



ABC, The Balanced Scorecard and EVA[®]

Distinguishing the Means from the End.

- ABC, the Balanced Scorecard and EVA are modern tools for performance measurement and management that are being used by many companies across Europe.
- Are ABC, the Balanced Scorecard and EVA frameworks mutually exclusive or can they be used together in the same organisation?
- ABC and the Balanced Scorecard provide managers with the information needed to make “value creating” decisions. EVA provides a decision framework, performance measures and incentives to motivate management to create value.

EVALuation is a series of monthly reports from Stern Stewart Europe Limited, drawing on the depth of our experience and internal research, to cover issues of valuation, organisational design, decision making, remuneration, and corporate governance. Our focus is to assist managers in understanding how their actions affect the value of their organisations. We believe that all stakeholders benefit from the creation of value through both innovation and efficiency.

“In a sense, business is like football. A manager of a football club needs to push many factors to succeed, such as getting shots on goal, winning corner kicks, providing a solid defence and having a goalie who makes saves. At the end of the match, however, all that matters is that you win, not how many corner kicks you get. In business too, a manager must manage many inputs, and both ABC and the Balanced Scorecard help managers to make decisions. But EVA is needed to determine whether we win or we lose. By using EVA for decisions, performance measures and rewards, managers are motivated to use the information at hand to act as owners and create value.”

Greg Milano, Managing Director, Stern Stewart Europe Limited.

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Executive Summary

Increasingly competitive global product markets have rendered many traditional performance measurements and reward systems obsolete. The need for organisations to adapt to today’s dynamic and complex business environment in order to remain competitive is clear. In addition, the investment community has increased the pressure on managers to deliver value, driving for more accurate and transparent performance measurement. As a result, many organisations have had to re-examine their traditional performance measures and the structure of the compensation schemes that were built around them in the past decade.

New measurement techniques are now based on economic theory rather than the accounting framework. But what framework should a company use? And once a new framework is implemented, does that mean that a company should ignore all others?

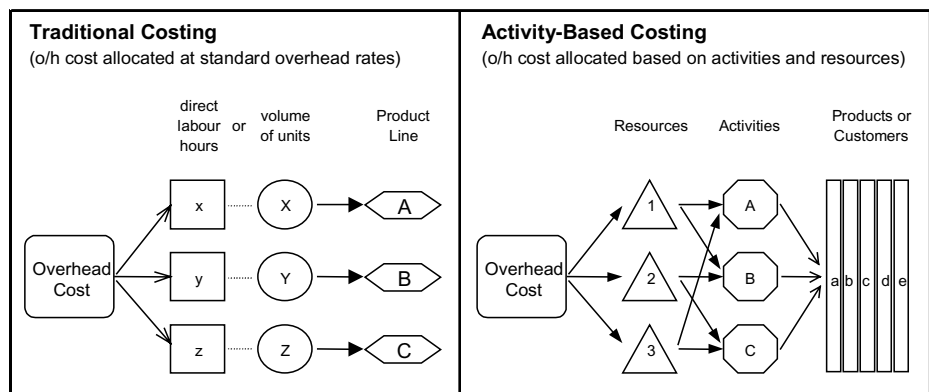
This paper will discuss Activity-based costing (ABC), the Balanced Scorecard and Economic Value Added (EVA®), three frameworks that are becoming increasingly popular with companies in a wide range of industries. Although we will briefly describe each of these frameworks, we are more concerned with answering the question “Can these frameworks be used simultaneously or are they mutually exclusive?” Our research suggests that these frameworks are in fact complementary and can be very affective when used together.

Activity Based Costing

Activity-based costing addresses deficiencies in the traditional cost accounting systems. These legacy systems are based on a few cost drivers, usually direct labour or direct machine hours, and do not accommodate the recent changes in business environment. As an organisation’s product and customer mix becomes more diverse, the assignment of overhead expenses becomes grossly misleading, distorting the costs of individual products/services. As a result, many manufacturing organisations have cost systems which can support financial reporting, but provide distorted information about the individual products. This sends the wrong signal to decision makers.

