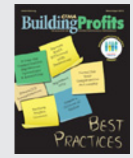


BY SHANE E. BROWN & ANDREW J. STEGER

KEY PERFORMANCE INDICATORS
Are Not Just About Profit

Imagine this scenario: It's the 15th of the month.

You have just received the previous month's financial statements and sit down at your desk to review the results.

Flipping through the pages, the numbers seem off. Profits are three points below your expectations.

As CFO, you pass the results on to the company owner and after a quick review, he remarks, "Costs should not be this high! What happened to labor last month? I thought we billed that project already!"

Your reaction is to tighten things up. So, you fire off messages to accounting to speed up the billing process. You call the foremen and tell them to reduce labor costs. You put actions in place to correct the situation. Sound familiar?

There are three key things you should consider:

1) Historical numbers, by definition, look back and only allow you to do one thing: react.

2) Financial measurements are not the whole picture and provide only limited insight into business operations.

3) While many contractors behave this way, ask yourself, "What do the others do?"

Historical financials are important in managing a business, but to grow and remain competitive, you need a broader view.

CEOs and CFOs who manage their businesses primarily based on the financial statements may run very successful companies; however, without forward-looking indicators to inform them, it's likely that they live their entire lives managing through the rearview mirror.

KEY PERFORMANCE INDICATORS

Not Just About Profit

We believe organizations that take time to identify, measure, and track decisions based on financial, operational, historical, and predictive measures stand the best chance to achieve their goals.

In this article, we'll share our perspectives on those forward-looking measures, or key performance indicators (KPIs). We'll discuss some traditional financial indicators and offer some predictive KPIs to consider and implement in your own organization.

What Exactly Is a Key Performance Indicator?

Effective KPIs are vital signals that help indicate if your business is functioning according to plan. Let's break it down:

- *Key* – An important or vital aspect. It means you have to prioritize. However, it doesn't mean you can leave everything on the list and just shift the order of priorities.

  Everything you measure can't be considered a key metric. Start with a manageable number. We typically see organizations effectively use 3-7 KPIs.
- *Performance* – The manner in which something operates, functions, or behaves. Just like an engine's performance can be measured by more than its miles per gallon, a company's performance needs to look beyond profit metrics.
- *Indicator* – A sign that gives information about and draws attention to a condition. This is usually a number, percent, or color code that quickly conveys favorable or non-favorable status.

Traditional Financial Indicators

Traditional financial indicators are important gauges for measuring a company's progress. These measures help to understand if the business is growing, shrinking, or maintaining its performance, and can also reveal important trends (such as changing expenses or revenue patterns). Three of the most commonly used historical financial indicators for contractors include:

Profit

As a contractor's profit margin shrinks, so does its margin for error. GCs must be vigilant in monitoring the profit margin to spot risky projects and project portfolios. Similarly, subcontractors must assess a project's profitability to determine if they should continue working with a GC.

Revenue

Both GCs and subcontractors should compare their revenue with the budget to ensure projects are progressing as planned. Comparing prior years can be helpful, but if the business depends on a small number of large projects, then this may not always be the best metric.

GCs must maintain a close watch on this indicator to determine success or failure on opportunities to acquire projects. Monitoring revenue is also important to subcontractors to help assess whether relationships with GCs are producing enough work.

Costs

Contractors operate on slim margins, which makes cost monitoring and containment a critical focus. With volatility in the supply and price of labor and materials, slim margins can quickly disappear or become losses.

