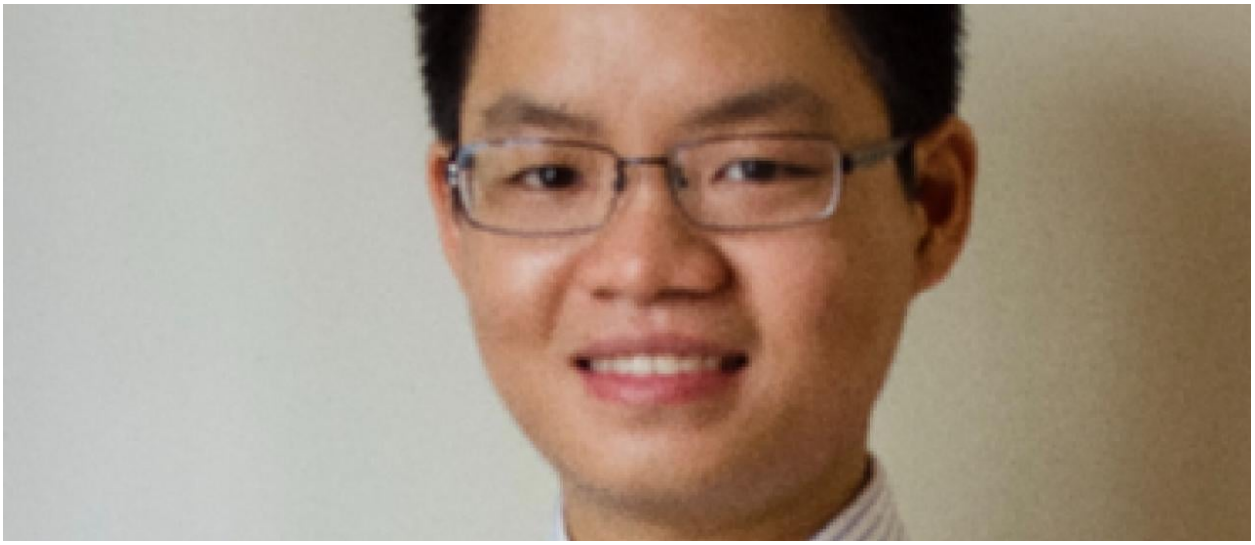
KPIs Should Never Be Tied to Compensation



By S. David Young , INSEAD Professor of Accounting and Control, and Kevin Kaiser, INSEAD Professor of Management Practice

Monetised indicator targets too often get in the way of value creation.

We recently had the opportunity to ask a large group of supervisory board members the following question: “If there is a trade-off between hitting this year’s targets and managing the company’s long-term health, which would you like your executives to choose?” About 86 percent of the audience said they would rather executives prioritise the company’s long-term health, in other words, value.

Next, we asked them: “In that same scenario, what do you think your executives would actually do?” You can probably guess their answer. Every single one of them expected executives to prioritise the year’s targets, considering that their compensation depended on it. The board members also recognised that, indeed, business targets are often at odds with long-term value creation.

A basic tenet of value creation is that a company should systematically invest in projects where the expected value of the cash coming in is greater than the cash going out. A big issue with this seemingly simple equation is that future cash flows are based on managers' forecasts and thus loaded with biases and other potential for error, made in good faith or not.

The confusion between value and price

We propose that all investments have an intrinsic value that exists independently of management's beliefs and which is based on probability. John Maynard Keynes himself recognised the role of probability in value nearly a century ago. He illustrated it with the story of the SS Waratah, a ship that disappeared off the South African coast in 1909. Re-insurance rates changed by the hour as flotsam surfaced and rumours went wild. Yet, no matter how re-insurance *pricing* fluctuated, the probability that the ship was lost (i.e. its true *value*) remained constant.

In business, the actual value of an asset typically depends on numerous factors dealing with an uncertain future. Knowing the true, intrinsic value of an asset would require accurate and instant information about it, plus everything that might prevail in the future and could potentially affect it. Since such information is not available to mere mortals, managers naturally turn to what they can actually observe and quantify. For instance, the most visible proxy for a company's value would be its share price, i.e. a consensus forecast reflecting the beliefs of many individuals at a given point in time.

In the same vein, it's widely thought that businesses can promote value-creating behaviour by focusing on observable and measurable KPIs. This naïve view has been responsible for staggering amounts of value destruction.

Red-line management

The insistence on using KPIs to guide value creation is what we call red-line management. With this approach, value creation may be the stated goal but the business is managed to deliver on arbitrary, short-term targets.

As KPI outcomes determine promotions, compensation and bonuses, employees quickly discover that it is in their best interest to hit their targets – even if value is wrecked in the process.

At the C-suite level, value creation is sometimes expressed erroneously as a rising share price. Though stock price can be an excellent indicator of value in theory, it is merely a market consensus often mistaken for the real thing. Converted to a KPI, it can be gamed, as commonly happens when firms invest in **buybacks** for the sake of increasing earnings per share.

Given the incentives, most managers achieve their KPIs, but this often requires cutting corners. For example, they might underinvest in brands or training to trim short-term costs, or they might play revenue recognition games to artificially boost sales growth.

Another side effect of managing by KPIs is misalignment and silo creation. Individuals, teams and departments all work towards achieving their own KPIs and have no interest in collaborating beyond what narrowly serves themselves.

In sum, drivers of value creation easily get denatured when converted to measurable indicators. This can promote questionable behaviour, which may even happen in good faith, though clearly not always. Delivering on KPI targets is no guarantee of value creation.

Blue-line management

In today’s complex world, there will always be knowledge gaps. Value creation is ultimately about how managers deal with this ignorance. It requires a culture in which having the right answers is less important than asking the right questions. In other words, value creation demands experimentation.

Indicators used as a basis for employee compensation cannot be trusted and therefore do not foster learning and continuous improvement. For example, while sales growth and profit margins are undeniably important indicators, how can they be interpreted when they are likely to be lies to some extent?

To replace red-line management, we propose blue-line management, an approach in which all decisions of consequence are made with one aim: To create value for the organisation.

Blue-line management doesn’t do away with KPIs, but keeps them as instruments for organisational learning. KPIs should be an integral part of a data-based effort to continuously learn and adapt. They should be neither carrots to reward employees who hit targets, nor sticks to punish employees who fail to deliver. They should be unbiased results used to learn the truth and promote the maximisation of long-term shareholder value.

This is an adaptation of an article published in **SF Magazine***, based on* **The Blue Line Imperative: What Managing for Value Really Means** *by Kevin Kaiser and S. David Young.*

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