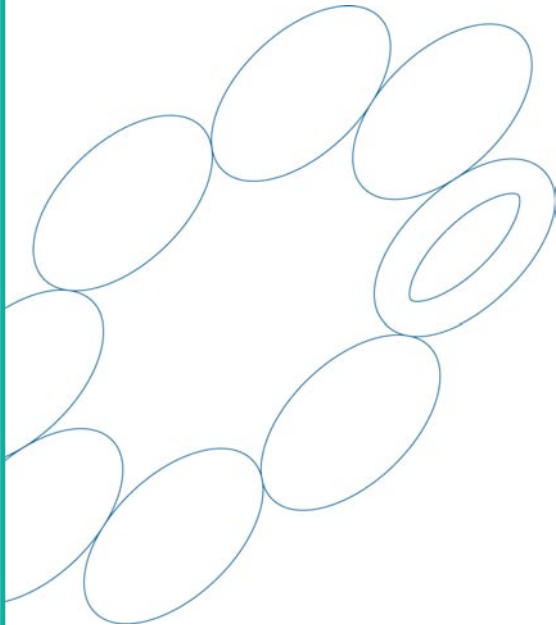


# Combining Balanced Scorecard & EVA

**Presented to BetterManagement.com  
Balanced Scorecard Authority web seminar  
May 2001**



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## Structure of presentation

What is EVA?

What is  
Balanced  
Scorecard?

Combining  
EVA and the  
Balanced  
Scorecard

Conclusion

# What is Economic Value Added (EVA)?

## What is this all about?

The ultimate goal of any commercial activity is normally to generate a positive return on invested resources . .

This raises three fundamental questions:

- How do we define “positive return”?
- How are we going achieve it?
- How do we know we are on track to achieving it?



# What is Economic Value Added (EVA)?

## Background & underlying philosophy

### What is it?

- A composite measure of financial performance used to measure the difference between return on a company's capital and the cost of that capital i.e. creation vs. destruction of shareholder value

### Origins

- EVA is claimed to date back to Alfred Marshall's theory of economic income, but was refined and popularised by US consultancy Stern Stewart's definition of EVA in the early 90's

### Underlying philosophy include:

- Persistent management focus on creation of shareholder value as guiding principle of good management practice

$$\text{EVA} = \text{NOPAT} - \text{capital cost}$$

$$\text{EVA} = \text{NOPAT} - \text{cost of capital} \times \text{capital employed}$$

*If rate of return is defined as  $\text{NOPAT} / \text{Capital}$  then*

$$\text{EVA} = (\text{Rate of Return} - \text{Cost of capital}) \times \text{capital employed}$$

*If ROI is similarly defined (after taxes) then*

$$\text{EVA} = (\text{ROI} - \text{WACC}) \times \text{Capital Employed}$$

- 1) NOPAT = Net Operating Profit After Tax
- 2) WACC = Weighted Average Cost of Capital



# What is Economic Value Added (EVA)?

## Theory and practice

### In theory EVA can help organisations:

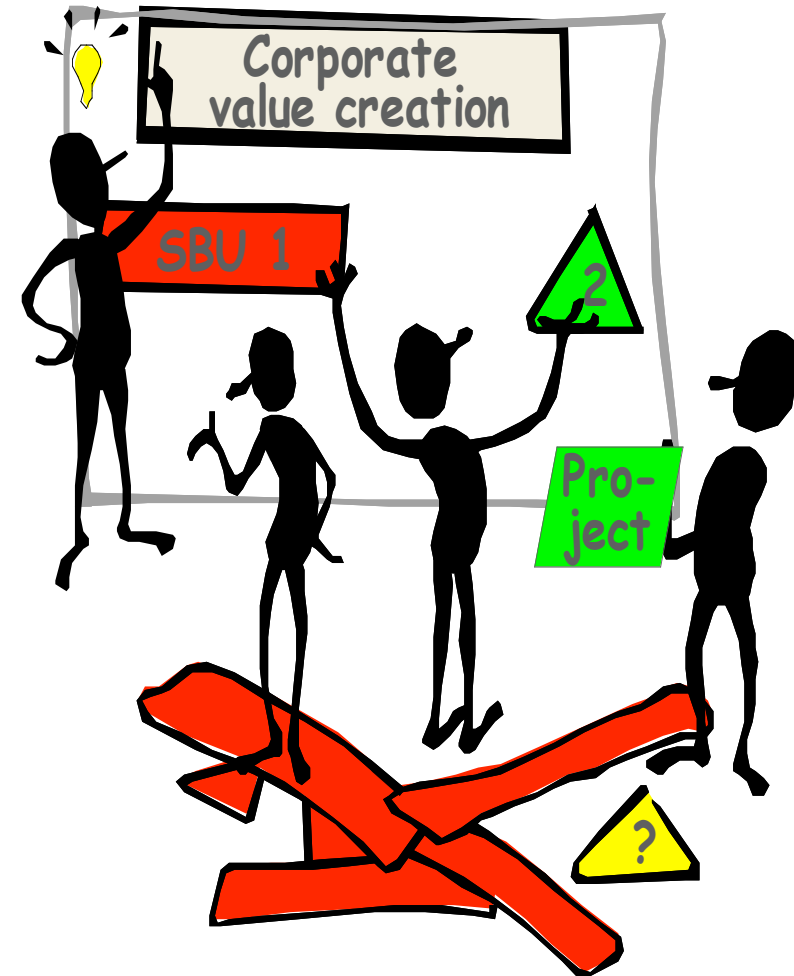
- Evaluate which Business Units, Divisions, processes, projects etc. contribute to the generation of shareholder value and which do not
- Design “fair” reward schemes
- Perform post-hoc investment appraisal
- Generate benchmark data for e.g. internal cost comparisons

