Measuring success: Creating metrics that deliver the information you need
Performance metrics can drive accountability at all levels of an organization. For strategic planning to transform into action within the organization, and for that action to stay on track, companies need to develop accurate ways to measure success and ensure that those measures drive operational activity. The best metrics are those that communicate to senior management whether the company is progressing toward stated goals or is stuck in a holding pattern. Good metrics also involve buy-in at all levels of the organization—not just from management but also from those whose activities are being measured. “Performance metrics are a way to keep your strategic planning activities honest,” says Justin LaChance, Senior Vice President, Financial Planning & Analysis.
Most companies employ a variety of general metrics that allow management to track the overall financial performance of the business—compared to previous months and years and compared to its competitors. Operating profit percentage is an example of a performance metric that is useful for almost every company. However, when analysts dig deeper, drilling down into those general metrics to find the true drivers of business performance, metrics can be developed that give management company-specific insight into particular ways that performance can improve. The DuPont formula, developed by that company in the 1920s, is a widely emulated example of this, where return on equity is broken down into a more complex equation, multiplying the net profit margin by asset turnover and an equity multiplier.

Just as a company’s goals and objectives evolve over time, the set of performance metrics management uses to track progress toward those goals should also change over time. If metrics are well designed and continually examined for relevance, they can be the precise tools management needs to turn strategic planning into action, and guide company-wide decision making so that stated goals are achievable and continually in focus throughout the organization.

**DuPont return on investment formula**

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**Introduction**

Management of a small-parts manufacturer held a strategic planning session where the company’s operating profit margin was discussed. Profit margins were lower than the company’s three major competitors by a significant amount. The income statement showed that the problem lay with materials costs, but nobody in the room could tell, from looking at the financial statements, whether the problem was a general one or was particular to one area or type of material. Management asked a financial team to develop a more detailed quantitative measurement of materials pricing. After careful analysis of the figures, management was able to pinpoint the problem: a long-term contract from previous years had locked the company into paying a high price for a commodity whose spot market price had fallen precipitously in recent months—a price decline now benefitting competitors’ profit margins. By first examining operating profit, a general performance metric, and then digging deeper to measure one component of that metric, management acquired the information it needed to improve financial performance.

GE believes that the best metrics companies can develop and use to measure performance are the ones that each company develops to meet its own particular long-term goals. While certain general performance metrics such as operating profit percentage are important and useful to most companies, no combination of ideal, “one-size-fits-all” measurements exists to deliver the right information for every company in every industry or operating environment. For example, inventory and sales volume metrics—tracked with detail and frequency—may be the most important metrics for large retailers. Inventory turnover ratios might be crucial information for a distributor, but of limited value to a service provider. A manufacturer of capital goods might focus on detailed orders analysis, including book-to-bill and backlog-to-sales ratios, while a restaurant would want to focus on...
customer satisfaction metrics such as percentage of repeat customers, or human resources metrics such as staff turnover ratios.

The first step, therefore, in devising metrics that fit your company’s needs is to look carefully at your own company, and your competition. “Always begin by identifying what your most important stakeholders think is important,” says LaChance. The second step is to make sure you clearly define long-term and short-term operational goals, so that you can create metrics that align with those goals.

**Strategic planning and metrics: The first step**

GE’s system for developing effective financial performance metrics starts with strategic planning sessions that take place each year. Financial Planning & Analysis (FP&A) analysts work with senior management to identify the company’s three-year goals. Once long-term strategic goals are in place, GE then hones in on the current year and the particular goals that we want to achieve. Only then do we develop metrics that align with those particular goals.

Performance metrics are most useful when analyzed as a group. Therefore, an important next step is to develop a matrix of measurements that, taken together, will provide management with insight into how a particular area of the business is performing in relation to strategic goals. The right combination of metrics, studied as a group, can show not only where the company is succeeding but also highlight specific areas of weakness. As data accumulates, the matrix can display trends and identify places where management can take steps to improve performance.

For example, management might decide on a one-year goal of raising yearly sales growth from 3% to 5%. From that goal, the strategic planning team would develop more specific execution targets. In order to boost overall sales growth, a goal for one division might be to increase sales by 6% in the coming year. Meanwhile, at another division, a tough economic forecast might cause planners to conclude that new sales volume will not materialize in the coming year. Therefore, management may decide that the primary one-year goal for that division is to generate stronger earnings growth from core operations. From these division-specific goals, a matrix of performance measurements could be created to track progress toward those goals and identify areas that need improvement.

The next step for planners is to test and then demonstrate that their method for calculating metrics is consistent and repeatable—and to develop a well-defined and controlled process for generating and reporting those metrics over time. “More than anything else the credibility of the metrics is crucial,” says LaChance. The team responsible for ensuring the accuracy and timeliness of the performance metrics also needs to make sure that they have a system in place to communicate those metrics to the right people at the right time—and to present the information in the most useful way possible.
Operating profit percentage: A key performance metric

While the strategic planning process identifies business-specific goals and develops new metrics for tracking progress toward those goals, some performance metrics are particularly valuable at all times and common to all types of business. At GE, the primary metric used for measuring overall performance and productivity is operating profit as a percentage of revenue. Operating profit metrics strip out the impact of one-time revenues and expenses to reveal how the business is performing.

GE’s calculation of operating profit

- Subtract variable costs from sales to arrive at the contribution margin.
- Subtract base costs from the contribution margin to arrive at the operating margin.
- Add in external “other income,” net interest income or expense, and subtract minority interest to arrive at operating profit.
- Calculate total revenue by adding external income to sales.

