Performance Measurement: Stakeholder and Shareholder Approaches

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## Measurement Metrics

<table>
<thead>
<tr>
<th>Stakeholder Perspectives</th>
<th>Shareholder Perspectives</th>
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<tbody>
<tr>
<td><strong>SMART Pyramid</strong></td>
<td><strong>Discounted Economic Profits</strong></td>
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<tr>
<td>(Lynch &amp; Cross 1991)</td>
<td>(Marakon Associates)</td>
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<tr>
<td><strong>Results &amp; Determinants</strong></td>
<td><strong>Economic Value Management</strong></td>
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<td>(Fitzgerald et al, 1991)</td>
<td>(KPMG Peat Marwick)</td>
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<td><strong>Balanced Scorecard</strong></td>
<td><strong>Economic Value Added</strong></td>
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<tr>
<td>(Kaplan &amp; Norton, 1992)</td>
<td>(Stern Stewart)</td>
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<td><strong>Performance Prism</strong></td>
<td><strong>Cash Flow Return on</strong></td>
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<td>(Neely &amp; Adams, 2001)</td>
<td><strong>Investment</strong></td>
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<td></td>
<td>(Boston Consulting Group’s</td>
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<td></td>
<td>HOLT Value Associates)</td>
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The Balanced Scorecard
Kaplan & Norton, 1992

Financial Perspective
Goals Measures

How do we look to shareholders?

Customer Perspective
Goals Measures

How do customers see us?

Internal Business Perspective
Goals Measures

What must we excel at?

Innovation & Learning Perspective
Goals Measures

Can we continue to improve and create value?
Residual Income

Residual income (RI) can be calculated in two ways;

- $RI = \text{Operating Profits after Tax} - \text{Capital Charge}$
  - *where the Capital Charge is defined as:*
  - Invested Capital $\times$ the Weighted Average Cost of Debt and Equity Capital (WACC)

or

- $RI = \text{Invested Capital} \times (\text{Return on Capital} - \text{WACC})$
Economic Value Added

EVA® = Adjusted operating profits after tax – (Adjusted invested capital x WACC)

or

EVA® = Adjusted invested capital x (ROI – WACC)
The building blocks of performance management
(adapted from Fitzgerald & Moon, 1996)
Strategy mapping (Kaplan & Norton, 2001)  
(note Norreklit, 2000)

Linking of incentive compensation to Balanced Scorecards

“the only generalisable finding from all of the company experiences in linking compensation and reward to Balanced Scorecards is that they do it” (Kaplan & Norton 2001, pg265)
Shareholder Approaches to Rewards

- Holt Associates adopt a prudent position and suggest waiting some time before linking rewards to outcomes of the CFROI model.
- Rappaport (1998) managers must be given time to understand and accept the measures they will be accountable for otherwise the SHV programme could be compromised.
- Reward system is central to the Stern Stewart Model (Bonus Banks).
## Incentive Schemes

<table>
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<th>Dimension of Performance Measured</th>
<th>Balanced Scorecard</th>
<th>Economic Value Added</th>
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</table>
| Multiple objectives based on strategy | Single Financial Objective  
Other measures abandoned |
| Target Setting                    | Limited advice           | Zero EVA as the minimum acceptable target  
EVA goals as a basis for stretch targets |
| Rewards                           | Acknowledged as important but limited guidance on compensation packages | Appropriate incentive schemes are a central part of the methodology |
Empirical Evidence

- What metrics are organisations using?

- Is performance improved by adopting as formal business performance management programme?

- How is the performance measurement system used in the firm?
What metrics are organisations using?

Marr Survey, 2004 – US
- 46% use formal PM
  - Of that 46%
    - 75% use BSC
    - A small minority rely on EVA
    - No mention of CFROI

Ittner & Larker, 2003 – US Financial Services Industry
- 20% BSC
- 36% EVA

Speckbacher, Bischof & Pfeiffer, 2003 – German speaking countries
- 24% BSC
Is performance improved by adopting as formal business performance management programme?

Organisations with formal BPM believe they out-perform organisations without it

(Marr, 2004, US)

Measurement managed companies outperform non-measurement managed companies

(Lingle & Schiemann, 1996, US)

Kleinwort Benson investment portfolio based on EFQM’s Business Excellence Model and Investors in People criteria outperformed others by 16% in the short term and 38% in the long term

(Ashton, 1997, UK)
Does the adoption of a BSC lead to improved performance?