### In practice

- The accuracy of EVA calculation is open to question due to the reliance on supporting calculations based on assumptions
- E.g. calculating cost of capital for individual parts of an organisation is considered notoriously difficult leading to unreliable results

### Most useful EVA applications include;

- Measuring relative performance improvement over a period of time
- Internal comparison of different operations of an organisation



# What is Economic Value Added (EVA)?

## Conversion and adjustments drives complexity

Example of adjustments made to convert book profits and book capital to operating profits and economic capital enabling cross company comparison:

NOPAT =	(Profits After Tax + Non-Recurring Expenses + Revenue Expenditure On R&D + Interest Expense + Goodwill Written Off + Provision For Taxation) - Non-Recurring Income - R&D Amortisation - Cash Operating Taxes.
Cash Operating Taxes =	(Provision For Taxes + Tax Benefit Of Interest Expenses + Tax Benefit Of Non-Recurring Income).
Economic Capital =	Net Fixed Assets + Investments + Current Assets (NBGLs + Miscellaneous Expenditure Not Written Off + Intangible Assets) - (Cumulative Non-Recurring Losses + Capitalised Expenditure On R&D + Gross Goodwill Revaluation Reserve - Cumulative Non-Recurring Gains).



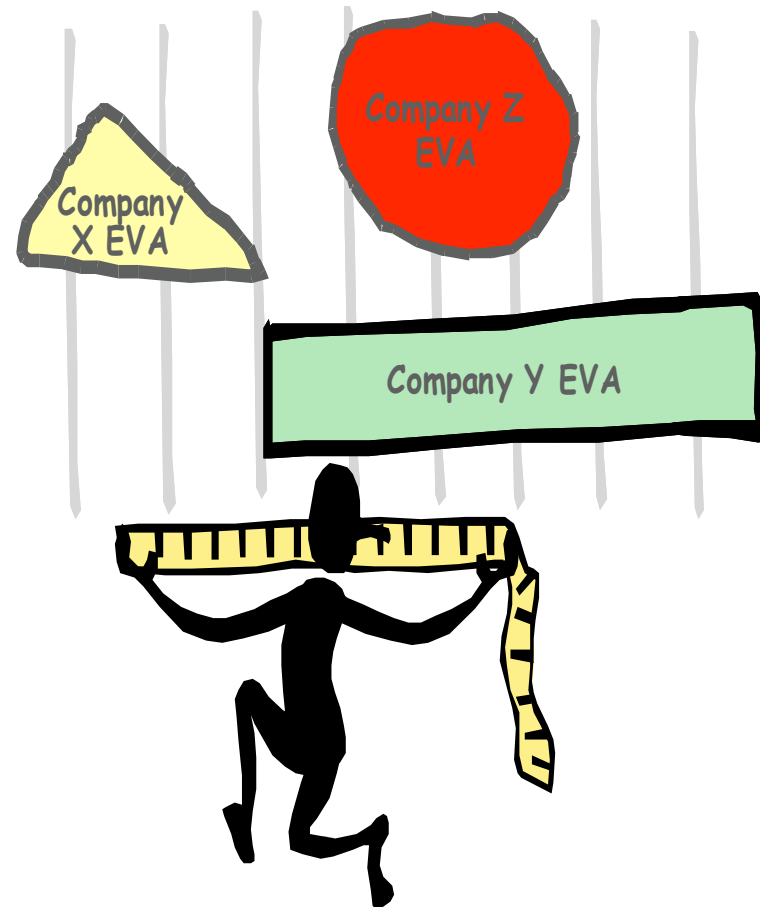
Source: India Today BT and Stern Stewart (March 2001) India's biggest wealth creators  
<http://www.indiatoday.com/btoday/20010306/mva.html>

