KPI Masterclass

Fact Sheet

Performance Management related theories

1. Goal setting theory

Promoters: Ed Locke and Gary Latham
Year: 1968
Principles:

- Goals should be challenging, but attainable;
- Goals should be specific rather than vague;
- Employees should be involved in the process of setting their own goal;
- Goals should be measurable in terms of being clearly understood by employees: quantity, quality, time, and cost.

Mechanisms:

- Directive function. They direct attention and effort toward goal-relevant activities and away from goal irrelevant activities;
- Energizing function. High goals lead to greater effort than low goals;
- Impact on persistence. When participants are allowed to control the time they spend on a task, hard goals prolong effort;
- Affect action indirectly by leading to the arousal, discovery, and/or use of task-relevant knowledge and strategies.

The KPI Institute's perspective:
Setting targets motivates employees to perform better and keeps them focused on what matter the most for the organization. Establishing targets for the right KPIs aligns the entire personnel to the corporate strategy.

2. General Systems Theory

Promoter: Ludwig Von Bertalanffy
Year: 1968
Principles:

- A system is characterized by the interactions of its components;
- A system is characterized by the nonlinearity of the interactions between its components.

Previous principles:
Since Descartes, the "scientific method" had progressed under two related assumptions:

- A system could be broken down into its individual components, so that each component could be analysed as an independent entity;
- The components could be added in a linear fashion to describe the totality of the system.

The KPI Institute's perspective:
Setting objectives and analyzing KPI results must be done in context, using a system thinking approach. Only by understanding how different KPIs influence each other, or how one of more objectives from the Internal Processes perspective* contribute to the achievement of a Customer related objective, true value from KPI measurement can be generated. The decision making process must rely on system thinking, as the organization is like a living organism constantly changing and adapting to internal and external factors of influence.

3. Agency theory

Promoter: Kathleen Eisenhardt
Year: 1989
Principles:

- Organizations are composed of a complex network of relationships between individuals and entities with conflicting objectives;
- The divergent goals of the principal and agent raise conflicts;
- Both the principal (i.e. employer) and the agent (i.e. employee) are wealth seeking "economic men" who pursue their own self-interest;
- It is difficult or expensive for the principal to verify what the agent is actually doing;

Mechanisms:

- There is an information asymmetry between the principal and agent;
- Moral hazard, as the principal can't determine the effort level employed by the agent and cannot be sure if the agent has put forth maximal effort;
- Adverse selection, as agents may claim their skills and experience level is higher than the actual one;
- The difference between principal and agent in terms of attitude towards risk. Often the principal is assumed to be risk taker while the agent risk averse.

The KPI Institute's perspective:

In the business environment, there is one main agency dilemma between the employer and the employee. The employer wants to minimize his costs, while the employee desired to receive the highest possible remuneration for his work. Finding the balance between what both parties aim for can be facilitated by a performance contract. In this document, the employer and the employee agree upon performance standards expected and the remuneration paid for delivering work at pre-established quality parameters.

**Note: the Balanced Scorecard methodology clusters objectives into four perspectives: Financial, Customers, Internal Processes and People, Learning and Growth.*