

CHAPTER TWO: CORPORATE PERFORMANCE AND FINANCIAL MEASURES

It is fundamentally the confusion between effectiveness and efficiency that stands between doing the right things and doing things right. There is surely nothing quite so useless as doing with great efficiency what should not be done at all.

(Drucker, 2006:3).

2.1 INTRODUCTION

The existence of relationships between an organisation and its stakeholders and relationships between the stakeholders themselves are attracting a lot of interest amongst academics, researchers and business practitioners. Stakeholders come from within or outside the organisation. Internal stakeholders that come from within the organisation include management and employees. External stakeholders that come from outside the organisational boundaries (environment) include shareholders, government, debt providers, customers, suppliers, competitors, the natural environment (ecological systems) and the community (David, 2005; Laudon & Laudon, 2006; Rossouw, 2010e).

An organisation is always in constant interaction with these stakeholders, all of whom have various interests in the performance of the organisation. For example, shareholders would be interested in the profitability of the business, whereas debt providers would want to assess the liquidity of the organisation. To meet different stakeholder interests, corporations set up systems to measure their performance and report such measurements accordingly.

Chapter Two reviews relevant literature on corporate performance measurement systems and traditional financial measures. The chapter discusses the significance and practical use of performance measurement systems.

Furthermore, there is an analysis of the challenges that the performance measurement systems currently face.

Finally, the chapter reviews in detail traditional financial measurement systems in respect of their background, their significance and practical use to organisations, and finally the limitations of their application in a modern, changing environment.

2.2 CORPORATE PERFORMANCE

In order to meet the expectations of different stakeholders, senior managers continuously strive to improve the performance of their organisations. Generally, organisational improvement processes follow a continuous circle of three major processes, namely corporate planning, strategy implementation (execution) and performance measurement or evaluation (David, 2005:5-6). The corporate planning phase involves setting goals and objectives that are congruent with the corporate vision, mission and value statements of the organisation. Goals and strategies are formulated after a careful and critical analysis of the organisation's internal strengths and weaknesses and also of the organisation's external opportunities and threats, conducted through a SWOT analysis, which is also sometimes referred to as corporate analysis. After the corporate analysis, strategies are formulated as a means to achieve the goals that have been set; and that is followed by the implementation of the corporate plans.

The implementation phase involves translating plans into action (David, 2005:5-6). To put it differently, implementation is the part of the process where strategies are executed.

Finally, corporate performance is measured to assess whether or not the goals and objectives that were set in the planning phase have been achieved in the implementation phase. A suitable feedback control system enables managers to use the information provided by performance measurement systems to plan further actions to ensure the continuous improvement of the organisation.

The researcher's personal observations suggest that performance-based systems usually follow specific prescriptions that are intended to satisfy the needs of primary stakeholders such as shareholders, customers, suppliers and government. In the process, such performance-based systems often alienate other stakeholders, such as the general society, local communities and the ecological systems. In the current study, such prescribed performance-based systems are referred to as **mechanistic** performance systems, as they are guided by procedures and policies.

Examples of mechanistic systems would be traditional financial measures that are targeted at meeting the needs of different stakeholders. The production of financial information is governed by prescriptions set out in the International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board (IASB), a board that sets the accounting and financial guidelines for the purposes of objective financial reporting using a system that is internationally acceptable. The prescribed financial reporting standards also facilitate comparability of performance between different corporations, usually from the same industry (Iatridis, 2010:193-204). Corporate performance is compared using ratio analysis, as discussed below. However, the use of financial measures is fraught with many limitations, including their focus on short-termism, which is problematic where management makes short-term decisions that are accomplished at the expense of the long-term sustainability of an organisation.

The Balanced Scorecard model was developed to overcome some of the limitations of financial measurement systems, which are prone to abuse by executive managers. Apart from combining both financial and non-financial measures, the Balanced Scorecard model is conceptualised on the maxim of the *maximisation of shareholders value* (Kaplan & Norton, 1992:171-179). The Balanced Scorecard model is governed by the set prescriptions and procedures that an organisation has to follow in order to "maximise" a shareholder's wealth.

Hence, the model has been classified under the mechanistic performance measurement systems in this study (see Chapter Three).

Other business models have also emerged and evolved, including the stakeholder model. The stakeholder model proposes that organisations must adhere to a stakeholder-centred approach which sees all stakeholders as critical components of organisational operations and performance (Atkinson, 2006; Ferreira & Otley, 2009; Freeman, 1994). There are no prescribed rules underlying the use of these models; and such systems are flexible, as they focus on accommodating social and environmental dimensions which are usually overlooked by many corporations. When a stakeholder-centred approach is used, corporate performance is measured in terms of the involvement of all the stakeholders concerned (see also Chapters 4, 5 and 6).