ABC is a cost measurement system that provides a cost for each product, service or customer by analysing each activity needed to produce a product or service a customer. The difference from traditional methods is illustrated in Exhibit 1. For example, a product that has a short processing cycle may use a disproportionate amount of inventory space or time on the receiving dock. When indirect costs are allocated to products based on the wrong cost driver products will appear less or more expensive than they actually are. ABC is used to identify all activities, direct and indirect, and allocate the costs associated with these activities more precisely.

Exhibit 1. Cost allocation under the two approaches - Traditional costing and ABC.



Traditional cost accounting sends the wrong signals to managers

ABC improves the quality of product and customer costing...

... and helps identify areas for improvement

ABC can be used in any type of organisation. It is most useful though, when an organisation has complex transfer pricing issues, high indirect costs and shared



processing stations. ABC provides useful insights, but information without action does not add value. The results should be used to generate improvement. Procter & Gamble makes use of ABC technologies to identify the per case cost of inefficient industry practices, and the amounts that can be saved by improving those practices¹. Process reengineering programs often follow an ABC analysis, with streamlined processes, reduced cost and higher quality pursued.

Many ABC systems are designed to capture costs that appear on the P&L statement only. We would argue that this approach is flawed because it provides incomplete information. One must also capture the cost of capital employed to produce a certain product or serve a certain customer. For example, if a customer insists on extended terms of payment, the additional carrying cost of Accounts Receivable associated with this customer must be captured in the ABC system. Managers must focus on cost *and* capital.

Cost information alone does not provide a complete picture

But even when a typical ABC system is upgraded to include the cost of capital, it still provides an incomplete picture. While the cost aspect is vital, managers need to understand the impact on revenues, volumes, customer satisfaction, market position, employee morale and a host of other factors. Therefore, cost information alone, regardless of how accurate it is, is insufficient to maximise value. Managers need to understand how costs interact with other performance indicators before they can improve the performance of their business. This ties into the Balanced Scorecard.

The Balanced Scorecard

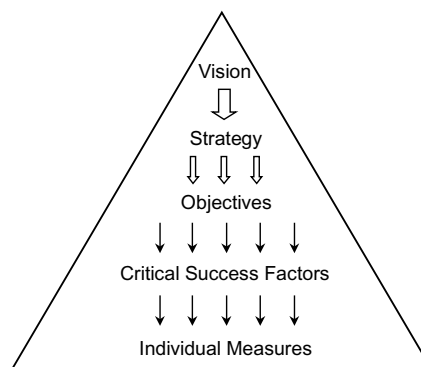
Balance Scorecard provides a broader view of the business...

The Balanced Scorecard recognises the need to identify and track a number of financial and non-financial measures to provide a broader view of the business. For this purpose, an organisation is not limited to accounting data. A company may select indicators of process efficiency, safety, customer satisfaction or employee morale. This can capture information about current performance and emphasise leading indicators of future success. The objective is to produce a set of measures matched to the business so that performance can be monitored and evaluated.

... and helps translate the business strategy into objectives

The Balanced Scorecard was created by Robert Kaplan and David Norton to translate vision and strategy into objectives. The balanced scorecard is meant to help managers keep their finger on the pulse of the business. Each organisation will emphasise different measures depending on their strategy. Management is, in effect, translating their strategy into objectives that can be measured (see Exhibit 2).

Exhibit 2. The Balanced Scorecard links strategy to measures.



Choose variables that can predict the future or explain the past

The scorecard is a collection of data that helps a manager understand performance. The measures help managers balance their focus between current and future performance. Leading variables are future performance indicators, and lagging variables are historic results. Financial measurements are typically lagging variables, telling managers how well they have done. On the other hand, an example of a leading indicator is training costs, which influences customer satisfaction and repeat business. Some variables

