FINANCIAL PERFORMANCE ABSOLUTE AND RATIOS

Grouping	Number	Name of Ratio	Formula
Profitability	**1**	**Return on Capital Employed**	PBIT / Capital employed
to capital	2	Return on Owners Equity	Profit before tax after interest / OSC + Reserves
to assets	3	Return on Net Assets	PBIT / Net Assets
to sales	**4**	**Operating Profit %** (Operating Profit = PBIT)	PBIT / Sales
	5	Asset Turnover	Sales / Capital employed
	6	Gross Profit %	Gross Profit / Sales
	7	Expenses %	Expenses / Sales
Gearing (Financial Risk)	**8**	**Total Loans to Equity**	All Loans / OSC + Reserves
	9	Total Gearing	Long term Liabilities / Capital employed
	10	**Interest Cover**	PBIT / Interest
Liquidity	11	Current Ratio	Current Asset / Current Liabilities
	12	Quick Ratio (Acid Test)	Current Asset – Stock / Current Liabilities
Working Capital (all in days)	13	Stock turnover period	Average Stock x 365 / Cost of Sales
	14	Debtor collection period (turnover)	Debtors x 365 / Sales
	15	Creditor payment period (turnover)	Creditors x 365 / Cost of Sales (if not Purchases)

NON-FINANCIAL PERFORMANCE

Identify and discuss the various dimensions of performance (such as Fitzgerald

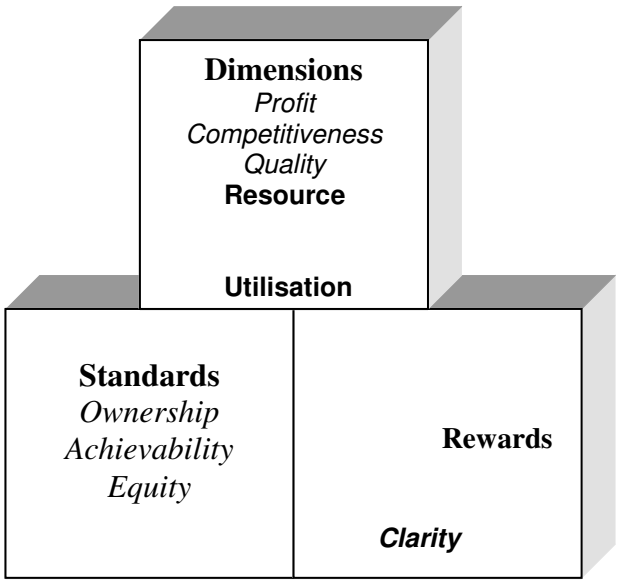
You're at the airport and there's a little while to your flight. You have a drink to pass the time and a person in uniform comes and sits next to you at the bar and after a while you get chatting and you find out that she is the pilot of the aeroplane that you are about to catch. You say that it must be very difficult flying an aeroplane with all those dials and knobs and switches and meters and things, and she says, "No, not really. All I look at is the speedometer and I figure that if I get my speed right then things are fine." You look at her a bit funny and you say, "Well, what about the fuel gauge? Isn't that important?" She says, "Yes, you're right, it is important and I used to look at it, but now I just look at the speedometer". Then you say, "Well what about the height meter? Surely that's important? She replies, "Well, yes it is, but I try and focus on one thing at a time. Once I'm happy with my airspeed then in a few flights' time I might concentrate on height"

The question Kaplan and Norton now ask is; would you catch that aeroplane?

Building Blocks for Performance Measurement

Three central questions

- What should be measured? What are the *dimensions* of performance that the organisation is seeking to encourage?
- How are *standards* set for the measure?
- What are the *rewards* for achieving the targets?



The point that Kaplan and Norton are trying to make (in the unlikely event that you missed it) is that you cannot fly an aeroplane with only one instrument. Nor can you run a business by looking at one performance measure.

Dimensions

There is increased recognition that companies compete on a wide range of dimensions whose evaluation cannot be confined to narrow financial indicators. Simply focusing on financial performance can give misleading signals.