Chenhall (2005:395) discusses some attributes, strengths and the coherence of performance measurement systems. Business executives should consider the multiplicity of stakeholders by focusing on relevant measures such as efficiency, effectiveness and equity. Still, performance measurement systems should capture financial and non-financial outcomes whilst providing vertical links between strategy and operations, and horizontal links across the value chain of an organisation. Finally, performance measurement systems should provide information on how an organisation relates to its external stakeholders and its ability to accommodate them.

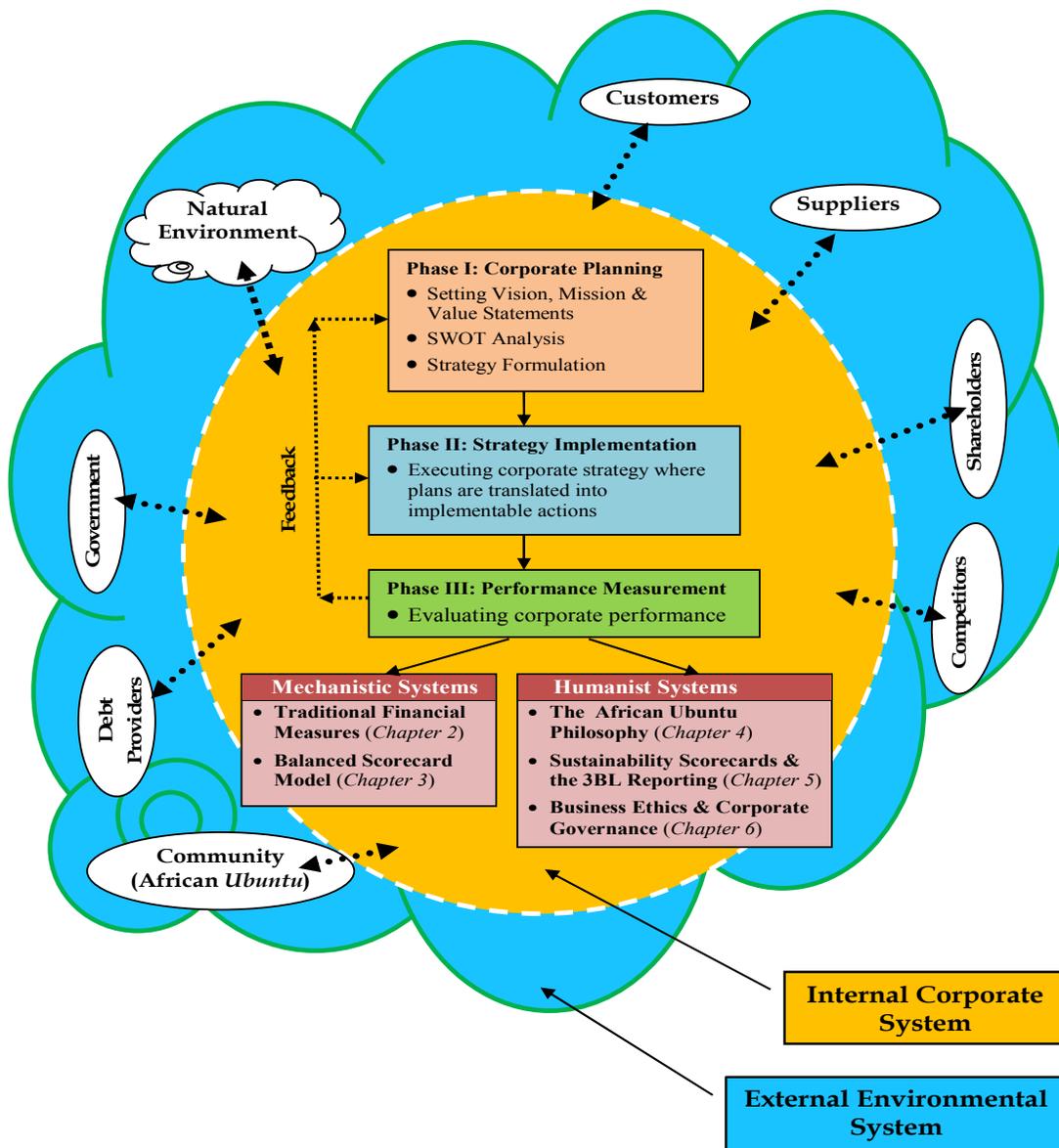
In the current study, the scenarios where the systems are integrated with external stakeholders, especially society, are collectively classified under the **humanist** performance systems, as they involve a consideration of human elements. In the same humanist dimension, practitioners have recently become more receptive to the notion of the necessity to incorporate business ethics, corporate governance and corporate conscience parameters into modern organisational reporting systems (Rossouw, 2010a:78-80). Within the

organisational sphere, issues of business ethics and corporate conscience are now becoming more pronounced and more critical than in the past.

2.3 THE CORPORATE PERFORMANCE FRAMEWORK

The corporate performance framework is based on a stakeholder-centred approach to corporate performance systems, as summarised in Figure 3, below.

Figure 3: Corporate performance framework



Source: Own observation

The corporate performance framework summarises organisational interactions with different stakeholders from the external environment. The framework also highlights three components of corporate performance, namely corporate planning, strategy implementation and performance measurement, as discussed above.

