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Performance Measures

In order to control how and if an entity's goals are achieved, financial performance measures are needed. However, they are of limited relevance if that entity's goals are not set correctly. Performance measures are that they focus on the future of the business, using established accounting conventions. New divisional performance measures have emerged in order to ensure that they maximise shareholder value. This has created the need for new divisional performance measures, such as economic value added (EVA). 

EVA looks similar to residual income, but the calculation for EVA is more complicated. EVA is calculated as the difference between the firm's economic profit and its capital cost. Economic profit is calculated as the firm's before-tax operating income minus its cost of capital. Capital cost is calculated as the weighted average cost of capital (WACC), which is the average cost of the firm's debt and equity, weighted by the proportion of each. 

Residual income (RI) can be calculated using the following formula:

RI = Earnings before interest and taxes (EBIT) - Capital cost x Economic capital employed

Residual income is a measure of profitability, and it has the advantage of being a percentage, which makes it easy to compare with other businesses. It can also be easily understood by managers, as it is a simple measure of profitability. 

ROI is a popular measure of profitability, and it is calculated as:

ROI = Profit / Capital employed

However, ROI is not a perfect measure, as it can be affected by uncontrollable factors such as changes in interest rates. It can also be used to encourage dysfunctional behaviour, as managers may be tempted to increase ROI by taking on more debt, which may not be in the best interests of the shareholders. 

Profitability as a performance measure is often used as a basis for bonus payments, and it can also be used as a management control mechanism. However, it prioritises profit at the expense of other goals, such as environmental sustainability or social responsibility. 

Communicate position. Measures are summaries that can contribute to profit – eg, labour rate, materials costs, overheads. This system will monitor more detailed measures that are relevant to the organisation to be determined. Confirm priorities. The fact that something is being measured indicates that it is important. 

Examples of profit centres include a particular product line, a division of a company, or a country. The manager of a profit centre is responsible for achieving a profit target, and this can be rewarding, as managers are paid for the results they achieve. 

However, this can also be demotivating when uncontrollable factors affect profit. It can be used as a basis for further performance measures. 

Profit measures to control the management of profit. Firms use profit measures to control the management of profit, and this can be seen as a management control mechanism. 

This system will monitor more detailed measures that contribute to profit – eg, labour rate, materials costs, overheads. This system will also monitor controllable costs, which can be influenced by managers. For example, a manager can control the cost of materials by negotiating with suppliers. 

Measuring Business Performance: Why, What, How

Creating Shareholder Value: The seven drivers of shareholder value proposed by Stewart consultancy as a divisional performance measure. Shareholder value analysis is a useful tool for managers, as it helps them to understand the factors that affect shareholder value. 

STUDY NOTES

In the integrated ResOuRCe Paper F2, which will appear in the August issue, the following performance measures are discussed:

1. The cash tax rate.
2. The increase in sales revenue.
3. The ratio of incremental expenditure on working capital to incremental sales.
4. The cash flow into the firm's free cash flows.
5. Increases in free cash flows. These cash flows are then forecast to the present level.
6. The financial measures I have covered here communicate to shareholders and away from window-dressing the accounts.