Common threads emerging from a review of three performance measurement frameworks - Fitzgerald et al's determinants and results matrix, Kaplan and Norton's Balanced Scorecard and Lynch and Cross's performance pyramid - are that performance measures should:

- Be linked to corporate strategy
- Include external (customer service type) as well as internal measures
- Include non-financial as well as financial measures; and
- Make explicit the trade-offs between the various measures of performance.

Fitzgerald & Moon's Six Factor Scorecard

The Balanced Scorecard complements "financial measures with operational measures on customer satisfaction, internal processes, and drivers of future financial performance".

The Fitzgerald and Moon framework proposes that measures of financial performance and competitiveness are the 'results' (record success) of actions previously taken and reflect the success of the chosen strategy. The remaining four dimensions of quality, resource utilisation, flexibility and innovation are factors that determine competitive success now and in the future. They represent the means or 'determinants' (ensure success) of competitive success.

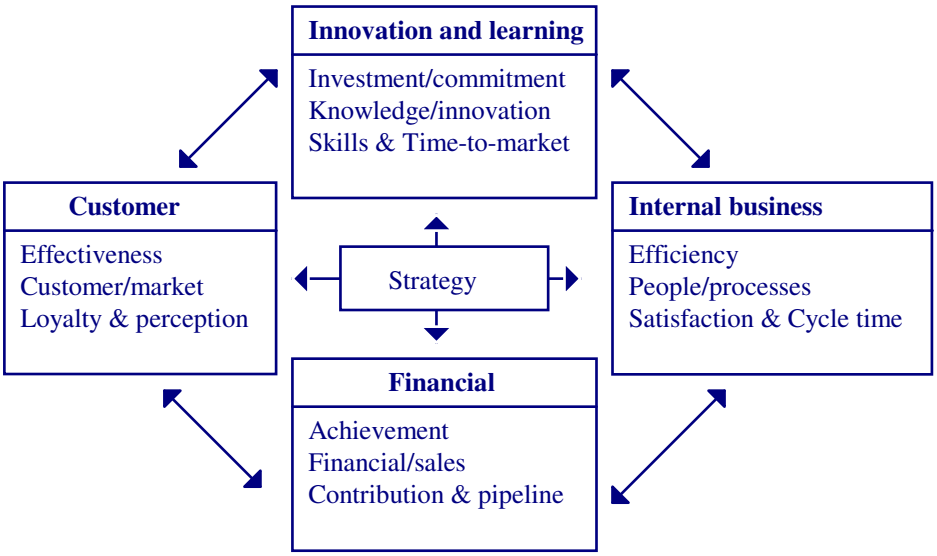
This is an attempt to address the 'short-termism' criticism frequently levelled at financially focused reports.

	Dimensions of Performance	Types of measure
RESULTS	Competitiveness	Relative market share and position Sales growth Measures of the customer base
	Financial	Profitability Liquidity Capital Structure Market ratios
DETERMINANTS	Service quality	Reliability Responsiveness Aesthetics/appearance Cleanliness/tidiness Comfort Friendliness Communication Courtesy Competence Access Availability Security
	Flexibility	Volume flexibility Delivery speed flexibility Specification flexibility
	Resource utilisation	Productivity Efficiency
	Innovation	Performance of the innovation process Performance of the individual innovations

Kaplan & Norton's Balanced Scorecard

Kaplan and Norton developed the balanced scorecard technique to integrate the various features of corporate success. It deals with internal and external, current and future perspectives.

The balanced scorecard focuses on four important perspectives - the customer, the financial aspects, innovation and learning, and the internal business - shown in the diagram below:



Customers

Customers are concerned with four main issues:

- Lead time - the time it takes from receipt of the order to delivery.
- Performance of the product.
- Quality - defect levels.
- Service - what is the average time taken before the maintenance person arrives?

To measure performance in these areas, the organisation will use market research methodologies to ascertain customer acquisition, retention, profitability and satisfaction.

Internal business

Internal business is linked to the customer perspective and identifies the processes that they must excel at, ie the ones that have the most impact on customer satisfaction (eg quality). To ensure continued success and competitive leadership, the organisation should attempt to identify and measure their distinctive competencies and the technologies required.

