

Feature Article:

Value Creation –

6 The Key Performance Indicators

(relevant to PBE Paper II - Management Accounting)

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Introduction

The intensity of competition in the globalized business landscape is continuously increasing in this information and knowledge age. The key to survival for a firm is to formulate and implement value-creating strategies in order to gain a strong advantage over its competitors. While implementing strategies requires a set of commitments and actions at different levels to acquire key resources and to exploit core competencies and internal capabilities, successful implementation of a strategy requires a set of key performance indicators (KPIs) to keep track of performance during the strategy implementation process. This article first addresses how value is created and measured by the major stakeholders of a firm, then looks at how KPIs are used to evaluate the performance and effectiveness of implementing a strategy.

Value creation in the strategic management process

Business value is created through quality strategic management, which is a combination of three main strategy processes: formulation, implementation, and evaluation. Strategy formulation is the process of analyzing the external and internal environments, including competitor analysis, in developing a strategic plan to achieve the various objectives of the firm. This process helps to answer the following questions: where you are now, where you want to go, and how to get there. Strategy implementation involves the acquisition and allocation of resources to get the required tasks done by individuals or groups. This relies on sound management of the internal value chain activities required to create value for the firm. Strategy evaluation deals with the integrated measurement of the performance and effectiveness, and to what extent, in achieving the pre-determined objectives in the process of translating the strategy in action.

The success of a firm depends on striking a balance between the conflicting values created for different stakeholders. While there are a number of stakeholders (in light of the changing corporate governance and corporate social responsibility requirements) this article focuses on the value creation for the major financial stakeholders of a firm (shareholders, customers and employees), though it should be noted that other non-financial stakeholders such as social and pressure groups have been exerting increasing influence on management decisions in recent years.

Shareholder value

Shareholders, along with other providers or creditors, provide the capital to the firm. Owners of the firm are looking to increase in their wealth represented by dividends received from the business and the appreciation of the stock price. The return on their investment should exceed the cost of capital or their required rate of return in consideration of the risk involved. The source of shareholder value creation is sustainable earnings coupled with the timing of cash flows which determines the enterprise's value over a specified time horizon. In other words, the net present value of the discounted cash flows generated over a period of time creates value for shareholders. For a listed company, shareholder value in the long term is measured by the market value added (MVA) based on the increase in market price of its stock. Other measurements include economic value added (EVA) which is the excess of net operating profit after tax over the weighted average cost of capital (WACC) based on the capital employed in the business. The total shareholder return is the appreciation of the market price of the stock and the total dividends received over an investment period in relation to the initial investment made by the investor. However, maximizing shareholder value might jeopardize the interests of other stakeholders and this can erode the competitive advantage of the firm in the long term. In addition, the time horizon of value creation needs to be balanced as focusing on short-term value creation based on profits can erode a firm's ability to create value in the long term.

Customer value

The driver for shareholder value is the capability to create and deliver customer value. From the customer's point of view, value is measured by the excess of total satisfaction or benefits accrued to them over the total costs (price and non-price) in exchange by buying a particular product or service. While tangible benefits and costs can be quantified without much difficulty, intangible benefits and hidden costs are more customer-specific and, hence, they are more difficult to quantify. The customer-value proposition is based on value for money which is the satisfaction generated for what the customer gets in return for what the customer pays. In the process of creating customer value, a firm must deliver what the customer wants within a target cost at an affordable target price. This requires the identification of the target customers in a target market through market positioning. The generic customer value propositions focused by leading and competitive organizations to deliver superior customer value are choices of operational excellence, customer intimacy, and product leadership which depend on the nature of industry and the firm's competitive strategy.

Employee value

Employees are the key resources and assets in any kind of organisation. The driver for customer value is the capability to create value, financial and non-financial, for the employees. Committed, motivated and loyal employees are the source

of competitive advantage of a performing and competitive firm in the market by adding value to its internal business processes and to the customers. As a result, the philosophy of people management is linked to the financial performance of firms. Employees look for financial remuneration as well as non-financial value, such as career development and training and development opportunities which are the drivers for employee motivation and job satisfaction, in providing value-added services to the firm. Employee stock option plans and proper recognition of employees' outstanding services (their social and psychological value) can increase the commitment and motivation among the employees with whom rest the responsibility for delivering customer value and, ultimately, creating shareholder value.

Key performance indicators in the value creation process

KPIs are critical to the success of any organization. They are developed, defined and measured based on the goals, objectives and strategy of a firm. While KPIs are industry- and strategy-specific, some of them are generic measurements across all enterprises. The balanced scorecard (BSC) system, which was introduced by Drs. Robert Kaplan and David Norton of Harvard Business School in 1992, provides an integrated and coherent framework for measuring performance in the process of executing a strategy. As financial success is a lagging measure of the outcome of various business processes of the organization, the identification of KPIs must start from a clear definition of the business process from which clear performance objectives can be set. The setting of KPIs needs to be specific, measurable, achievable, relevant, and time-bound. Although performance indicators are industry- and process-specific, the following sections aim to provide examples of KPIs which are categorized based on the BSC approach.

Financial KPIs

These are financial measurements of the short-term and long-term organizational goals in quantitative terms, usually through comparisons with the previous periods, budgets, industry averages, or competitors. Common financial KPIs for the creation of long-term shareholder value include return on investment, return on assets, various profitability ratios, revenue growth, cost reductions, and cash flows. These are basic indicators in analyzing the financial health of any profit-oriented organization.

Customer / marketing KPIs

Based on the value-creation premise, customer value is the ingredient of shareholder value. KPIs such as market share, customer satisfaction, customer complaints, and customer attrition are generic measurements in most industries, if not all. More specific customer-related KPIs include those measurements in relation to major product/service attributes (such as price, quality, and function) and customer relationship, as well as brand image and awareness.

Business process KPIs

During strategy implementation, the internal business processes ensure the delivery of the customer value proposition and the achievement of process improvement through productivity and efficiency enhancement. KPIs in this perspective provide the foundation for creating customer and shareholder value. The indicators focus on the processes of operations management, customer management, innovation, and those related to the social and regulatory performance. Relevant KPI measurements are related to the activities of inbound logistics, production, distribution, customer acquisition/retention/growth, research and development, new product development and testing, environmental protection, as well as those on safety and health issues.

Capability / intangible assets KPIs

The tangible outcomes described above are contributed by the management of intangible assets including people, technology and culture. These measurements are more difficult to develop due to their intangible nature. KPIs for human capital are measured by employees' skills, talent and knowledge. Technology KPIs include the deployment of sophisticated information systems such as the infrastructure in database / knowledge management and information networks of the Internet, intranet, and extranet. Lastly, management culture / leadership and employee empowerment are also critical elements in developing the capability and competency to create value for the entire organization.

Conclusion

For all types of organizations, value creation is a strategic imperative based on the linkage of employees, customers and shareholders. The ability to create value at different levels in a firm is critical to its short-term and long-term success. In order to create shareholder value, profits must be earned through the delivery and creation of customer value based on the value discipline selected and focused on. Employees must possess the required knowledge and skills with the required commitments and motivation to perform value-creating activities. The conversion of intangible assets into tangible outcomes requires the identification of suitable KPIs linked with organizational strategy at different levels.

Further reading

1. Berry, J, 2005, "Tangible Strategies for Intangible Assets", McGraw Hill.
2. Kaplan, R S, and Norton, D P, 2004, "Strategy Maps: Converting Intangible Assets into Tangible Outcomes", Harvard Business School Press.