At GE, all eyes focus on operating profit. But having that metric is only the beginning of performance metrics development, not the end. In examining operating profit components, GE’s analysts dig deeper, searching for the drivers of change and then identifying specific activities that can be quantified, tracked and improved.

Drilling down: Devising metrics to drive performance improvement

Basic measures of financial performance such as return on capital and operating income are typically common to most companies and are used quite extensively to measure success and set future goals. GE has developed ways to create and monitor metrics that identify very specific components of those general measurements, in order to isolate individual activities that might enhance or put a drag on earnings. The FP&A team then hones in on those activities and develops measurements to describe them, in order to quantify their cost of benefit to the company. Once the metric is developed, the team can track progress and work on execution targets to improve performance.

For example, GE Capital leases aircraft to customers. Leases last for 7 to 12 years, after which GE will redeploy the aircraft by negotiating a new lease. That process creates a time period when the aircraft is not under lease and therefore not generating revenue. When measuring the costs of downtime for aircraft leases, GE Capital’s FP&A team spends time with the operations team so that they understand the process and activities involved with transferring an aircraft from one lessee to the next one. This process involves activities such as inspection and maintenance, which have to be factored into the necessary time and cost of downtime measurement. The FP&A team then develops a baseline calculation of necessary downtime that is included in the financial plan, and then monitors the days off lease and dollar value of lost rental income compared to the baseline amount in the plan. That metric is included in a weekly “dashboard” report of performance statistics and reviewed with senior leadership and the operations team to identify root causes of incremental downtime. All participants can then work together to devise a plan of action to ensure the negative effects of off-lease aircraft time on operating profits are lessened.

Identifying the right activity to measure and then developing a metric to monitor that activity is only the first step. The FP&A group works to understand the components of the metric that drive costs higher or lower. To do that, members of the group embed themselves with the operating teams in order to hear directly from them the specific actions needed to improve performance.

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When measuring the costs of downtime for aircraft leases, the FP&A team asked the operations people for insight into why the downtime occurs. In this case, those responsible for the aircraft leases explained that a large period of downtime between leases is spent negotiating new leases. Since the team now is quantifying the cost of the downtime, it can factor that variable into calculations of lease value. Therefore, when concessions are made during lease negotiations, the cost of aircraft downtime and the cost of the time spent negotiating the new lease are part of the calculation—and the total cost and benefit to GE Capital are clearer. Management and operations people can work together to devise ways to reduce downtime, as the costs are now transparent and quantified.
Making the most out of your metrics: A few suggestions
To get the most benefit from performance metrics, consider the following:

• At their most fundamental level, performance metrics measure the performance of your team. The most direct way to achieve results from performance metrics is to tie compensation to the most relevant metrics. However, in GE’s experience, pride, more often than not, drives performance. When team members examine measurements of improvement and must justify to their peers whether goals have been met, satisfaction in achieving those goals on a personal and group level is a strong incentive that drives superior performance.

• If the metrics developed are not relevant to performance, or if they are measuring something that is too insignificant to affect performance, then management jeopardizes effectiveness by focusing on those measurements instead of others. “If I am publishing metrics that are not relevant or impactful, I am wasting my time and the time of others,” says LaChance. The credibility of the metrics that are developed, how they tie into broad company goals and whether they are communicated to and adopted by all stakeholders involved in the activity measured are critical factors to the success of performance measurement.

• Calculate metrics accurately. Unless a company calculates metrics carefully, the operations personnel whose activities are being measured will not cooperate—or will ignore the metrics altogether. It is important to have buy-in not just from management but also from everyone whose activities are being measured.

Adapting to change, changing metrics
Just as a company and its goals evolve, the set of metrics used to evaluate performance should not remain static but should change over time. Each year at GE, when the growth playbook is reexamined, new metrics are developed and existing ones may be replaced. This allows the metrics to match GE’s goals looking forward, rather than backward. “As management goals and interest change, certain performance metrics fall off the list,” says LaChance. “If they are not replaced with more pertinent measurements, they will continue to be published but no one will look at them.”
A start-up manufacturing company may in the first few years of operation focus primarily on meeting revenue growth goals. The best performance metrics for this stage in the company’s operations might include measurements of revenue, including pricing, quantity and product mix. Later, as the company meets sales goals and ramps up production, productivity measures might take center stage. A mature company might shift its goals away from growing sales to growing margins, maintaining market share and enhancing productivity.

Crises, extraordinary events and environmental factors can also impact the measurements that take priority at any given time. For example, quality concerns within the supply chain might cause a retailer to track customer return-to-sales ratios more frequently. Transportation disruptions could magnify the importance of on-time delivery metrics.

A change in regulations might oblige a manufacturer to devise performance metrics related to carbon emissions. Careful reexamination of the set of metrics used each year is an important step in making sure you are measuring performance accurately and with an eye toward both current competitive conditions and future goals.

**Conclusion**

Metrics provide senior management with the information they need to track and drive company-wide progress toward their organization’s particular strategic goals. The most useful sets of metrics include both high-level and business-specific metrics that are explicitly tied to a company’s strategic plan. Metrics need to be well designed and should evolve over time as circumstances and goals change, so that they provide the right information about performance to ensure measurable progress toward those company-wide goals. Without a clear tie-in between the metrics used and a company’s strategic goals, developing and studying irrelevant metrics can be more than a waste of time: metrics might actually jeopardize organizational effectiveness by keeping management focused on the wrong issues. Well-designed metrics, however, can help turn strategic planning into action, and deliver to management the information necessary for effective decision making.