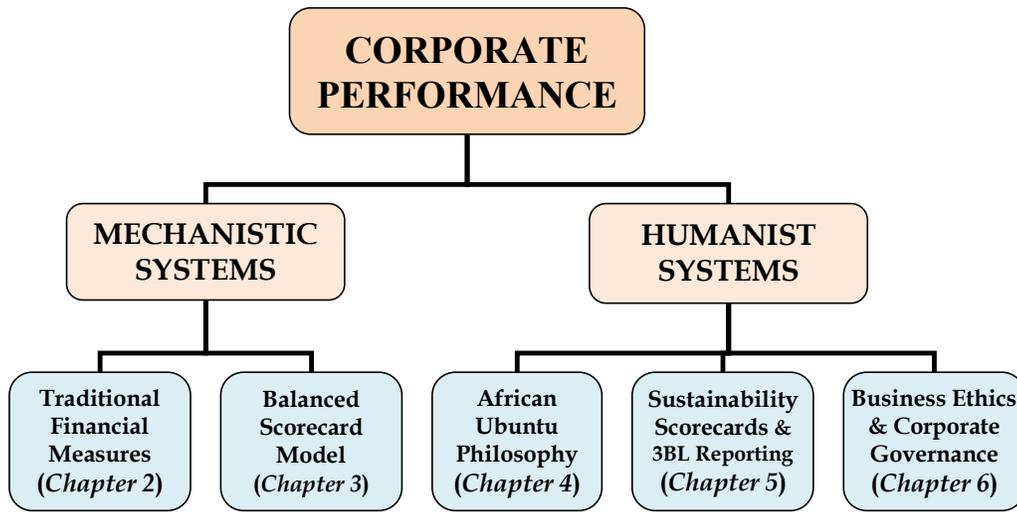
Finally, for there to be an effective continuous improvement system on corporate performance, an effective feedback control system is needed (Flamholtz, Das & Tsui;1985:46-47; Otley, 1994:289-299; 1999:365-368). Such an effective control system, expectations and actual performance are compared and such comparisons serve as a basis for determining proper responses to operating results (Drury & McWatters, 1998:32-33). Information on the performance measurement has to be fed back into organisational management systems for further management actions. Where there are significant variances between the planned targets and the actual results, managers should institute appropriate adjustments to the planning and implementation processes that form part of the performance system. The feedback control system with its linkages is shown as dotted lines in the corporate performance framework in Figure 3, above.

With regard to performance measurement, the framework recognises two measurement systems relating to corporate performance: mechanistic and humanist measurement systems. For the purposes of this study, traditional financial measures (see the discussion below) and the Balanced Scorecard model (Chapter Three) fall into the mechanistic measurement systems category. The humanist systems include the African Ubuntu philosophy (see Chapter Four), the triple bottom line and sustainability balanced scorecards (Chapter Five) and matters relating to business ethics and corporate governance (Chapter Six).

In summary, a total of five chapters (Chapters Two to Six) are earmarked for the review and analysis of the literature on corporate performance systems, as indicated above. A diagrammatic presentation of the literature review is shown in

Figure 4, below. From here on, the highlighted area (green) amongst the five corporate performance systems indicates a chapter reviewing the relevant literature.

Figure 4: Literature review outline on corporate performance systems



Source: Own observation

2.4 CORPORATE PLANNING IN A CHANGING ENVIRONMENT

The business environment is constantly changing; and executive managers are increasingly exposed to new challenges in organisational operations. The operating environment has become ever more volatile as modern economies have emerged (David, 2005; Laudon & Laudon, 2006). Hence, modern industries cannot afford to be static and mechanistic, as there are constant rapid technological changes; there has been a shift to more knowledge-work based management systems; there is currently an increased emphasis on corporate citizenship in respect of social responsibility and corporate conscience issues; and industries have to address the problems of environmental degradation and global warming challenges.

The business environment has become highly challenging with the emergence of global economies, in which companies have to compete in both the local and the global marketplace. Adherence to international standards, including issues on product quality, has become a prerequisite for competitiveness. Consequently, organisations have begun to redesign their business processes in order to become global and competitive (Laudon & Laudon, 2006:501-502; Porter, 2008:85-92). In the current business environment, globalisation is a determining factor in the running of business operations. Globalisation explains the growing need for corporations to take advantage of improved information systems and enter into the global competition in the international marketplace (Drury & McWatters, 1998:36) – managers need to realise that globalisation is not an option, but a way to ensure strategic survival.

Because of the volatility of the corporate environment, corporate planning has become a determining factor in organisational survival in many arenas. As a result of increasing competitive pressure arising from the globalisation of industrial activities and markets, organisations have a duty to reorient their visions, missions, corporate objectives, strategies, operations, business processes and procedures in order for them to remain competitive in the local and global marketplaces (Porter, 2008).