**Positive associations:**

Davis & Albright, 2004
- Bank branches (US)

Malina & Selto, 2001
- Manufacturing – distribution channels (US)

Hoque & James, 2000
- Manufacturing (Aus)

Banker et al, 2000
- Hotel industry (US)

Ittner & Larker, 2003
- Financial Services Industry (US)

- Negative association between BSC adoption and ROA

- Further analysis focusing on adopters who had built causal models (23%) had higher ROA and ROE
BSC – Measurement or Management System

First Generation
- Focused on measurement combining financial & non-financial measures

Second Generation
- Developed linkages using cause-and-effect chains

Third Generation
- Completes the transformation by linking incentives to the achievement of BSC targets

Non Adopters

(Speckbacher, Bischof & Pfeiffer, 2003
German speaking countries)
Two key claims for using EVA as a performance measure

- EVA is a better predictor of stock market returns than traditional accounting earnings
  - *Biddle, Bowen & Wallace, 1997, found traditional accounting measures were more closely associated with stock returns and firm values than EVA, RI and cash flows from operations*

- A PM and reward system based on EVA will provide higher rates of return for shareholders than conventional reward systems based on EPS and other popular financial measures
A PM and reward system based on EVA will provide higher rates of return for shareholders than conventional reward systems based on EPS and other popular financial measures.

Kleiman, 1999
- Compared adoptors of EVA with non-adopters from the same industry
- 3 year period prior to adoption no distinguishable difference in stock market performance
- Following adoption EVA companies out-performed their median competitors by 28.8% over 4 years

Wallace, 1997
- Companies adopting EVA and residual income in compensation schemes tended to generate higher levels of RI than control companies (by improving operating efficiency, disposing of selected assets and repurchasing more shares)
Sample data comes from publicly available sources – typically published EVA data from Stern Stewart

- Although this contains the standard accounting adjustments it excludes firm-specific adjustments
- What is an EVA company?
### How is the performance measurement system used in the firm?

<table>
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<th>Stakeholder</th>
<th>Shareholder</th>
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<tr>
<td>Key stakeholders</td>
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</tr>
<tr>
<td>shareholders, customers, employees</td>
<td>shareholders, customers, employees and suppliers</td>
</tr>
<tr>
<td>Wide range of measures</td>
<td>&lt; 50% considered shareholders to be the most important</td>
</tr>
<tr>
<td>All used profit based +</td>
<td>Value based measures dominated supplemented with profit, ROCE and stakeholder measures</td>
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<tr>
<td>One third also used value based measures</td>
<td>Only 20% relied solely on value based measures for rewards</td>
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<tr>
<td>70% did not tie achievement of targets to rewards</td>
<td>(Cooper et al, 2001 – UK)</td>
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Implementation issues; technical, behavioural and organisational
Lloyds TSB

Brian Pitman CEO 1983-2001

- Market capitalisation moved from £1 to £40 billion
- Compound shareholder return averages 26% annually

First priority was to get some agreement on what constituted success – easy – they wanted to be the best financial services company

Agreed metric ROE

- Initial target 10% above the rate of inflation
- Changed the target to the cost of equity

Reformation of strategy to concentrate on unglamorous products such as mortgages and insurance; a move from profit to value
“Systems like those (BSC) rely on multiple objectives which set up competing claims on people’s time and send confusing signals about what you are trying to accomplish”

(Pitman, 2003)

System progressed: target setting - external process benchmarks,
Reward system extended throughout the organisation with significant bonuses
System driven from the top – senior managers used the system, targets and rewards were explicit and reinforced motivation
Global Survey on Value Based Management Implementation (Haspeslagh, Noda & Boulos, 2001)

- An explicit commitment to shareholder value at board level
- A training programme that encourages thinking in terms of generating shareholder value
- Reinforcing training with broad based incentive schemes closely tied to value based performance measures, thus giving employees a sense of ownership
- Being prepared to make major organisational changes through divestment, investment and structural change within the company
- Broad and inclusive changes to company processes.
  - avoid accounting complexity
  - identify value drivers
  - integrate budgeting with strategic planning
  - invest heavily in information systems.
Conclusions & Research Opportunities

Organisations with formal performance management systems outperform organisations without

Then things become confused – some studies show adopters of BSC and EVA outperform control groups. There are definition problems

- What do we mean by BSC? Is it generation 1, 2 or 3?
- How do we define an EVA organisation? Is it sufficient to use EVA as a reported performance measure and for executive compensation?

Cultural dimension

Around 60% of survey respondents continue to manage within the traditional accounting framework
Conclusions & Research Opportunities

Within the firm the stylised theoretical approaches of stakeholder and shareholder approaches seem to break down in the UK context – companies appear to mix and match the methodologies.

It may be that EVA works at the company level but translating this to business unit levels and down to operational managers is problematic. *Similarities with strategy mapping?*