# What is Economic Value Added (EVA)?

## The importance of context . . .

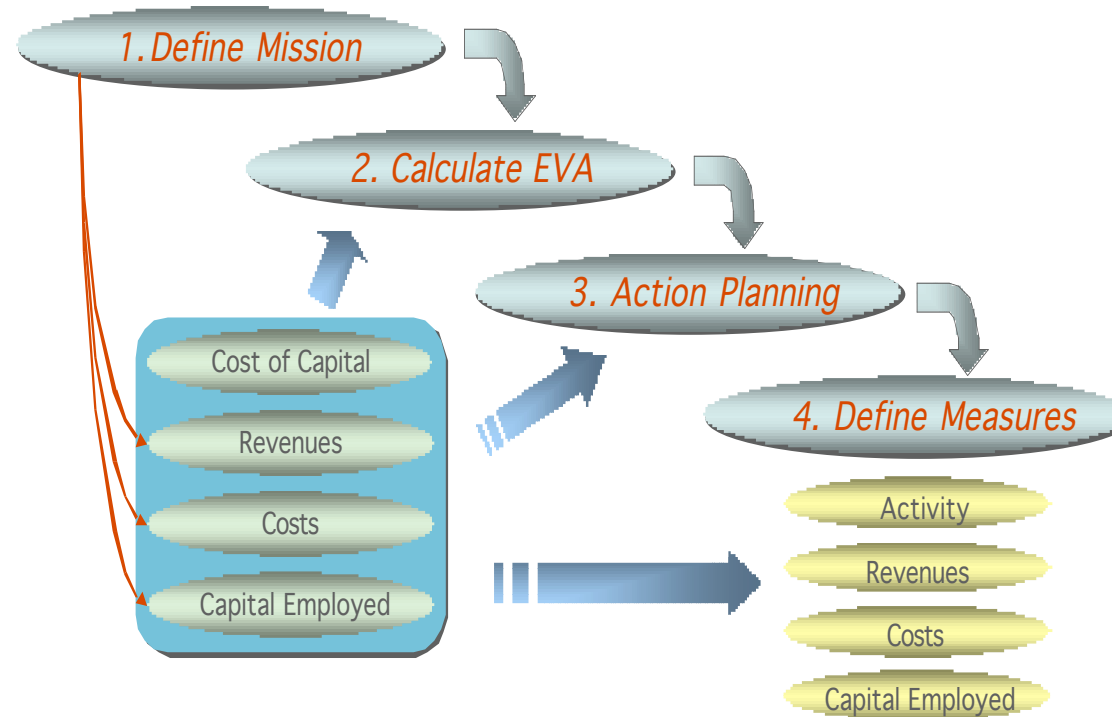
Focusing on any good measure out of context can lead to undesired behaviour and results

- As long-term above-average shareholder value creation is the ultimate goal, EVA like e.g. Intellectual Capital measures (IC) and similar important measures must be viewed in relation to what the organisation is trying to achieve in general and where it is at the moment - is it an established firm in a short-term investment environment or perhaps a start-up in a long-term investment environment?
- Without context how can we know that pursuit of high EVA today won't lead to economic disaster tomorrow due to under investment, short-termism etc.



# What is Economic Value Added (EVA)?

## Example of an EVA application



Target revenues, cost ratios and capital requirements are defined by the mission / vision statement

EVA is calculated from its key components; revenues, costs, capital employed and cost of capital

Each of the components are linked to action plans designed to improve their value

A set of measures is identified for each action plan designed to monitor progress in its implementation

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# What is Balanced Scorecard?

## Background & underlying philosophy

### What is it?

- A strategic communication and performance measurement tool. It is designed to help management teams articulate and communicate their strategy in the form of strategic objectives, measures and initiatives as part of an ongoing strategy dialogue

### Origins

- Multi-company research from 1990's undertaken by R. Kaplan & D. Norton aimed at developing alternatives to purely financially based performance management tools (e.g. budgets)

### Underlying philosophy includes:

- The importance of clear communication of goals and priorities
- The benefits of learning & team-working



# What is Balanced Scorecard?

## Strategic control versus operational control

### Strategic Balanced Scorecards

- Monitor implementation of strategy i.e. *strategic control*
- They are linked to a strategic 'Destination Statement' through key strategic objectives

### Operational Scorecards

- Monitor and promote best practice behaviour within an operational environment i.e. *management control*