Corporate planning involves setting goals and objectives that an organisation wants to accomplish. These plans are drawn up in line with the stipulated vision, mission, and value statements that form the guiding principles for how an organisation wants to engage in future activities. Good plans must be achievable and implementable in order to improve the overall performance of an organisation.

2.5 IMPLEMENTING CORPORATE STRATEGIES

The execution of a corporate strategic process involves the translation of plans into action. Organisations get inputs from their environment in the form of financial capital from shareholders, debt capital from financiers, labour capital from the local community and labour markets, and natural resources capital from the natural environment. Through their internal business processes, organisations process and transform these inputs into finished or semi-finished goods and services. During the implementation process, organisations are supposed to use their resources in the most economic, efficient and effective manner.

The efficiency and effectiveness of modern organisational knowledge-creation processes depend partly on the local circumstances that dictate how information is created and disseminated within an organisation. Feedback and information dissemination systems have become essential sources of input into management decisions (Elg 2007:226). The value of information systems has become so pronounced that managers have now started investing massively in new information technologies, in the hope that such investments will help managers to run their corporations more effectively and efficiently for better performance.

Modern business practices also dictate that companies have to be ethical in their undertakings. For instance, manufacturing companies have an ethical duty to protect the environment against degradation and pollution (Rossouw, 2010b:20-25). Once goods and services are produced, they are given back to the environment through customers and consumers for final consumption, thereby completing the ecosystem as shown in the conceptual framework of stakeholder relationships and networks (see Figure 1).

The above analysis reveals that business activities and processes are complex because they reflect the interconnectedness and interdependence of many stakeholders with different interests in the organisation. Thus, there is a lot of

interaction between an organisation and such stakeholders. The performance status of an organisation that is reflected through the measurement systems would likewise determine how attractive an organisation is in the eyes of these stakeholders.

2.6 PERFORMANCE MEASUREMENT SYSTEMS

The basis of corporate performance is managers' ability to compare actual results to the plans that were originally drawn up to address the strategic vision, mission, and value statements of an organisation. After developing plans in the course of the budgeting process, managers can compare actual results against the set targets to measure performance with regard to various activities and the overall organisation.

The planning and comparisons are done on the basis of the stipulated variables that form part of the planning process. Therefore, performance measurement systems have become critical sources of input for the management policies and decisions of various organisations. Within a corporate performance framework, the feedback control system provides a valuable platform for the continuous improvement processes of organisations.

Generally speaking, organisational systems and functions have always been associated with performance measurement systems (Neely *et al.*, 1995:80-116). The most notable areas of such organisational systems and functions include strategic management, financial management, total quality management, organisational behaviour, human resources management, budgeting and budgetary control systems, standard costing and variance analysis, activity-based costing, and production and operations management systems.

2.7 SIGNIFICANCE AND PRACTICAL USE OF PERFORMANCE MEASURES

The importance of performance measures for organisations has been widely researched and is emphasised by both business practitioners and academic scholars. This section reviews literature on the significance of performance measures for an organisation.

2.7.1 Performance measures facilitate the identification of critical areas for special attention

The use of performance measures facilitates the identification of areas that are critical for organisational operations and the ultimate survival of organisations. Through variance analysis and gap analysis, performance measures serve the purpose of monitoring performance, by identifying areas that need special attention and then enhancing motivation, improving communications and strengthening accountability amongst employees and managers (Bourne, Franco & Wilkes, 2003; Busi & Bititci 2006; Mackay, 2005). Therefore, performance measures constitute a set of key success factors that enhance the effectiveness of and efficiencies in an organisation. Generally, performance measures enhance effective communication systems and employee behaviour, and boost morale.

2.7.2 Performance measures instil positive employee behaviour

Good performance measures contribute towards improved behaviour by the people who are affected. Because measurements affect future results, the proponents of performance measurement systems argue that the use of well-designed performance measures create possibilities for business managers and employees to gain knowledge about what is going on in their establishments (Elg, 2007:226; Fitzgerald & Collins 2006:40-47; Otley, 1999:380-381). The knowledge that is gained through effective communication systems maintains sanity amongst the managers and employees of an organisation. Performance measures direct the current and future behaviours of individual managers and employees (Flamholtz *et al.*, 1985:85).

Perceptions about which corporate decisions will be affected by performance measures are critical to individuals and departments charged with using performance measurement systems. Performance measurement systems look at behavioural aspects and attach relative priority to values such as efficiency, equity and service quality, among other attributes (DeBusk, Killough & Brown, 2009:19-20; Otley, 1994:289-299, 1999:380-381). Performance measurement attracts so much attention because of the positive organisational outcomes that are achieved when such systems are effectively adhered to.

Once proper systems are instituted and followed in detail, organisations are bound to realise their strategic vision, mission and goals (De Waal, 2010:79). Therefore, monitoring behavioural aspects linked to people that affect corporate performance should be an ongoing process if a continuous improvement of processes and activities is to be achieved. Organisations usually compare their internal business processes and practices with those of the best in the industry through benchmarking systems.

