



ACCOUNTICA

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Content :

1. The contribution of stakeholder and shareholder approach made to the development of financial performance measurement– Katarzyna Gierusz

The article discusses the contribution of Balance Scorecard (stakeholder approach) and Economic Value Added/Market Value Added (shareholder approach) made to the development of financial performance measurement.



The contribution of the stakeholder and shareholder approach made to the development of financial performance measurement.

The unpredictable changes in company's environment have a strong influence on firm's activity and performance. To face the customers' needs and improve competitiveness organisations have to be innovative, dynamic and active. There is no doubt whatsoever that those features enable company to expand and improve its financial performance. However, because of non-financial nature of those factors the firm's assessment can not longer be based only on financial data. The indicators such as return on assets (ROA) or return on capital employed (ROCE) do not take clients' satisfactory or employees' development into account. That is why they can be misleading for investors and be a reason of wrong decisions. Moreover, the indicators based on financial data impose on managers the profit's maximization which is no longer acceptable approach. To solve all problems which have arisen two approaches have been suggested. Both stakeholders and shareholders approaches encourage companies to maximize their value instead of profit. However, they promote

alternative solutions. They improve the performance measurement in two ways. The stakeholder approach supplements the traditional financial measures by non-financial data, while shareholder approach ties the company's performance with residual income concept. Although their contribution to this issue is unquestionable, it does not mean that those approaches do not have disadvantages or limitations.

As it has been already mentioned running a business is no longer a matter of profit, it is a matter of value. According to stakeholder approach the long-term value can not be built without stakeholders. Nowadays, customers' loyalty, employees' knowledge and suppliers' trust are crucial for company's survival. Thus, firms should focus on developing the relationships with all these parties. To put those words into action some multidimensional frameworks such as SMART pyramid, balance scorecard or performance prism have been proposed. They recommend the performance measures which are strongly related to corporate strategy, include



financial and non- financial measures and can be used on all company's dimensions.

Balance scorecard (BSC) seems to be the best example of stakeholder approach. The dimensions of company's competitiveness are clearly outlined in this framework. The original model proposed four perspectives (financial, customer, business process and innovation and learning), however, nowadays some new areas such as international dimension are added. Thus, this framework can be easily adopted and adjust by companies. Moreover, BSC provides balance between financial and non- financial measures. The original idea was that *'the non-financial measures would be leading indicators of futures success, that is, future financial performance would be determined by the current non-financial measures'* (T. Hopper, D. Northcott, R. Scapens, 2007, p. 225). In other words, firms should not worry about their financial success because it is the logical consequence of making improvements in their non- financial activities.

The balance scorecard's contribution to the development of financial performance measurement is incontestable. It provides

data from at least four different perspectives, but in the same time it minimizes information overload by reducing the number of measures used. Thank to this the company's performance can be summarised in one page of report and managers can focus on critical factors of current and future performance. Furthermore, BSC enables to *'see whether improvement in one area may have been achieved at the expense of another. Even the best objective can be achieved badly'* (R. S. Kaplan, D. P. Norton, 1992, p. 72). On the other hand, the complex environment makes a pressure to add new perspectives of company's performance. Thus, in few years time the output of balance scorecard might not be so clear and concise. *'The major limitation of BSC is that it promotes multiple objectives (...) of equal weight'* (L. R. Irala, 2007) which might lead to misunderstanding and interests' conflict. It is also criticized that this framework ignores employees as a stakeholders. However, in my opinion the innovation and learning perspective encompasses them by providing an opportunity to develop. Moreover, BSC, like all frameworks of stakeholder



approach, seems to notice only the competition in area of products and services. Nowadays, this issue should be broadened to competition for funds. Shareholder approach is the solution for those companies which want to improve their position on this field, attract potential shareholders and offer competitive rates on return.

Shareholder approach adopted the value-based management programme according to which the cost of capital employed should be taken into account to assess the financial performance of company and shareholder return. However, the traditional ratios could not be accepted by this framework, because they are based on accounting profit which has many disadvantages. It can be easily manipulated, ignores risk, does not take the cost of shareholder funds into consideration and is strongly related to accounting policy adopted by company (P. Atrill, E. McLaney, 2007, pp. 320-321). The consulting firms developed many innovative measures, but economic value added (EVA) and market value added (MVA) are probably the best known method. EVA is an internal measure

based on economic profit thus it enables to measure the organisation's profitability in economic sense. By taking cost of shareholder funds into account not only does it provide information about return on investment, but it also answers the question whether this was the best allocation of investors' money. In contrast, MVA is an external measure which assesses the company's financial performance from market perspective. It presents the increase of investors' wealth as a difference between firm market value and amount of shareholder funds.

Shareholder approach began a new chapter of financial performance measurement. It changed the object of companies' interests from profit to value. The contribution made by this approach can be discussed on two perspectives: corporate and market. EVA develops the performance measurement on company field. It encourages managers to use firm's resources efficiently so now there is no danger that the funds used to achieve any increase in profit will not be taken into account (P. Atrill, E. McLaney, 2007, p. 333). Moreover, it helps to establish the cheapest capital structure in favour of



loan capital. EVA has also application on rewarding managers. It allows to link managerial performance with financial performance. Under this method, managers receive bonuses based on current achievement during a particular period. And here EVA's first limitation arises. There is a justify danger that directors will focus on maximizing EVA in actual period instead of maximizing it in the longer term. Furthermore, bonuses are calculated as a percentage of this indicator. However, EVA has no upper limits which indicate that managers' bonuses have also no limitations. The third disadvantage is connected with calculation. The profit provided by income statement must be adjusted to economic profit. *'Critics have pointed out that the adjustment can be time consuming and costly, and many are based on decisions that are as subjective as the original accountant's numbers'* (G. Arnold, 2005, p. 836). Moreover, it is also hard to arrange the cost of shareholders fund.

MVA represents the market perspective. It takes market point of view into account and its assessment of the firm's efficiency of dealing with limiting factors. Moreover,

MVA enables to compare organizations which represent different lines of business. Unfortunately, it has also some shortcomings. First of all, it reflects the growth of shareholders' wealth but only those who bought the shares when company was established (B. Nita, 2007, p. 121) Thus, MVA changes depending on shares' prices. Secondly, this indicator is focused *ex ante* while the data which are used to calculate it are focused *ex post*. Then it is still doubtful what MVA presents.

Stakeholder and shareholder approaches changed the way of perceiving the company's performance. They proved that financial results depend not only on managers, but also on customers, employees and market. Moreover, they enabled to measure the factors such as clients' loyalty, products' quality, flexibility and innovation which were unmeasured up till now. This motivated organisations to act and manage those factors. The indicators suggested by stakeholder and shareholder approach are more complex than traditional ones such as ROE, ROA and EPS, and provide more accurate figures. Because of that the financial



performance measured this way has now many applications which used to be out of its reach. They enable the systematic measure of financial performance not only of the company as whole but also single divisions. Moreover, those indicators can be used to evaluate the firm and its projects, assess the different ways of organizations development including mergers and takeovers, set managerial performance targets and subordinate all activities and decisions to one aim (as long as EVA and MVA are concerned). Thank to

this, the comparison of companies is easier and more reliable. However, the most important change in the financial performance measurement is connected with the potential of organization. This means that not only current results can be measured, but also the company's ability to earn money and multiply its value in future. This knowledge seems to be the best reward for both companies and investors.



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