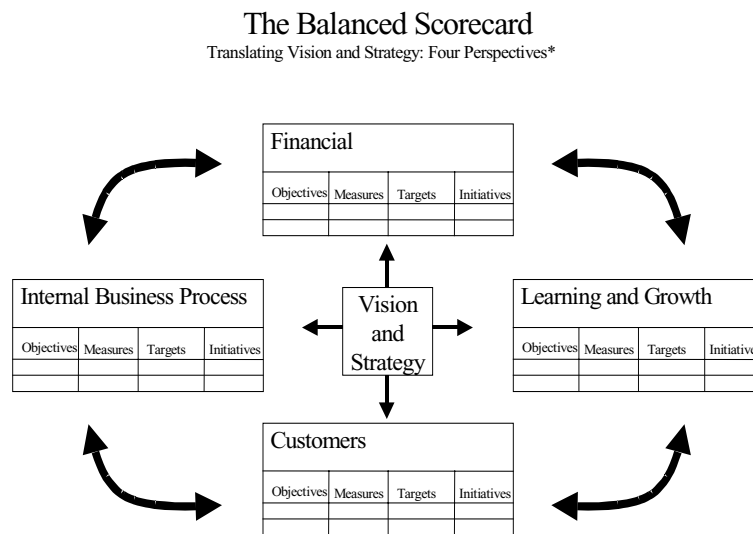
¹ Page 197, Cost & Effect; R. S. Kaplan and R. Cooper; Harvard Business School Press, Boston Massachusetts 1998.



exhibit both lagging and leading characteristics, such as on-time deliveries (a lagging measure of operational performance and a leading indicator of customer satisfaction).

What do organisations focus on?

The balanced scorecard usually has four broad categories, such as financial performance, customers, internal processes and learning and growth. Typically, each category will have two to five measures. If the business strategy is to increase market share and reduce operating costs, the measures may include market share and cost per unit. Another business may choose financial indicators that focus on price and margin, willingly foregoing market share for a higher-priced niche product. These measures should be set after the strategy is in place. A list of objectives, targets, measurements and initiatives comes with each variable, as shown in Exhibit 3. The saying “we manage what we measure” holds true. One reason the balance scorecard works is because it raises awareness.



* Reprinted from "Linking the Balanced Scorecard to Strategy", by Robert S. Kaplan and David P. Norton, California Management Review (1996)

Exhibit 3. The Balanced Scorecard converts strategy into action.

Not limited to business ventures

Although the balanced scorecard is typically used for businesses, the public sector management of Charlotte, North Carolina has used this framework to manage their city. Their scorecard includes performance indicators that track improvements in safety of community, quality of transportation, economic development and effectiveness of government restructuring. Other more local measures of fire prevention, garbage collection and sidewalk maintenance are used for individual departmental scorecards². This illustrates the flexibility of the scorecard and re-iterates the point that the scorecard measures can only be determined after the overall strategy is understood.

It lacks a single measurement for accountability

The balanced scorecard, if properly implemented, is an excellent management framework that can help managers to track the many factors that influence performance. But it lacks a single focus for accountability. Management needs one overriding goal to summarise the interaction between the variables and, ultimately, determine success. Shareholders entrust management to implement strategy but their primary concern is earning an adequate return on their investment. EVA, as discussed below tells us whether managers have balanced the scorecard measures “right” and as Kaplan says “Creating EVA is the ideal outcome of a successful strategy, and that’s what we are trying to do.”³

² Charlotte adopts the “Balanced Scorecard”; The American City & Country; Pittsfield; October 1998; P. Syfert, N. Elliott, L. Schumacher

³ EVA and the Balanced Scorecard; Stern Stewart & Co. EVAngelist™ magazine Volume 2 Issue 4; Autumn 1998



Economic Value Added

There can be only one measure that summarises success

EVA is the one measure that is used to monitor the overall value creation in a business. EVA is not the strategy; it is the way we measure the results. There are many value drivers that need to be managed, but there can be only one measure that demonstrates success. A single measure is needed as the ultimate reference of performance to help managers balance conflicting objectives.

Improvements in EVA are synonymous with increasing shareholder wealth

The EVA measure was created by Stern Stewart to address the challenges companies faced in the area of financial performance measurement. By measuring profits after subtracting the expected return to shareholders EVA indicates economic profitability. It tracks share prices much more accurately than earnings, earnings per share, return on equity or other accounting metrics, as strongly supported by empirical studies. Creating sustainable improvements in EVA is synonymous with increasing shareholder wealth.