**Scorecards tend to vary between these two extremes, particularly in large hierarchical organisations**



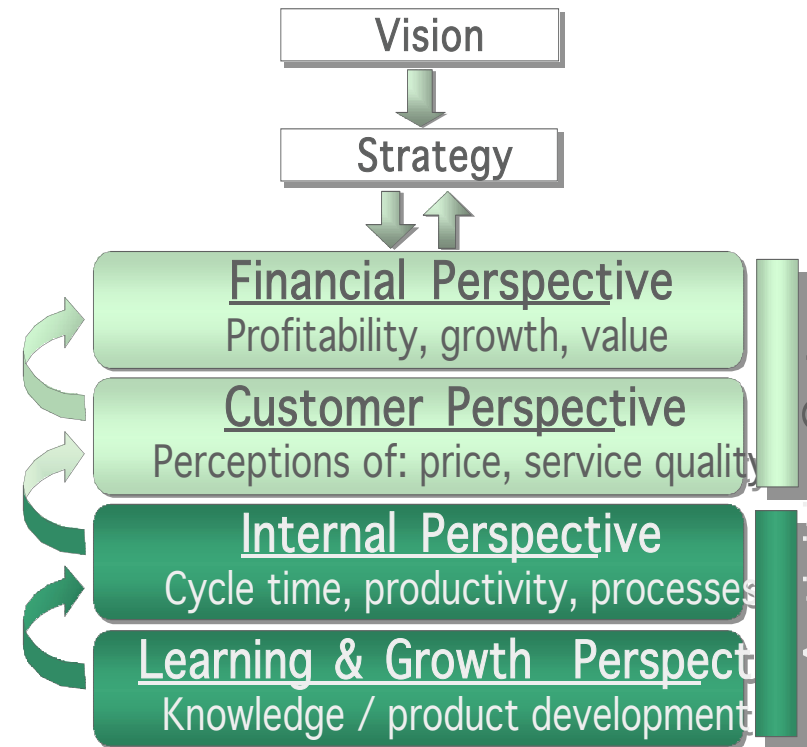
# What is Balanced Scorecard? Developing a Scorecard

Team effort involving future users

Based on the organisation's jointly held strategic vision, as documented in the Destination Statement

Identification of key strategic activities and outcomes (objectives)

Express management team's theory about which activities drive which outcomes across the business perspectives



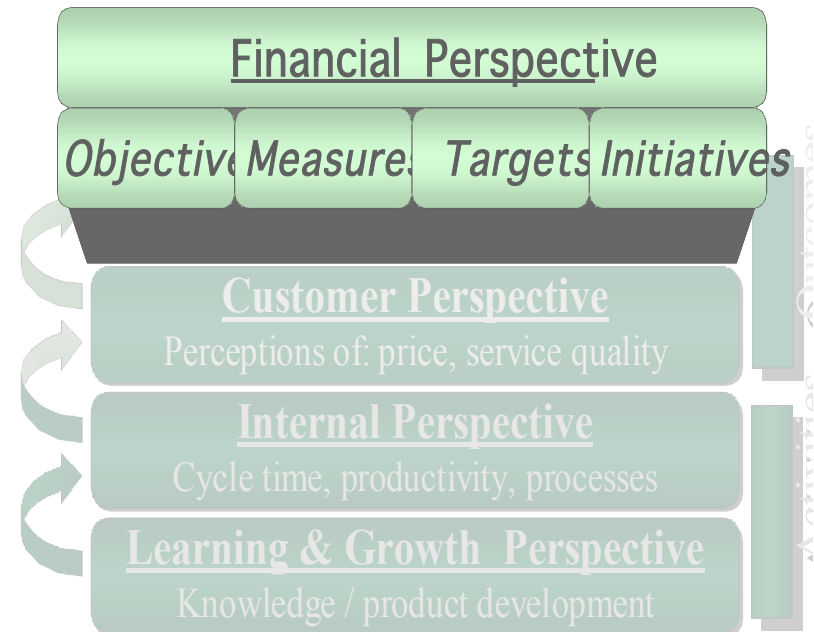
# What is Balanced Scorecard? Developing a Scorecard

Measures track progress in achieving strategic objectives against set targets

- Warning lights

Targets are based on the Destination Statement defining the state of the organisation at some point in the future

Initiatives are extraordinary activities and projects furthering achievement of objectives



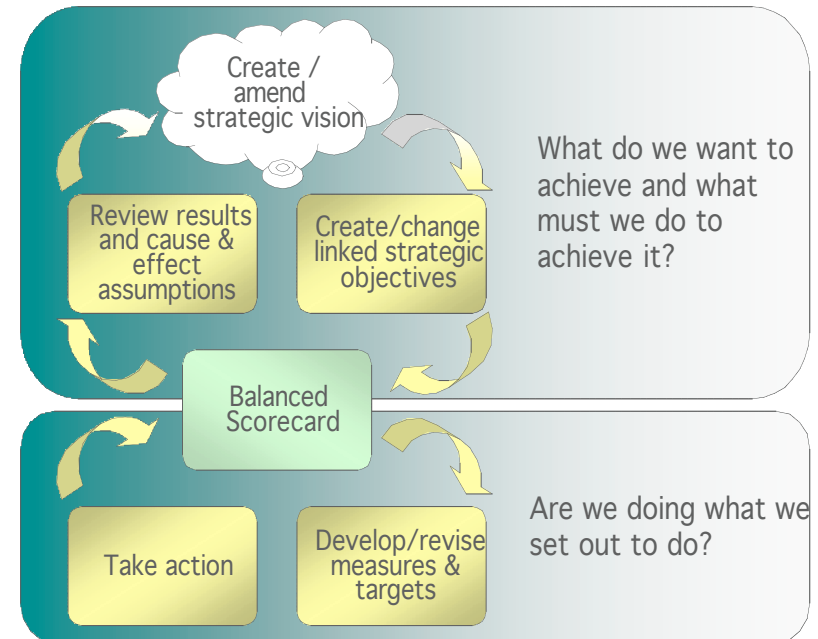
# What is Balanced Scorecard? Only as a good as you make it...

