Effective performance management requires an understanding of both the status quo and likely future changes. Leading and lagging indicators are valuable tools for boards to achieve that.

What's your position, what's your heading?—leading vs lagging indicators

Before GPS, navigating by air or sea required two key pieces of information—position (where you've traveled to so far) and heading (the direction you're going in next).

Similarly, effective performance management requires boards and executives to focus their attention in two directions—looking back to measure what's been achieved already, and looking forward to predict what's likely to occur in the future.

Placing too much importance on only one of these views can result in performance issues. Too much time spent measuring past success leaves companies assuming things will continue as they are indefinitely, and therefore vulnerable to unforeseen changes.

Too much time spent planning for the future, and day-to-day performance can suffer, often going unnoticed until serious damage has occurred.

Balance is key. Successful boards devote sufficient time to both aspects, using KPIs to monitor and evaluate both past and future performance

These are known respectively as lagging (also known as output) and leading (also known as input) indicators.

Examples of lagging indicators and how they are used

Lagging—or output—indicators give a picture of the status quo, i.e. what's happened up to the present time. As such, while lagging indicators are relatively easy to measure, as the results are already visible, there's no scope for changing them. For example, if profits were down 20% last quarter, it's easy enough to report the figure, but there's nothing the board of directors can do to change it.

Examples of lagging indicators include:

- Sales revenue
- Gross or net profit
- Number of attendees at an event
- Customer retention rate
- Total support tickets received

As they are unambiguous, lagging indicators are easy to interpret—giving an accurate picture of performance at a given moment, or for a given period. Taken in isolation, they can be a useful tool for comparing performance over time, i.e. month on month sales, or annual profits over a decade, but have little to say about future performance.

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Boards and management must be aware that using lagging indicators alone to predict the future is risky. Assuming sales will grow at 10% each month because they have done for the last 12 months is fine—as long as no other factor changes. In reality, that's highly unlikely to be the case. To make accurate predictions about future performance, companies need another view—which is given by leading indicators.

Examples of leading indicators and how they are used

Leading—or input—indicators are the inputs available to businesses to make predictions about future events or trends and adapt their direction appropriately. They can be harder to measure, as, by their nature, they are as yet undefined.

Defining and tracking them is often not as simple as a single number on a balance sheet (as with lagging indicators). Leading indicators are more of a prompt for managers or board members to ask themselves questions on how they can improve in specific areas, e.g.

- What processes can we implement to speed up the completion of this goal?
- What skills can the team improve to better achieve the desired outcome?
- What steps can be taken to streamline product development?

Examples of leading indicators include:

- Customer satisfaction
- Brand recognition
- Social media reach
- New products in the pipeline
- Economic or social trends

Monitoring changes in leading indicators allows businesses to predict how their performance may change (for better or worse) in the future. For example,

- An increase in customer satisfaction is likely to mean that repeat sales will increase.
- An upcoming product launch should result in greater sales of the new product.
- Doubling the number of social media followers should double the number of website visits.

As with lagging indicators, using leading indicators alone is unwise—without looking at the results it's impossible to know whether the predictions regarding performance changes associated with changes to these metrics were accurate. For effective performance management, businesses must combine both types of indicators.

Bringing the two views together

Combining the two sets of metrics—leading and lagging indicators—allows businesses to create a performance framework. This framework sets out strategic goals and the type of indicators that will be used to measure success.

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For example, a key responsibility of the board is setting out financial goals—sales targets, profit margins—which will be measured by lagging indicators, as well as non-financial goals—quality improvements, market share growth—which are measured by leading indicators.

Performance frameworks are not static, they're cyclical. Boards must undertake periodic performance reviews to both examine the past predictions made using leading indicators and to evaluate their accuracy by referring to lagging indicators.

To take a simplified example, in Q1 a company predicts that a new product launch (leading indicator) planned for Q2 will generate a 20% increase in sales revenue for the year. At year-end, the board reviews total sales (lagging indicator) and finds the prediction was incorrect, as sales grew by only 15%. Other lagging indicators, e.g. average order value, can help identify why the sales prediction was inaccurate. The company can then make adjustments to improve future predictions and improve performance in the next campaign.

Boards should continually monitor leading and lagging indicators, and compare them over time to evaluate their effectiveness, in order to drive continual and sustainable performance improvements.

Looking for some advice on managing performance?

MEIoD assists entrepreneurs, business owners, executives, and investors within companies of all sizes across the Middle East.

We offer a combination of targeted information and resources, capacity-building programs, independent business consultancy, and organizational evaluations, as well as support with the recruitment and running of boards of directors and advisory boards.

For more information on the services available, please contact us.

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Maali Q. Khader is a highly experienced, effective, and trusted lawyer. Today she is a luminary in the corporate governance, sustainability, legal training, and advice sectors.

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