2.7.3 Good performance measures enhance benchmarking systems

The deployment of useful measurement systems enhances benchmarking, where senior executives set the best standards within an identified industry. Without the ability to understand and measure performance, benchmarking efforts aimed at deploying the best operational practices cannot bear the desired fruit – enhanced corporate value (Gomes, Yasin & Lisboa, 2004:523-524). To be competitive, an organisation needs to apply performance measurement systems successfully to gain insight into and make judgements about the organisation itself. Executive managers measure value-for-money activities for better corporate performance. Through benchmarking, organisations strive to improve continuously upon productivity in general and product quality in particular.

2.7.4 Performance measures enable improvements in quality and productivity

Performance measures play an important role in improving quality and productivity in organisational systems and products (Neely, 1999). Quality control entails a greater use of non-financial measures than financial ones. Such non-financial measures include measures of intellectual capital and managerial competencies. When they have incorporated non-financial measures, many organisations have become to realise the importance of the attributes assessed by such measures of value creation for products and services. So, for example, some studies show that there is a direct positive correlation between the learning capability of managers and overall corporate performance (Prieto & Revilla, 2006:178-181; Vergauwen, Roberts & Vandemaele, 2009:239). The learning capability of managers has an indirect influence on financial performance through its significant effect on non-financial performance. Thus the learning process is a foundation for the improvement of overall corporate performance in all sectors.

In the public sector, performance measurement, with its promise of improving economic efficiency, helps to create an impression of a modern public administration by incorporating management elements from the private sector into coherent systems in order to improve efficiency and meet productivity challenges (Greiling, 2006:460-463). Performance measurement also helps public service providers to prove the legitimacy of their actions to political decision-makers and actors, who are often convinced that more market elements will lead to a better public service.

Past and present practices indicate that performance measurement is a management tool and that using it is a managerial responsibility. It is a quality management system, and should also form part of a learning organisation. In a learning process, performance measurement focused on future viewpoints include a driver towards good corporate governance, transparency and accountability as success factors that allow performance audit and assess organisational competency/capability (Phusavat *et al.*, 2009:660). Moreover,

performance measurement systems need an organisation to face the challenge of staff empowerment and of enhancing the way in which top administrators and executives view their members of staff. Since information becomes available from such systems, staff should be trusted and empowered to identify problems and initiate improvement interventions where necessary.

Generally, the literature review indicates that performance measures can play a pivotal role in improving the performance of organisations (Neely & Najjar, 2006:101-102). The areas that make it necessary for organisations to focus on performance measurement systems are the changing nature of work structures, increasing competition locally and internationally, specific improvements and innovative initiatives, national and international quality standards and awards, changing external demands, the power of information technology, and changing organisational roles.

The basic premise that underpins the use of performance measures is the desire of organisations to institute corrective measures and thus achieve continuous improvement in their operations that then translate into better overall corporate performance. However, the use of performance measurement systems is highly challenging.

2.8 CHALLENGES AND LIMITATIONS OF PERFORMANCE MEASURES

Although performance measures may make positive contributions towards organisational operations, their implementation is rife with challenges. These challenges are discussed below.

2.8.1 Performance measures are based on a single organisation model

Usually, performance measures are used to appraise an individual organisation. This creates problems in the more collaborative modern business environment, where corporations work together as partners. It is relatively easy to assess whether a single corporation is measuring its performance in terms of its

processes and its level of customer orientation well, and whether that performance is good or bad, but it is much more difficult to assess these matters, for example, at a supply chain level, where several organisations are involved (Cagnazzo, Taticchi & Brun, 2010:163).

Within an organisation, multidisciplinary perspectives can contribute to a more comprehensive understanding of performance measurement issues. In modern commerce, trans-organisational processes (which are encouraged) should be planned, implemented and evaluated via performance measurement systems. Busi and Bititci's (2006:7) study indicates that there is a need for organisations to go beyond their organisational boundaries in designing and using measurement systems that are consistent with modern collaborative commerce frameworks. Technologically-oriented organisations have to start using collaborative performance measurement systems in which customers, suppliers and business partners, including competitors, have to be linked to one another and work collaboratively for sustainable competitive advantage.

Furthermore, performance measurement systems face considerable challenges within the collaborative commerce environment where organisations form inter-organisational relationships. Performance measurement systems for extended enterprises are usually only partial, because performance measurement processes and practices used within firms are largely incompatible with the central characteristics of extended enterprises (Lehtinen & Ahola, 2010:181). The implication of these findings is that there is a need for common ground between performance measures when such measures are used to assess the performance of extended collaborative enterprises. Therefore, a deeper analysis of performance measurement systems is needed in order to understand the extent to which they could support performance measurement at the collaborative commerce level.

