Rethinking Performance Measurement

Performance measurement remains a vexing problem for business firms and other kinds of organizations. This book explains why: the performance we want to measure (long-term cash flows, long-term viability) and the performance we can measure (current cash flows, customer satisfaction, etc.) are not the same. The "balanced scorecard," which has been widely adopted by US firms, does not solve these underlying problems of performance measurement and may exacerbate them because it provides no guidance on how to combine dissimilar measures into an overall appraisal of performance. A measurement technique called activity-based profitability analysis (ABPA) is suggested as a partial solution, especially to the problem of combining dissimilar measures. ABPA estimates the revenue consequences of each activity performed for the customer, allowing firms to compare revenues with costs for these activities and hence to discriminate between activities that are ultimately profitable and those that are not.

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Beyond the Balanced Scorecard

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CAMBRIDGE
UNIVERSITY PRESS

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE
The Pitt Building, Trumpington Street, Cambridge CB2 1RP, United Kingdom

CAMBRIDGE UNIVERSITY PRESS
The Edinburgh Building, Cambridge, CB2 2RU, UK
40 West 20th Street, New York, NY 10011-4211, USA
477 Williamstown Road, Port Melbourne, VIC 3207, Australia
Ruiz de Alarcón 13, 28014 Madrid, Spain
Dock House, The Waterfront, Cape Town 8001, South Africa

http://www.cambridge.org

First published 2002
Reprinted 2004

Printed in the United Kingdom at the University Press, Cambridge

Typeface Sabon 10/13 pt *System* LaTeX 2_ε [TB]

A catalogue record for this book is available from the British Library

ISBN 0 521 81243 7 hardback

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Preface

Performance measurement is in an uproar. The collapse of the internet bubble, the bankruptcy of Enron, and the erosion of confidence in the accounting profession have placed the problem of measuring the performance of the firm – and of other kinds of organizations – squarely in the public arena. Enron's bankruptcy, in particular, is a watershed event. On the surface, it raises the issue of how a firm reporting pretax profits of $1.5 billion from the third quarter of 2000 through the third quarter of 2001 could file for bankruptcy the next quarter. The answers proffered so far are the expected: sharp if not fraudulent financial practices, cozy relationships with auditors and their consulting arms, even cozier relationships with Wall Street analysts, and directors so dazzled by Enron's growth and generous directors' fees that they failed to exercise proper fiduciary responsibility.

But there remains an underlying problem so daunting that to raise it is almost heretical: can we accurately measure the performance of firms like Enron or, for that matter, any firm? I raise this question because the answer is not clear. For decades we have accepted that the performance of non-profit organizations like hospitals and universities is difficult to gauge. To be sure, performance measures for hospitals and universities abound (mortality/morbidity/acceptance/graduation rates, patient/student satisfaction, professional reputation), but most are unsatisfactory because they are incomplete or susceptible to deliberate distortion or both.

Until recently, firms have been privileged because we have assumed that the profit motive simplifies the measurements of their performance. Perhaps it once did. But no longer. As the internet bubble, Enron, and the travail of the accounting profession have shown, metrics (e.g. pro forma earnings) and accounting practices (e.g. off-balance-sheet assets) now commonplace have obscured the performance of firms. But for managers simplicity has long since vanished. The appearance of the balanced scorecard ten years ago signaled how complicated – and uncertain – performance measurement has become. The balanced scorecard was intended to make sense of the myriad of financial and non-financial performance measures that emerged in the 1980s and early 1990s by organizing them into four broad categories. But the scorecard has floundered as a device for measuring and rewarding performance. This book shows why (see chapter 3). Nevertheless, the scorecard has remained immensely popular as a tool for tracking progress toward strategic objectives, an aspiration far more modest than measuring and rewarding the performance of the firm and its people.