The Balanced Scorecard process combines a double control and learning “loop”

It is only effective if it provides its users with relevant information

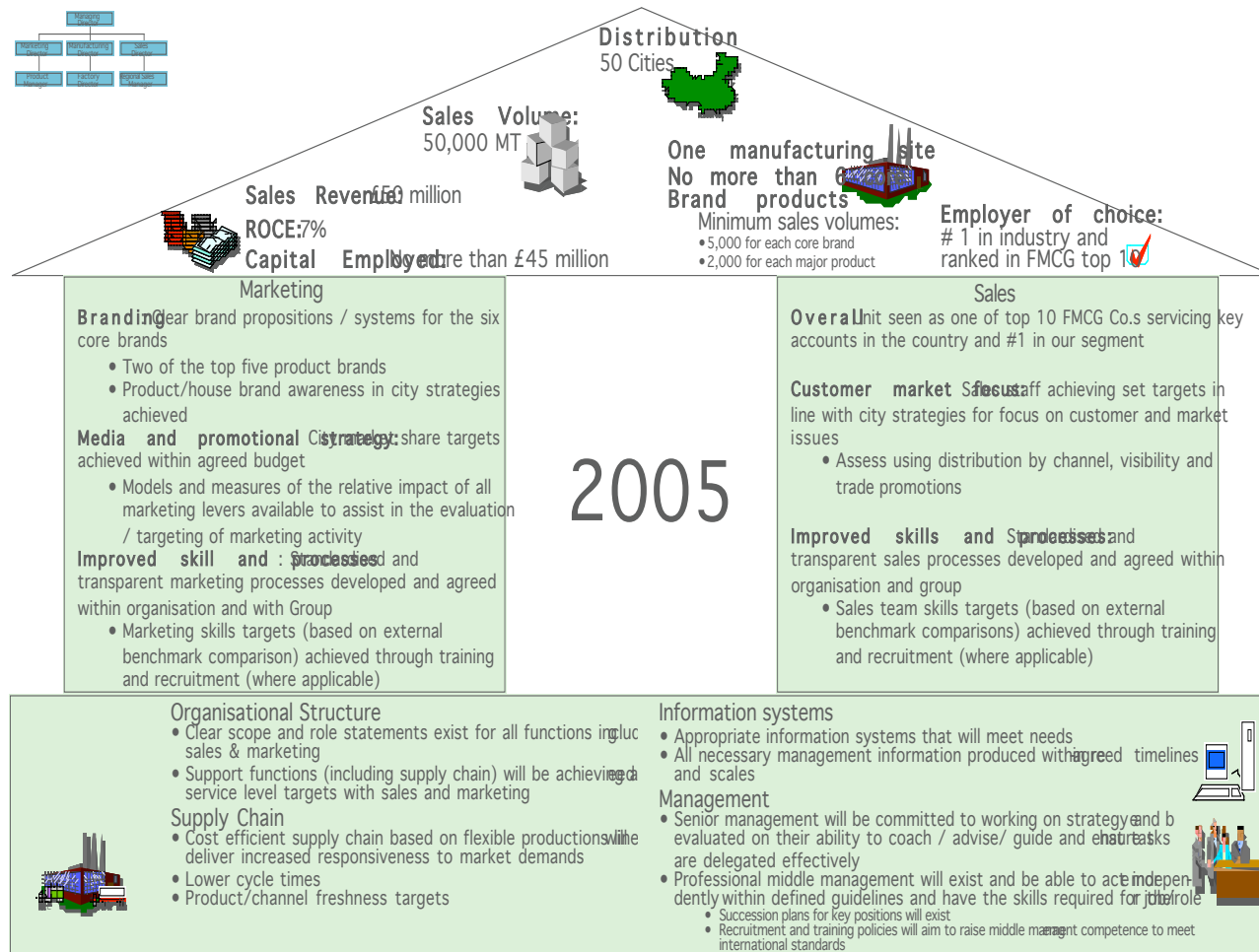
The original design (Scorecard content) therefore needs to be continuously updated taking into consideration;

- learning about validity of causal assumptions
- shift in strategic priorities driven by changes in the internal / external environment