Measures will include cycle time, yield, efficiency, new product introduction scheduling and comparisons of manufacturing configuration with the competition. Other performance measurements will need an information system such as an executive information system that allows the manager to drill down into lower level information.

Innovation and learning

The organisation needs to learn and innovate to satisfy future needs. Measures of likely future success include:

• length of time to develop new products (compared to competition)
• percentage of revenue from new products
• investment in innovative products/materials and processes
• intellectual assets and organisational learning
• employee satisfaction
• process time to maturity

Financial

Performance indicators show whether the organisation's strategies are effective. Cashflow indicates the likelihood of survival. Measures of monthly sales growth, market share and ROI give an indication of success.

Aims

The aim of the balanced scorecard is:

- to move away from the short term emphasis of management accounts.

- to encourage continued focus on key factors which are critical for financial success in the longer term, eg market share, sales growth, profits.

- to encourage directors to concentrate on a relatively small number of critical measures out of the very large number available.

- to encourage a balanced approach by ensuring that no one measure is attained to the detriment of the business as a whole, eg short term quantity against long term quality.

- to develop and use exception reporting, ie even when using a relatively small number of measures you should be concerned mostly by those measures that are 'out of line'.

Benchmarking

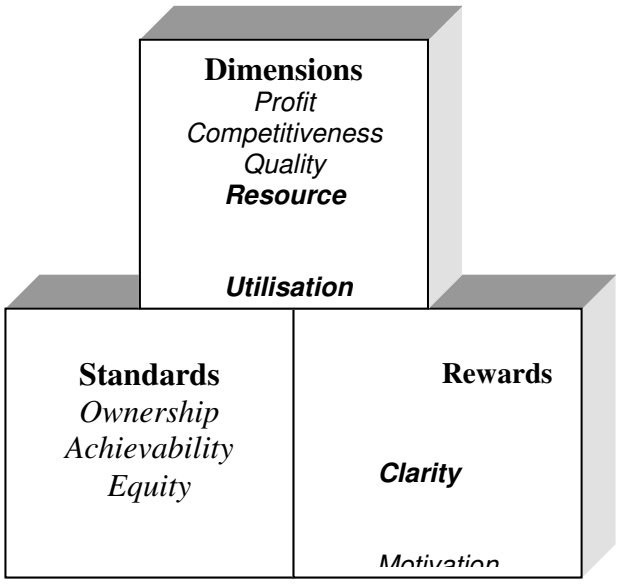
Benchmarking is defined as a continuous, systematic process for evaluating the products, services, and work processes of organisations that are recognised as representing best practices for the purpose of organisational improvement. Through benchmarking, organisations learn about their own business practices and the best practices of others. Benchmarking enables them to identify where they fall short of current best practice and determine action programmes to help them match and surpass it.

Benchmarking activities

Any activity that can be measured can be benchmarked. However, it is impracticable to benchmark every process, and organisations should concentrate on areas that:

- tie up most cash;
- significantly improve the relationship with customers; and
- impact on the final results of the business.

The choice of the activity to be benchmarked will determine the approach that needs to be taken.



Standards

The second building block relates to the setting of expected standards once the actual dimensions and measures have been selected. This involves consideration of who sets the standards (*ownership*), at what level the standards are set (*achievability*) and whether the standards facilitate comparison across the business units (*equity*).

Ownership

In establishing targets, the importance of individuals being responsible for owning the standards has long been established: this is often facilitated by the adoption of a budgetary system based on employee participation. This is considered to be beneficial to the organisation as it reduces many of the dysfunctional consequences associated with traditional control models. In particular, managers are more likely to accept the standard-setting process and the standards set, feel less job-related tension and have better relationships with their superiors and colleagues. Participation does, however, provide opportunities for introducing budgetary slack.