Managing in the Rear View

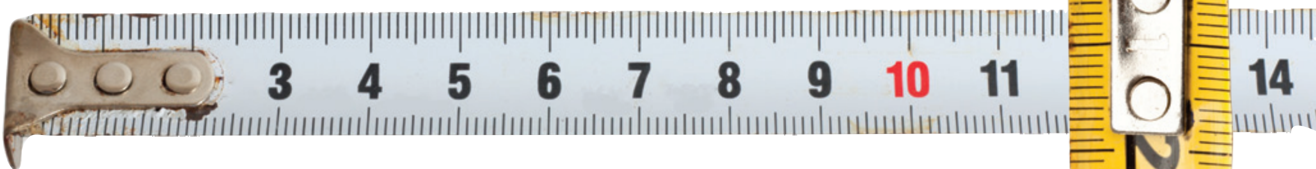
These traditional indicators, while valuable, are retrospective measures that only allow a view of the past and lack the ability to reveal how a business is likely to perform in the coming weeks, months, or years.

To drive the point home, imagine you are riding down the road in the back of a pickup truck. You use several indicators to determine how the trip is going:

1) It is very windy, which indicates you are moving fast. This is not necessarily a bad thing.
2) You see the road trailing off behind you, so you appear to be on track.
3) There is constant loud noise, not unlike your office during the rush of the day.
4) There are a number of cars falling behind, so you must be doing well compared to the competition.

You arrive at your destination, measure your gas mileage, and determine that everything seems to have gone well. However, because you were looking back, you were unable to spot a number of KPIs:

1) The temperature gauge was steadily rising, endangering the engine.
2) There were several forks in the road; better navigation may have allowed you to arrive at your destination faster.



Your KPIs are the equivalent of a temperature gauge or tachometer – they are the predictive measures that provide insight into future trends, challenges, and opportunities that allow you to make proactive decisions.

3) The driver failed to shift despite the roaring engine and red-lined tachometer, resulting in wear and tear on the engine.

4) You didn't notice the cars that started ahead of you and increased their lead. You thought you were ahead, but you were actually behind and losing ground.

Likewise, while historical profit, revenue, and costs are an essential part of measuring business performance, they don't represent a complete picture. Your KPIs are the equivalent of a temperature gauge or tachometer – they are the predictive measures that provide insight into future trends, challenges, and opportunities that allow you to make proactive decisions.

Five Sample Predictive KPIs

Predictive KPIs are forward-looking; they can drive changes in behavior and influence results. A strategic collection of both financial and non-financial indicators to capture all aspects of your businesses operations is preferred. Here are five sample predictive KPIs to consider:

Bid Development

Contractors often describe the funnel of business development as getting a certain number of bids into the top of the funnel in order to get the desired amount of work to come out the bottom.

A forward-looking KPI could be developed to track some of the following inputs:

- Pending bids currently in preparation
- Business development meetings scheduled and completed
- Active prospects and probability of winning work
- Meetings a subcontractor has with existing and new GCs to gain new work

Management can set reasonable weekly, monthly, quarterly, or annual expectations of these inputs and rationally predict outcomes well in advance. It may help management to know if indicators are slipping or surging when making staffing, purchasing, and bidding decisions.

For example, if revenue-driving activities have been increasing over the past two quarters, then management may be less willing to "buy" low margin work and more likely to make an opportunistic hire. Conversely, if business development activities are unusually low, then that may be the indicator management needs to readdress the current overhead structure and consider tightening up for a predicted decrease in revenues.

Buyout Process (Percentage of Work Bought-Out)

When a project is won, the GC immediately begins the buyout process. Management tracks the buyout percentage constantly, with an eye for potential problems. Slow buyout

is frequently blamed for job fade later in the project, but may be predictable and preventable if monitored.

While this may appear to be a KPI only for GCs, subcontractors can measure the amount of time between when a GC wins work and contacts the subcontractor or buys out the related work. The greater the time span, the louder the signal that there may be schedule issues manifesting that could affect the subcontractor.

Quality Control

Companies can put forward-looking indicators into place to increase the level of quality in completed jobs. Highly technical projects often have increased engineer involvement, a set number of owner inspections, building infrastructure monitoring updates, formalized architect sign-offs/inspections, and other levels of monitoring.