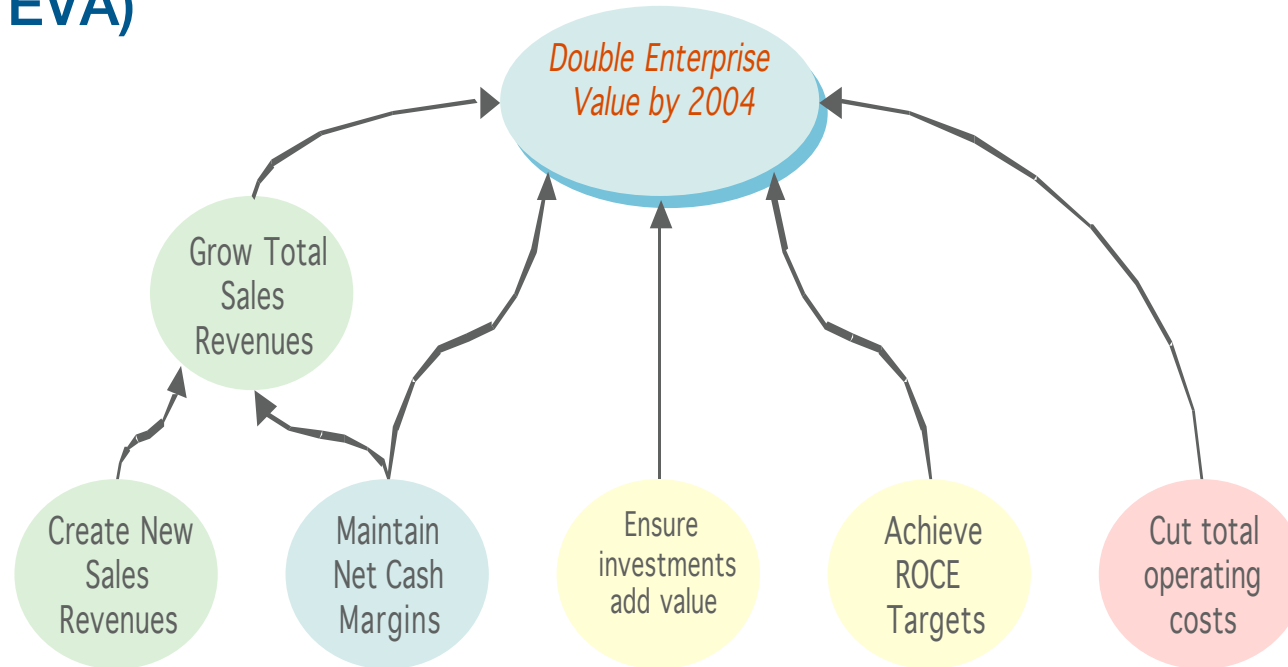
# Balanced Scorecard for Strategic Control

## Example of Destination Statement



# What is Balanced Scorecard

## Example of a Balanced Scorecard Financial Perspective (non EVA)



Financial objectives in a Balanced Scorecard is normally based on whatever is stated in the Destination Statement

The choice is typically driven by the organisation's historic preferences rather than any defined and tested framework

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# Combining EVA and the Balanced Scorecard