2.8.2 Performance measures are usually based on existing organisational structures

The development of performance measurement systems is usually based on existing organisational structures with business processes that are already in place rather than on a desired model for a future business process structure (Krause, 2003:5). The main problem of such an approach is that the existing organisational structure is a result of how things have been done in the past or how an organisation is conducting its current businesses. The approach may ultimately inhibit change which could promote future development. By contrast, the development of a model for a future organisational structure would focus on how best an organisation should work in order to achieve its goals.

2.8.3 Insufficient attention is given to performance measurement systems

In the corporate world, performance measurement still remains a serious challenge to many organisations and their managers. For instance, the identification of the appropriate measures to improve operating corporate performance is one of the central problems that persist in many organisations (Hammer, 2007:18-29). Executive managers are still unsure of what the best techniques to measure corporate performance are, but the choice of an appropriate performance measurement system can be the foundation of the success of an organisation. Moreover, some senior executives pay too little or no attention to the measurement systems used in their organisations. It is apparent from the above discussion that a performance measurement system's design and the use of proper measures to track and improve operating performance could be one of the most difficult problems that modern organisations encounter.

Studies have also revealed that the most common mistakes that managers make include the adoption of measures that are too stringent or set benchmarks that are too high and are therefore not achievable, focusing too much on organisational boundaries and hence neglecting business partners, and adopting only one point of view regarding performance measures, in the process

neglecting those measures that affect the customer (DeBusk *et al.*, 2009; Hammer, 2007). Some managers are also poorly prepared and they lack a proper understanding of measurement significance. They may focus their attention on trivial and insignificant elements, or neglect human behaviour, which is very complex and not mechanistic. Indeed, some managers completely ignore the impact and value of performance measurement systems.

The problems raised above regarding the use of performance measurement systems highlight the need for managers to take such systems seriously and to exert the utmost care when selecting performance measurement systems for their organisations. A suitable focus on performance measurement systems should enable managers to interpret such measurement systems better to achieve corporate improvement.

2.8.4 The multiplicity of performance measures leads to interpretation problems

There is also a growing concern in performance measurement that measuring performance itself is not enough. Measurement has to lead to insight; and insight should result in action at different levels – the level of an individual employee, the departmental level and the level of the entire corporation (Paladino, 2007a:42, 2007b:38-39, 2007c:43-44). Performance measurement should be an inclusive process that accommodates routine measurements of programme inputs, outputs, immediate outcomes, or end outcomes (Newcomer, 1997).

The entire information system, from data collection, data processing up to information dissemination, should be scrutinised where performance measurement systems are involved. Managers have to be particularly cautious in interpreting the information gathered via a performance measurement system, because viewing performance measurements as objective and as giving indisputable facts about reality might lead to an overreliance on what may be de-contextualised information (Elg, 2007:226). Therefore, performance

measurement systems must be used reflectively in order to get the best possible results.

In performance measurement, it is important to identify two key indicators: the intended use of the performance data, and the value priorities of those stakeholders who choose what to measure (Brown 2000; 2007; Olve, Roy & Wetter, 1999). The performance data should be synthesised and can then be used to support a variety of management decisions. Therefore it is advisable in designing and implementing tools for corporate performance measurement that systems be kept as simple as possible (Schulz & Heigh, 2009:1047-8), as the simplicity of performance measures can enhance the integration of the needs of all stakeholders into simple and user-friendly systems.

The objectives in setting performance measurement systems are varied, especially in the public sector. Usually, the power relationships between public sector stakeholders dictate the use of a particular aspect of performance measures within a public sector organisation (Modell, 2001:437-464). A specific aspect of performance measurement may thus be used by managers to seek legitimacy to satisfy a coercive stakeholder rather than to deliver organisational long-term objectives. Within the public sector framework, managers often behave differently from managers in the private sector when implementing performance measurement systems. For instance, when they face a coercive central government, local managers have been known to attempt to diffuse central government's performance targets into their local operations although government's targets are not consistent with their internal organisational objectives. In order to ensure stability and satisfy stakeholders such as government, local managers may act proactively to decouple the financial performance targets required by central government from the objectives of other local stakeholders.

Performance measures may also have an impact on the behaviour of executive managers and employees in the public sector. The managers' conforming

behaviour (De Waal, 2010:79-95; DiMaggio & Powell, 1983:147-160) may be due to the fact that their survival depends largely on their ability to fulfil mandatory requirements imposed by the financial support from central government rather than on any improvement of the corporate performance of the institution or department. There could also be implementation problems in the context of the corporate social responsibility of the public sector.

An empirical study by Chang (2007:101-117) indicates that the Performance Assessment Framework (PAF) was used by local health authorities in the United Kingdom primarily to seek legitimacy rather than to ensure rational performance improvements. Central government used the Performance Assessment Framework to make the performance of the National Health Services (NHS) visible to the public; so that the public would receive the message that central government had attempted to deliver government mandates. The study also reveals that the local health authority managers incorporated the imposed performance indicators into their local performance measurement practice. They did this in order to seek the approval of the central government. The use of the Performance Assessment Framework was symbolic and a matter of form, and had little impact on improving aspects of performance that were actually valued by local managers in the National Health Services.

