended 30 June 2015, <http://www.qantas.com.au/infodetail/about/investors/preliminaryFinalReport15.pdf>, accessed August 2015.

EXAMPLE

Woodside Petroleum Ltd

Woodside is an Australian oil and gas company with capabilities in exploration, development, production and supply.

Woodside aligns operating activities with its strategic goals and it has a number of KPIs to measure performance. Their performance reporting is separated into different themes, including Financial Position, People, Health, Safety, Security and Emergency Management, Environment and Community Management.

Some of the performance measures reported are specific financials related amounts (e.g. 'NPAT' and 'Underlying EPS'), while some are driven by other best practice initiatives (e.g. 'Indigenous employment' and 'Graduate recruitment' focused on diversity).

Source: Woodside Petroleum Ltd, 'Annual Report 2014', <http://www.woodside.com.au/>, accessed August 2015.

EXAMPLE

Office of the Auditor General Western Australia:

The Office of the Auditor General for Western Australia (OAG WA) provides the Parliament with information on public sector accountability and performance. It has two types of KPIs:

1. Key Effectiveness Performance Indicators; and
2. Key Efficiency Performance Indicators.

Effectiveness for this organisation is measured in terms of the number of reports tabled in Parliament. However, such a measure does not necessarily address the quality of the reports, nor the outcomes from such reports.

Efficiency is measured in terms of OAG WA costs per gross levels of government expenditure. The assumption here is that the actual amount of government expenditure reflects the size, scope and complexity of the audit and hence the OAG WA costs become a measure of efficiency in carrying out those audits.

Source: OAG WA, 'Annual Report 2013–2014', < https://audit.wa.gov.au/wp-content/uploads/2014/08/OAG_AnnualReport2014-Part2-PerformanceIndicators.pdf>, accessed August 2015..

EXAMPLE

CPA Australia Ltd

CPA Australia Ltd prepares its annual report as an Integrated Report, containing the entity's financial and sustainability information.

CPA Australia reports on its performance relative to its target KPIs, in the areas of Our Members, Public Interest and the Profession and How we do business.

The table below is an excerpt from CPA Australia's 2014 Integrated Report, of the reporting relating to Key Performance Indicators.

Strategic goal	Measure	2014 Target	2014 Actual
OUR MEMBERS			
Certification and the CPA Program			
Delivering the highest quality CPA Program	Maintaining ISO certification	✓	✓
Driving world's best member engagement and service			
World class member service	Call queue times	120 seconds	25 seconds
The professional recognition that comes from carrying the CPA designation	Member retention (fully qualified)	98%	98%
Strong engaging relationships with members	Member engagement	7.0	7.0
Brand and broadening the audience			
Innovative new approaches to take our brand to a broader audience	Social media engagement	225,000	233,000
Access to knowledge			
Knowledge and resources that keep our members skills current and relevant	Supporting the development of my knowledge and skills	6.8	6.8
	Measure	**2014 Target**	**2014 Actual**
PUBLIC INTEREST AND THE PROFESSION			
Representation and advocacy			
A recognised and respected voice in the global business, accounting and leadership space	Providing leadership in the field	6.7	6.8
Professional standards			
The highest standards for members who provide accounting services to the public	Number of practice quality reviews	900	>1000

Adapted from source: CPA Australia Ltd, CPA Australia '2014 Integrated Report', pp. 14–15.