Multiple measures cause confusion

EVA is not a new concept. Economists have known about the residual income framework for years, but businesses have only recently begun to make the switch from managing for earnings to managing for value. EVA has facilitated this process by providing practical applications that operating managers can use and embrace.

One of the great benefits of the balanced scorecard is that it illuminates the objectives that drive the strategy. In the same manner, EVA provides a common language across the organisation. Typically, different metrics are used for different processes. For example, sales growth and market share are discussed when strategy is formulated, NPV or IRR are calculated when capital investments are considered, earnings and EPS are considered when an acquisition is contemplated, yet trading profit is used when bonuses are determined. Which do you manage? Managers who use IRR to get a project approved don't need to worry about their actual performance because IRR cannot be used to measure performance in the middle of a project. Managers who are rewarded against a budget know that budget negotiation skills can be more lucrative than actually delivering results.

EVA gives you accountability

EVA can be the single metric used in all of these management processes. When decisions are made, performance is measured and compensation is determined using the same measurement you get accountability. Operating managers also find that EVA simplifies their job, as they barely understand the interaction between the multiple existing measures.

EVA is the way success is measured and rewarded

When EVA is the focal point of all management processes, the organisation will function more effectively. A common language and a clear objective based on one measure will remove much of the confusion and blurred objectives that cripple organisations. As Dr. Karl-Hermann Baumann, Head of Siemens' supervisory board, says "EVA removes the confusion arising from the existence of several planning measures and creates a common language for everyone...for the simple employee and the top manager."⁴

A large part of an organisation's culture comes from the way success is measured and rewarded. The balanced scorecard can help employees deliver on the corporate vision, but EVA tells them whether they have been successful and should be rewarded. John McGrath, the Chief Executive of Diageo stated "I needed a team that was efficient and focused on Diageo's business aims - a team that embodied the culture I foresaw for Diageo. EVA was one of the tools that would help enormously in this process of post merger integration."⁵

⁴ Capital magazine, 1997

⁵ FT Mastering Management Magazine, 1999



Critical success factors

All three frameworks begin with new measurement techniques. At the outset, it is important to understand the barriers that can prevent the project from becoming successful. Creating more or better information is not necessarily going to lead to better decisions. In fact, adding another measurement to the existing pile of measurements will actually complicate matters. Managers must be motivated to act upon their new information. When managers are not rewarded to make the right decision, it will rarely be made.

Balance simplicity and accuracy

Another critical factor is achieving a balance between simplicity and accuracy. An overly complex model may be more accurate, but the project could collapse under the weight of mountains of data that hide the relevant facts. And, as an overly complex model may be too difficult for managers to understand, an excessively simplistic model might lead to the wrong decisions.

Ensure senior management commitment

Senior management commitment is imperative for the project team to receive the support necessary to deliver results. Without this commitment, the project will be viewed as another “flavour of the month” or, worse, another “bean-counter” initiative.

Management behaviour is the critical factor

The desired result is not to get better information, but to increase the value of the organisation. The only way these frameworks will achieve this goal, is if the right decisions are made using the new information. People, not information, add value to the organisation, so the project must positively affect management behaviour for it to be successful.

The whole system of decision making, performance evaluation and compensation should be tied together

Long-term, sustainable increases in performance will come when an organisation’s culture is transformed from one focused on doing one’s job to a culture centred on value creation. The implementation of a measurement system alone will not create sustainable changes. Freedom to act upon the information can only be delegated when there is accountability for the results. A compensation plan that properly rewards the desired actions is needed to expect true “owner-like” behaviour.

Conclusion

ABC, the Balanced Scorecard and EVA are useful tools that can help a company achieve greater success in the current dynamic and competitive business environment. In fact, these tools are quite complementary. ABC can help managers understand the cost and capital impact of their decisions. The Balanced Scorecard broadens the view of performance to include financial and non-financial indicators of both a leading and lagging nature. EVA provides a link between decisions, performance measures and rewards, which focuses managers on creating value.

These frameworks help focus managers on performing better. Regardless of whether one of these tools has been implemented, the other two should be considered. Managers perform best when they have the information, decision frameworks, performance measures and rewards that motivate them to behave like owners. It is important to have a good strategy, but it is just as important to have managers who are motivated to execute the strategy and produce results.

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