A similar study was conducted in the United States, where a government system was used in an attempt to apply a multi-dimensional performance measurement system for accountability purposes (Cavalluzzo & Ittner, 2004:265). The study's findings reveal that externally-mandated performance measurement was implemented purely to meet legal requirements, which makes it likely that the exercise was just symbolic, with little influence on the internal operations of the organisations concerned. These findings suggest that legitimacy in itself is not enough in the implementation of performance measurement systems. The performance measures must go hand in hand with a change in the mindset of

those who implement them and are affected by them in order for the measures to be successful.

In Kenya, there has been noticeable progress towards the inculcation of the notion of corporate social responsibility. However, there are evidently still some obstacles to the implementation of performance-oriented civil service reforms (Marwa & Zairi, 2009). The Kenyan civil service reforms have not revolved around performance measurements that could lead to rewarding good performance and realigning resources to support the desired changes while simultaneously stimulating competition amongst public entities to support superior public service delivery.

These observations indicate that all sectors, and especially the public sector, lack vigilance and a strong sense of direction in respect of corporate performance measurement systems. Behaviourally speaking, managers use their subjective judgements when using and interpreting corporate performance measures. Even worse, many of the measures remain mere formalities and are not intended to improve the internal processes and activities of an organisation.

2.8.5 Performance measures incline towards subjectivity rather than objectivity

Prowse and Prowse (2009:75) have shown that there is lack of theoretical development in performance measurement systems, in that most of them are influenced by subjectivity and bias in judgement. The implications of this observation is that there a need for a more critical evaluation of interpersonal skills for measurement systems to develop into useful corporate performance systems. For example, the use and design of performance pay systems in public and private services linked to the measurement systems that are used have not always enhanced corporate performance. When they are poorly designed and implemented, performance measurement systems can reduce staff motivation.

The above study implies that designing corporate performance systems requires a more psychological approach to analysis and a more critical application of measurement techniques. Given the complexity of corporate activities, performance measures are supposed to provide managers with objective and accurate information to use in their decision-making processes.

2.8.6 There are often data accuracy problems with performance measures

The biggest challenges in corporate performance systems are related to data accuracy and to the fact that the current set of performance indicators may not be geared towards future corporate performance (Ittner, 2008:269-270; Van der Laan, Brito & Vergunst, 2009:22). This problem is more prevalent in emergency-oriented projects. The understanding of the measurement context is important because different intangible issues matter in different projects.

The literature review indicates that there might also be a practical challenge in the use of performance management systems, particularly from a point of view of an organisation funding the project, in that a measurement system and its information may not be available or that the system may be inadequate. Problems of data accuracy would affect the quality of management decisions, as information (the processed data) is the direct input into management decision-making processes. This problem would be more pronounced when financial measures are used for decision-making purposes by external stakeholders, including analysts.

2.8.7 Most performance measures are financially driven

Most performance measures focus on the maxim that all organisations should strive primarily to **maximise shareholders' wealth**, without considering the attributes and needs of other stakeholders. The financially driven approach usually brings about motivational problems amongst the stakeholders (other than the shareholders) who are directly connected with the organisational operations (Otley, 1999:375-376). Such motivational problems include "short-termism",

where too much focus is put on the achievement of immediate financial gains at the expense of long-term business sustainability. Some studies indicate that in a knowledge worker environment or in non-profit organisations, superior performance depends largely on an individual's perception of benefits (Krause, 2003:5).

The studies cited above indicate that the perceived benefits of an organisation's operations should go beyond financial benefits, although it is obvious that organisational financial health is a prerequisite for corporate sustainability. Organisations can use new models such as stakeholder theory to realign their measurement systems to meet the new challenges they face.

2.8.8 There is a need to redesign performance measurement systems

A way to redesign and implement organisational management systems is required to reflect and resolve up behavioural concerns. Specific references in performance measurement systems which enhance learning are critical, but require a lot of information gathering before any management decisions are made (Otley, 1999:365-368). Organisations that participate in making strategic decisions can deploy the required research to enhance the results of their performance. Because information remains an integral part of the input needed in any decision-making process, managers tend to adjust their behaviour on the basis of how much information they have. The information that they collect and can use affects them now and in the future, and what information they collect depends on how performance is measured.

2.8.9 There is some confusion between performance measures as sources of control versus sources of flexibility

Within the finance literature, performance measurement has evolved from a component of the planning and control cycle relying on financial information to an independent process used as a signalling and learning device for strategic purposes, based on multiple non-financial measures. Therefore, the use of performance measurement systems should be a means of increasing

organisational flexibility, as opposed to control (Henri, 2004:114-115; Neely & Najjar, 2006:100).

The dynamic use of performance measurement systems can have an impact on organisational operations by facilitating management decisions; and changed behaviours yield organisational change, innovation and organisational learning. Within the performance measurement systems, a holistic view tends to be more actionable, timely, long-term oriented as it reflects cross-functional processes. It can therefore be argued that such flexibility rather than control would improve corporate performance. The problems associated with confusion between control and flexibility would be even more challenging when managers are dealing with intangible assets such as intellectual capital.