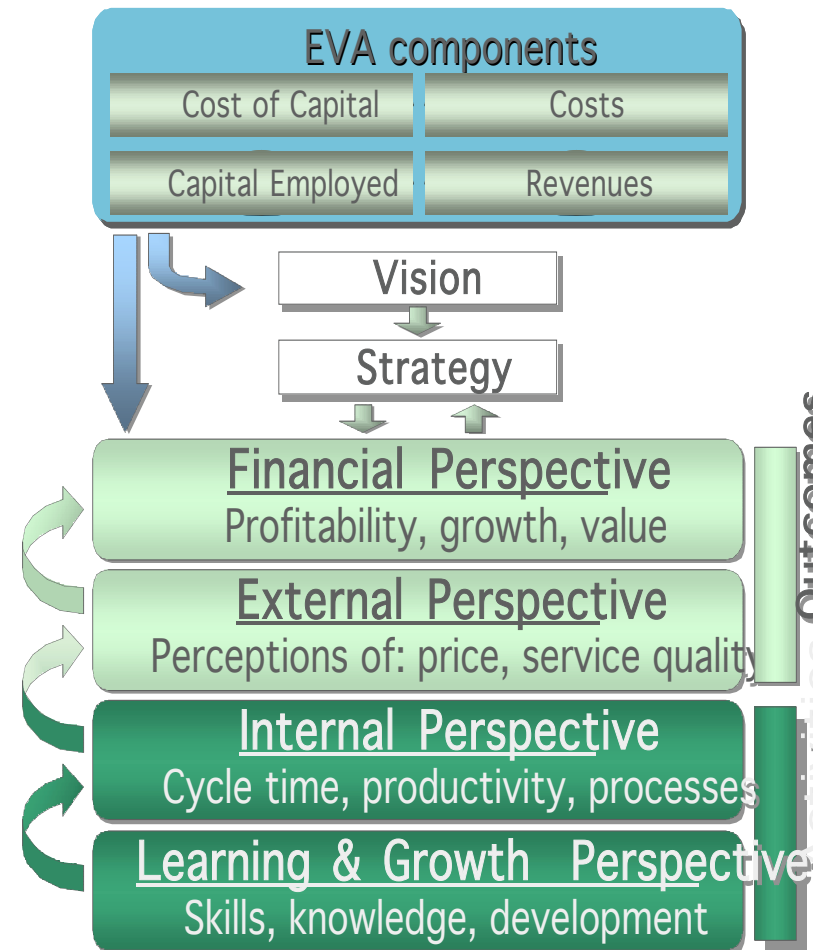
## Putting the two models together

Components of EVA are highly similar to the objectives often found in the financial perspective of non-EVA Balanced Scorecards

Using the “authenticity” of the structure of the EVA calculation may add increased credibility to the selection of financial Balanced Scorecard objectives and measures

The other three Balanced Scorecard perspectives “forces” the articulation of management assumptions about how to influence the EVA drivers and enables

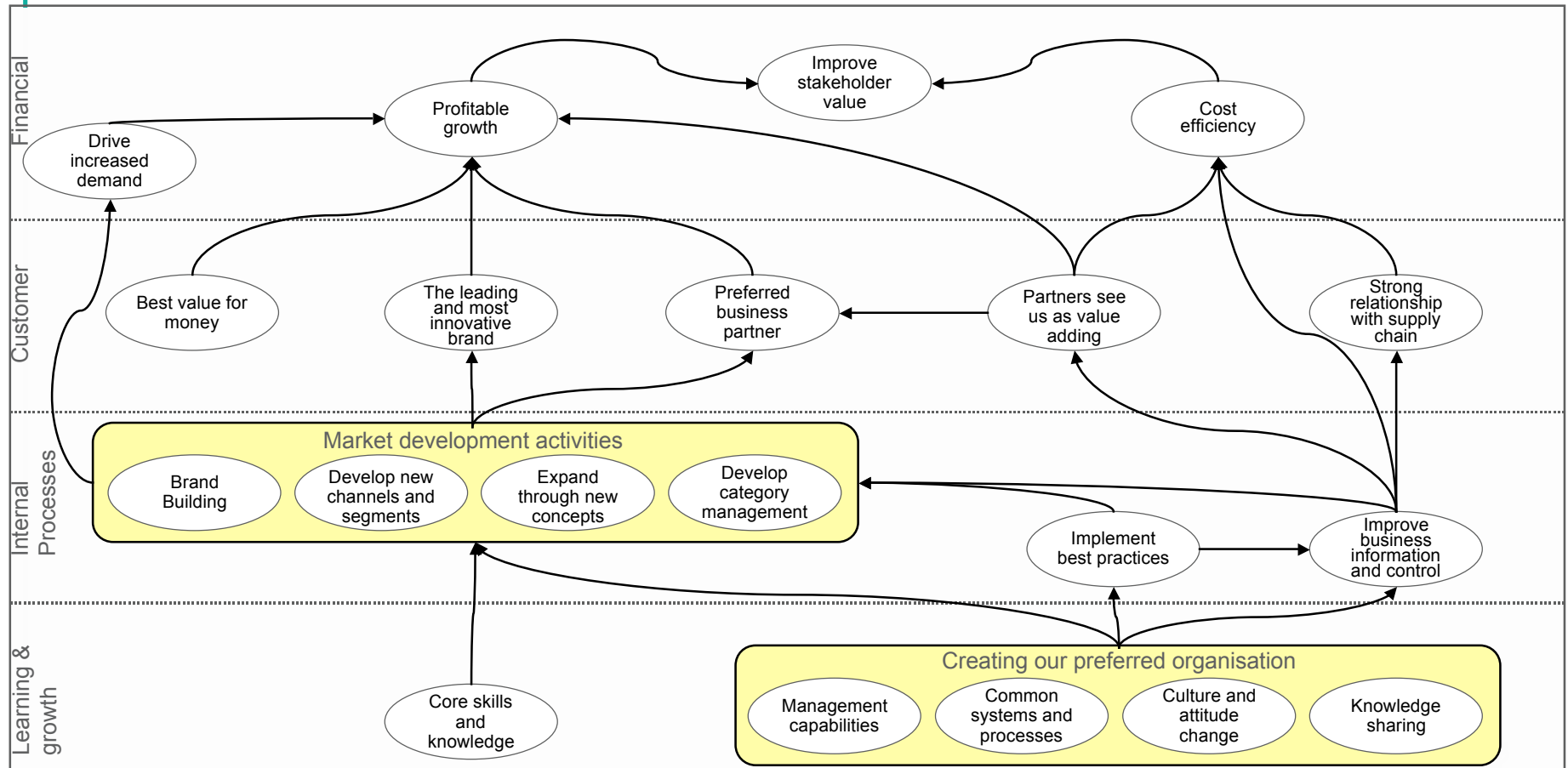
By applying measures and targets, the validity of these assumptions can be tested as they are applied rather than waiting for the retrospective results of an EVA calculation



