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Financial Performance Measures and Value Creation: The State of the Art

Springer

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To my parents, for their never fading support

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Introduction

The periodic measurement of firm's performance is conducted for several reasons. From an external standpoint, it helps investors in formulating their expectations concerning the future earning potential of firms. From an internal standpoint, we can list the objectives according to Vancil's (1979) framework: (a) it helps managers decide where they should allocate their resources (*operations evaluation*); (b) it supplies a plausible feedback on how well the company and its sub-units have achieved their goals (*activity evaluation*); (c) it furnishes the basis of an adequate bonus plan that gives incentives to achieve the firm's goals and rewards the results of proper decisions (*managerial evaluation*).

The measurement of corporate financial performance in terms of accounting-based metrics, has been viewed as inadequate, as firms began focusing on shareholder value as the primary long-term objective of the organization. These metrics fail to take into account the factors that drive shareholder value. Value-based measures were therefore created: they explicitly acknowledge that both equity and debt have costs, suggesting the incorporation of the financing risk-return into performance calculations.

The focus of this book is providing a systematic review of the most known value-based measures: the **economic value added** (EVA) described by Stewart (1991), the **cash flow return on investment** (CFROI) of the HOLT Value Associates/Boston Consulting Group and the **shareholder value added** (SVA) described by Alfred Rappaport (1986) and the LEK/Alcar Consulting Group. For the sake of completeness, the **economic margin** (EM), formulated by the Applied Finance Group (Obrycki and Resendes 2000), and the **cash value added** (CVA),[1] that is a registered trademark of FWC AB (Weissenrieder 1998) are also included in the discussion.[2] Both represent a sort of mix of some of the main metrics above.

[1] But it should not be confused with the CVA derived by the CFROI.

[2] All cited metrics are registered trademarks by the respective consulting firms and their rights are all reserved. Now CFROI is a trademark of Credit Suisse Group.

Conversely, metrics that are very similar to one of the main measures are omitted, like McKinsey's economic profit, for example, that works much like the EVA.

Information and empirical results about the efficacy of the different approaches are limited and contradictory and seem to be primarily provided by authors with strong commercial interest in the outcome of any research into the effectiveness of the methodologies. On the one hand, consulting firms have been battling for the last two decades over the superiority of their value metrics, stating that competitors' measures have flaws that compromise their evaluation ability. On the other hand, a growing number of firms have adopted various economic value measures, moving from one metric to the other over the years and often abandoning all of them in favor of traditional accounting measures.

In sum, despite the increasing emphasis on these value measures, no definitive evidence exists of which metric works better than others do, and research on the extent to which any of them is superior to traditional accounting measures is limited and not yet univocal.

In this scenario, the objective of this book is contributing to the on-going dialogue on the appropriateness of different value-based performance measures, by providing a systematic and updated framework of their respective strengths and weaknesses and by summarizing and systematically comparing the main international empirical evidence on their effectiveness. It would be a mistake to believe that any single measure is perfectly suited to all types of financial decision support, while it could be very useful to *compare* the different measures. We will point out both their differences and their similarities, adopting different perspectives, from which their respective effectiveness can be evaluated: (1) measurement logic; (2) association with market financial performance; (3) consistency with the discounted cash flow (DCF) approach in measuring value creation; and (4) implications on managerial incentives.

The book can be a powerful tool for guiding managers and graduate students in the "tangled forest" of the existing metrics, by providing them with the quick, but adequate, knowledge and skills for "piloting" the choice and the use of these measures, instead of being passively dominated by them.

The book is organized as follows. First, we summarize the shortcomings of the accounting-based measures of performance. Therefore, we illustrate the economic value measures, pointing out their differences in calculation. Subsequently, we compare the economic value measures' effectiveness from three different perspectives:

a. the empirical evidence on their association with stock market measures of return: the objective is comparing the relative extent to which the different value-based measures predict stock returns;

b. their linkage with the DCF approach, in order to verify their consistency with the economics of value creation;
c. their impact on management behavior when used in compensation systems: the key question here is whether the use of economic value measures, for internal decision-making, performance measurement, and compensation purposes, improves organizational performance.

A final summarizing scheme of the strengths and weaknesses of the value-based metrics will conclude the analysis.