Jobs with quality surprises often miss inspections and appropriate documentation. Managers can set the expectation for tracking key indicators early in the project and insist on periodic reporting.

A common approach to monitoring quality control is to conduct an independent review of all jobs that present significant risk to the company. An internal senior committee often performs these at agreed-upon milestones to look at what levels of review are occurring, determine where additional quality control reviews may be conducted, and ensure that any additional quality control measures are carried out.

Subcontractor Inventory

Sometimes companies assume that the materials they use are consistent from job to job and there is little risk of overpurchasing. However, the economic downturn revealed buildups in both unique and common inventory far in excess of future job needs. When unneeded inventory builds up, precious cash is taken out of circulation. Also, bonding credit is rarely extended to inventory.

A simple series of leading indicators can verify that periodic inventories are occurring. This helps compare monthly purchasing activity to inventory on hand, identifying instances of purchasing inventoried stock. A KPI may be a simple exception report that compares monthly purchases of materials with unchanged primary location inventory of the same items.

With this information, management can investigate why inventoried items are being purchased and improve practices. Using inventoried materials instead of double purchasing can increase margins by 100% on items that may not be used again, which can greatly improve cash flow.

Safety

While a low experience modification rate (EMR) or high number of days without lost work demonstrates a safe past, a predictive KPI might be the number of safety activities currently implemented that includes the number of safety meetings, communications, notifications, or awards that recognize someone doing something safe. Other examples may include team-wide "near miss" meetings or self-audits of OSHA preparedness.

When you hear of a company with an accident or fatality, how often do you hear them say that they had an exemplary record? A great safety record is obviously a good thing, but is not necessarily a predictor of future success.

How to Select the Right KPIs for Your Company

All GCs and subcontractors should recognize the need to develop their own KPIs, but knowing which ones to select can be difficult and take significant time.

Start by understanding what makes your company distinctly different or better than its competition. We often celebrate success as the result of great input and attribute mistakes to bad input. However, that is not always the case, and there is often more to be learned from our successes and mistakes.

We recommend that management teams follow two distinct processes:

Critically Examine Your Successes

Create a list of your most successful projects. After a well-deserved pat on the back, identify why these projects were successful. What was different? Was there more estimator/PM collaboration than normal? Was project growth higher than expected (though still manageable)? Was there a fast buyout? Was the schedule compressed? Did the subcontractor work faster than anticipated? Were there more subcontractor bidders than expected?

One exercise to try is the Five Whys. Start by asking, "Why did this project go well?" Then ask, "Why?" four more times for each successive answer you give. The goal is to arrive at answers that had not been recognized before and be able to leverage them for other projects.

Understand Your Mistakes

Be courageous. Work with your management team to create a list of the most difficult failed projects. Ask, "What information was missing? How could we have made different decisions?" Then, identify the gaps to give you greater tracking and predictive opportunities. Also try the Five Whys exercise and begin with, "Why wasn't this project a success?"

Once this discovery has taken place, KPIs may be created to build on and duplicate those successes, while avoiding repeats of the failures. By tracking and watching these measurements, similar outcomes should become more likely.

Five Critical Steps for Putting KPIs to Work

The next challenge is using KPI data effectively to improve decision-making. To be successful, KPI data must be measured, tracked, and rewarded. While gathering this information is not always easy, technology provides the capability to more readily compile and analyze data throughout the construction project.

The following five steps can help you successfully implement KPI metrics and improve results.

1. Get Buy-In

Involve critical individuals early when determining and selecting your company's KPIs in order to significantly increase your success. If your team was not included in this process, then they may not have the incentive or ownership to drive participation. They may not intend for the new KPI initiative to fail, but change is difficult for most of us.

2. Measure

Almost any aspect of business can be measured in dollars, units, percentages, or time. Even less-defined measurements like satisfaction, confidence, or perception of quality can be determined through surveying and rating. Make sure someone is assigned the responsibility for measuring these factors.