# Combining EVA and the Balanced Scorecard

## Balanced Scorecard for Strategic Control

*Example of a 4 Perspective Strategic Linkage Model (SLM)*



# Combining EVA and the Balanced Scorecard

## Using the Scorecard for strategic alignment & goal setting

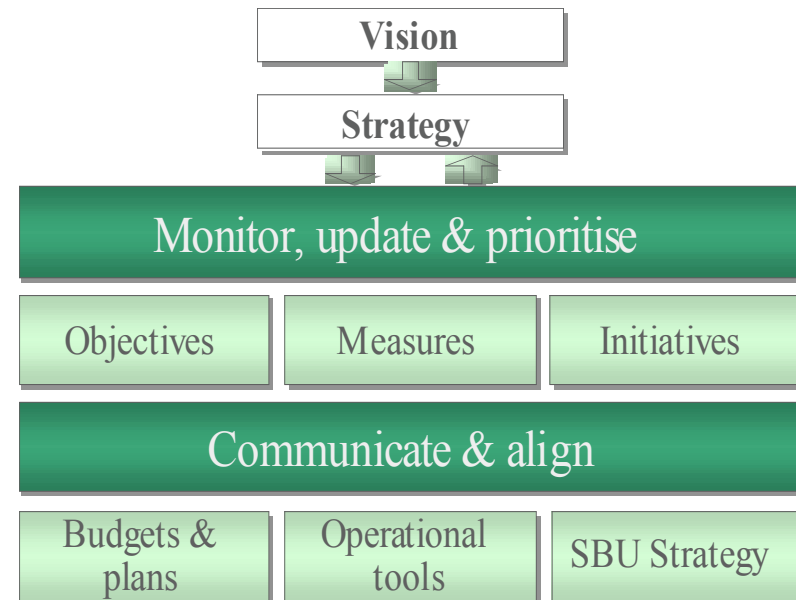
Management attention need to remain focused on execution of what is always top priority activities and results

- For this to happen, regular management meetings are needed to monitor and evaluate measures and targets, amend vision, strategy and best practise as well as monitor and re-prioritise implementation of strategic initiatives

Decisions about “what need to change – our behaviour or our goals?” must be as factually based as possible?

- Ongoing evaluation of whether activities actually produce the expected results provides a better basis for making such decisions

Successful organisational alignment towards achievement of an overall vision requires budgets, operational plans and tools as well as SBU strategies to reflect the priorities of board-level Scorecards



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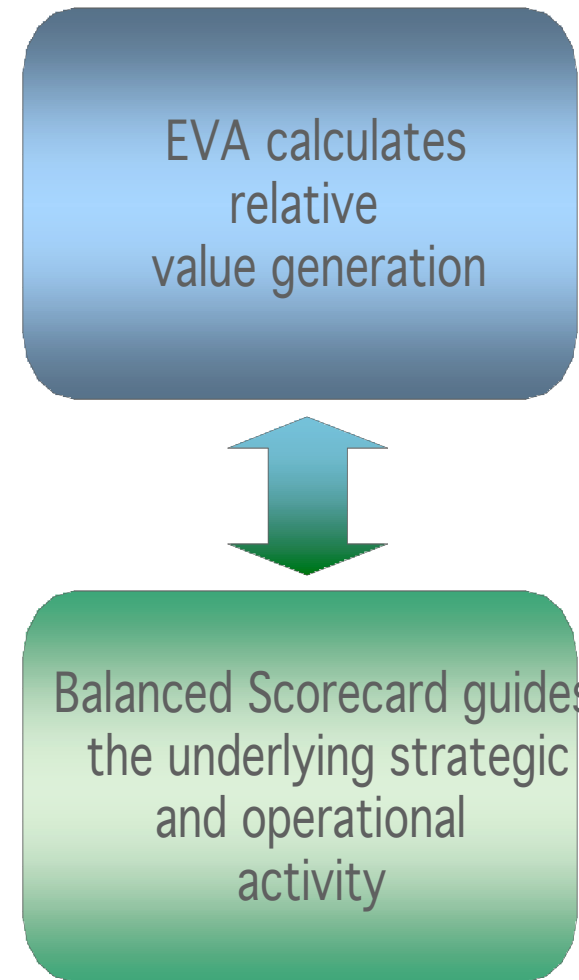
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## Conclusion

Both tools have valuable potential to help managers focus more effectively on generation of shareholder value

- EVA is efficient at tracking relative value generation
- Balanced Scorecard is a powerful tool to guide the management of strategic and operational plans intended to trigger the desired improvement in value generation

Clear benefits can be achieved from applying the tools in combination



## To find out more

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