Why has performance measurement proved so challenging? Part of the answer lies in the gap between what we want to measure and what we can measure. We want to measure (or predict, if we cannot measure) how people and firms will perform. But we can only measure how people and firms have performed in the past. And the past is not necessarily a reliable guide to the future. Part of the answer lies in human nature: people will exploit the gap between what we want to measure and what we can measure by delivering exactly what is measured rather than the performance that is sought but cannot be measured. Part of the answer lies in the complexity of organizations we have created: the more complicated the organization, the more performance measures are taken and the more dissimilar those measures are – hence the more difficult it is to understand the actual performance of the organization. (It is likely that Enron's managers understood this principle better than their auditors.)

The gap between what we want to measure and what we can measure is endemic. The gap will not go away unless, of course, we revert to a command economy and quotas – the hallmarks of the failed experiment called socialism. Human nature will not change, but we can monitor measures and replace measures no longer discriminating good performance from bad because people have learned too well how to deliver what is measured rather than what is sought. Organizational complexity will not go away either. But we can analytically simplify otherwise complex organizations and reduce, if not eliminate, the dissimilarity of measures.

What I call ABPA – activity-based profitability analysis – is intended to accomplish this simplification by addressing some basic questions: what does the firm do for each of its customers, what does it cost, and what will customers pay for it? ABPA, to be sure, is not an all-purpose performance measurement tool. ABPA is not a panacea for all the underlying problems of performance measurement. Neither is the balanced scorecard, as will be amply demonstrated. However, ABPA, unlike the scorecard, has the virtue of focusing attention on the basics: what are we doing, what does it cost, and what will the customer pay for it? My hypothesis is that firms that persistently ask these questions will do better than firms that don't. ABPA is simply a structure for asking these questions in a disciplined way.

This project began from a persistent observation: the most common measures of organizational performance are statistically uncorrelated (see chapter 2). There are two ways to interpret this. One interpretation is that organizational performance lacks construct validity, in other words, that organizational performance does not exist. More than a few of my colleagues have taken this position, and many have had successful academic careers. Another interpretation is that sloppy thinking pervades performance measurement. This occurs because we have confused performance measures with performance. It is easy to measure something and call it performance (and then to rate and rank firms on the measure and publicize the ranking so that the measure becomes performance in people's minds). It is far more difficult to answer the fundamental questions, first, what is performance – that is, organizational performance – and, second, how to measure it. It turns out that organizational performance is not in the dictionary, which may be surprising because theatrical performance, mechanical performance, and psychological performance all are. It also turns out that theatrical performance, mechanical performance, and psychological performance, which are observable, are much easier to measure than organizational performance, which is not. The skeptic may argue that the performance of a firm is captured in its earnings and share prices. My answer is that earnings and share prices capture performance partially but far from completely. Consider the internet bubble. Consider Enron.

I owe a substantial debt to Professor Robert K. Merton. In the early stages of this research Merton persistently asked whether I was confusing performance measures with performance, in other words, had I fallen into the trap similar to operationalism, a doctrine of the 1930s asserting that the physical sciences should deal only with observables? It took me six months to understand Merton's question and much longer even to begin to answer it, and I am still not sure that I have done

so satisfactorily. I am also indebted to Beth Bechky, Chris Ittner, Dave Larcker, Ian MacMillan, and Sarah Mavrinac for comments on the manuscript. Mavrinac treated the manuscript like a draft of a PhD dissertation – there were handwritten comments on practically every page. Chris Harrison of Cambridge University Press is responsible, among other things, for the title of the book. Chris is one of the smartest editors I have ever encountered. My work on performance measurement would not have been possible without the backing of several organizations, including the Reginald H. Jones Center of the University of Pennsylvania, the Russell Sage Foundation, where I was a visiting scholar for the 1993–94 academic year, and the Citibank Behavioral Sciences Research Council, which funded the research on the balanced scorecard. My deepest thanks go to all those who supported this project and to Judy, Josh, and Gabe who smiled whenever they asked, "Where's the book?"