3. Track & Distribute

Record and distribute the information you measure. New behaviors will fade if there is no way to share the results of the new KPIs. Further, progress in KPIs and the behaviors that support them are more likely when tracked against individual, team, and project goals – not just according to activities completed. Simply monitoring activity could encourage busywork rather than smart work.

Tracking performance is strongest with an open and accessible system that all employees (or at least those involved) may access. If accessibility is an issue due to privacy or security of data, then frequent feedback about the status of the KPIs can be shared with employees who are important to the success of the work.

4. Incentivize Behaviors That Drive KPIs

The most important way to drive KPI results is to reward the behaviors that produce positive results. It is human nature to be motivated by your own self-interest. This applies to customers, employees, and business partners, and each of these groups must be included. Customers must be rewarded with good service; employees must be rewarded with good pay and opportunities; and business executives must reward the organization with financial security for continued growth.

Be thoughtful about the activities you are rewarding. This may seem obvious, but many companies are guilty of rewarding the wrong behavior. Consider the pervasive, conflicting trend of companies that ask executives to make long-term decisions based on KPIs, but instead reward them for short-term profits. Be clear on what you are rewarding and what is required to be recognized for the desired behaviors.

5. Revisit & Revise

Don't let too much time pass before you revisit the KPIs you've selected and ensure they are doing what you intended. Your KPIs don't need to be set in stone – you can change or improve them. You may try a few before settling on those that work best for your company.

Cautions About KPIs

It is important to determine the KPIs that are best for your company. The ones we've mentioned may or may not work for your company. Here are some caveats to keep in mind:

- *Stay relevant to your company* – The most important factor in determining the value of a new KPI is its relevance to a particular company and situation. Industry, company size, project portfolio, and finances can all affect which KPIs are most relevant and useful.
- *Add KPIs slowly* – Don't attempt to track and analyze too many new KPIs at once. Collecting and tracking data is a time-consuming and expensive task. Before adding too many, make sure your effort is reasonable and aligned with your goals.

- *Don't dump everything you already use* – Don't lose track of useful indicators that are currently being monitored. As previously described, closely following revenue, cost, and profit trends are still important to a contractor's success.
- *Ensure data is accurate, timely, and safe* – Trusting the data is an important part of identifying the right KPI. As they say, "Garbage in, garbage out."
- *Be open to new information* – If every indication in your initial review of a potential KPI suggests operations should change, then be open to change. It may indicate that a specific KPI is not the right one for you, but it may also raise a warning flag that needs your attention. Ignoring or rejecting trends revealed with new KPIs because they do not fit a prescribed expectation or belief is a roadmap to disaster.
- *Keep them simple* – Many people often waste time calculating and manipulating data, only to find that they do not reveal anything of value. Keep your indicators simple and actionable.

Conclusion

While profit, revenue, and costs are frequently used to measure the business, these alone will not be the most useful indicators to drive business decisions. Recall our opening scenario – you've just reviewed the previous month's financials. It turns out that invoices were issued as soon as the information was received, and the foremen were managing labor costs within their control.

Two entirely separate issues were the culprit: Superintendents were not completing their reports on time, and labor estimates were not correct in the first place because of faulty labor formulas. Unfortunately, these can't be resolved based on your reactions. It will take some time before the underlying causes are identified and corrected.

Forward-looking KPIs tailored to individual business operations can provide much more information on trends, issues, and margin-eroding roadblocks.

Based on our experience, once KPIs are determined, successful implementation requires diligent measurement, tracking, and incenting the proper behaviors. With little margin for error, the construction industry can't afford to ignore the power of KPIs to help achieve and exceed business goals.

With a more complete and strategic collection of indicators, we believe you'll find yourself behind the wheel, confidently looking at the horizon – not just focused on the rearview mirror. It may not be a leisurely Sunday drive, but with the right indicators and persistence, we believe you will enjoy the ride. ■

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