Achievability

Research findings indicate that defined quantitative targets motivate higher levels of performance than if no targets are set and providing the target is accepted, the more demanding the target the better the resulting performance. Thus the budget level that motivates the best performance is unlikely to be achieved all of the time and adverse budget variances will occur. If adverse variances are treated punitively by management this may encourage budgetary slack, where individual managers overstate expected costs and/or understate expected revenues, so that subsequent monitoring of actual outcomes presents them with a favourable evaluation. Budgets need to be realistic enough to encourage employees to perform, but not set at levels set so high they become totally demotivated. Finding the balance between what the company views as achievable and what the employee views as achievable is a frequent source of conflict.

Equity

Are the targets comparable across all similar business units, or do some have an inherent advantage unconnected with their own deliberate initiatives.

Rewards

The third building block relates to the reward structure of the overall performance measurement system. It is concerned with guiding individuals to work towards the standards derived above. It means posing three questions. First, does the system exhibit *clarity* to all those whom the system affects? Second, if you know what is expected of you how are you *motivated* to achieve that performance? Third, what level of *controllability* do you have over areas for which you are held responsible?

Clarity

If one of the main purposes of the performance measurement system is to ensure the successful implementation of company strategy then this should be clearly understood by employees throughout the organisational structure. Research studies indicate that most managers react well to clear, unambiguous targets, and acceptance of targets is facilitated by good upward communication. People should know what the organisation is trying to achieve, what is expected of them, and exactly how and why their own contribution to the organisation's performance in meeting its objectives, will be appraised.

Motivation

In principle, employees may be motivated to work together for the pursuit of the company's strategic objectives by tying performance-related rewards, for example bonuses, to the attainment of key success factors. Goal clarity and participation have been shown to contribute to higher levels of motivation to meet targets, providing managers accept those targets. However, the effects of targets on motivation are complicated by the reward system and how it is used. Is the system used positively to encourage, or negatively to condemn, or both? When properly used, a responsibility accounting system does not emphasise blame. If managers feel they are criticised and rebuked when unfavourable variances occur, they are unlikely to respond in a positive way. Instead they will tend to undermine the system and view it with scepticism.

Controllability

The traditional view in responsibility accounting is that people should only be made responsible for financial elements which they can control (that is, have some influence over) and that they should only be rewarded for results of their efforts. The implication is that managers would lose interest in cost control if their performance were being judged on events outside their control. From the viewpoint of the organisation as a whole all costs are controllable and need to be controlled. The difficulty here is pin-pointing responsibility, particularly regarding the allocation of those costs arising from activities that benefit many departments or divisions within an organisation. Inevitably, the principle of cost controllability also involves the principle of the perceived fairness of cost allocations.

Performance in the Service Industry (SHIP)

Discuss performance in the service industry

Fitzgerald et al in 1991 asked what differentiated performance measurement in a service business from performance measurement in a manufacturing industry where traditionally most of the focus had been directed in the past. They came up with 4 main differences - intangibility, perishability, simultaneity and heterogeneity.

Simultaneity

This means that the service is provided and consumed at the same time. In most cases it is not possible to check the quality of a service before the delivery to the customer.

Heterogeneity

Heterogeneity means that the service is provided differently by different people and even by the same person differently on different days. It is therefore very difficult to compare performance between different people and across time, eg the way that I give this lecture today may well differ from the last time I gave the lecture and may well differ from the way I give the lecture next time. Also the way that I give this lecture will differ from the way that another lecturer performs it even though we are using the same notes.

Intangibility

The factors that go into the judging of performance of a service are likely to be of an intangible nature as opposed the more objective performance measures which would be used for a product, eg for a car we can consider objective measures such as 0 - 62 mph time, the mpg, the no of seats, the size of the boot, etc. For a computer, we can see how fast the processor is, how big the hard drive is, the size of the monitor, etc. We can even using a benchmarking program to test the performance of the computer. For a service, however, things are not so straightforward. Imagine trying to judge the quality of a meal out in a restaurant or of a haircut. What factors would you consider?

Perishability

Services are perishable. They cannot be stored. This means that at times of high demand the level of provision of the service must also be high. It is not possible as a rule to take advantage of slack periods to produce a buffer of the units of service, eg lecturing. This can cause problems when an abnormally large demand causes a delay in the provision of the service, causing the customer to perceive the quality of the service to be poor, when the actual service itself is excellent, just slow.