2.8.10 There are difficulties in measuring intangibles

The business environment has changed tremendously in that many activities and operations now represent intangibles. There are many potentially relevant intangible factors, such as knowledge and information. It has been observed that formulating and using performance measures in such undertakings as research and development projects is not simple (Vuolle, Lonqvist & Van der Meer, 2009:30-31). One of the challenges that organisations face is that many performance measures are fairly undeveloped and there is not much experience of applying them in practice (Ittner, 2008:269-270). However, some performance measures contain surrogate indicators that may provide hints about the status of intangibles, for example, information technology investments or the percentage of time that staff members spend in direct contact with customers. Table 1, overleaf, summarises the significance and limitations of the use of corporate performance measures in current business applications.

Table 1: Significance and limitations of performance measures

Significance of performance measures	
1.	Performance measures facilitate identification of critical areas for special attention
2.	Performance measures instil positive employee behaviour
3.	Performance measures facilitate enhancement of benchmarking systems
4.	Performance measures enhance quality and productivity improvements
Limitations of performance measures	
1.	Performance measures are based on a single organisation model
2.	Performance measures are usually based on exiting organisational structures
3.	There is insufficient attention given to performance measurement systems
4.	The multiplicity of performance measures leads to interpretation problems
5.	Performance measures incline towards subjectivity rather than objectivity
6.	There are often data accuracy problems with performance measures
7.	Most of performance measures are financially driven
8.	There is a need to redesign performance measurement systems
9.	There is some confusion between performance measures as sources of control versus sources of flexibility
10.	There are difficulties in measuring intangibles

Source: Own observation

The literature analysis on corporate performance measures has highlighted some important points about the use of performance measures in general, especially the fact that performance measurement systems have to be designed and implemented with an understanding of the general uses and limitations of performance measures, as summarised in Table 1. More should be done to develop performance measures that enable all stakeholders to assess organisational performance status for the purposes of making various management decisions. As has been outlined under the limitations of performance measures, corporate performance assessment has traditionally hinged on financial measures. Thus, it is necessary to review and analyse recent literature to assess whether or not the various financial measures are still relevant in a modern organisational context.

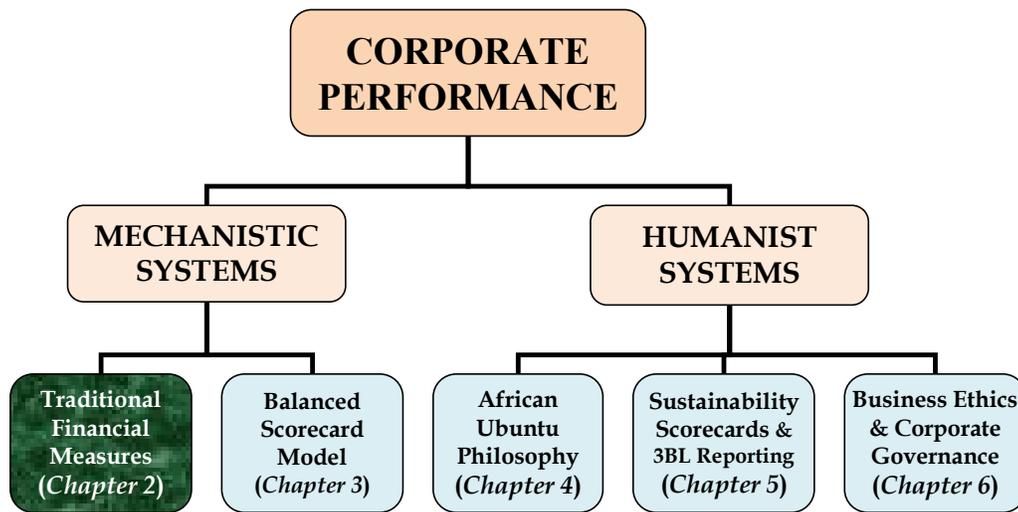
2.9 FINANCIAL MEASURES

2.9.1 Introduction

Traditionally, corporate performance has been assessed on the basis of financial measurement systems with the focus on the maximisation of shareholders' wealth as the ultimate goal of corporations (McNamee, 1993). Corporate performance has been assessed mainly in terms of the degree of an entity's achievement of its overall financial goals and the quality of its financial performance relative to the needs of different stakeholders, including competitors.

Traditional financial measures are the first corporate performance systems to be analysed in this study, as highlighted in Figure 5, below.

Figure 5: Corporate performance and the traditional financial measure



Source: Own observation

This section presents a detailed literature analysis on traditional financial measurement systems. The literature review includes background on financial measures, the significance and practical use of financial measures, and the limitations of the use of financial measures in the modern business environment.

2.9.2 Background on financial measures

Through interaction with different stakeholders, organisations facilitate value creation by using financial performance measures. Financial measures enhance effective planning through budgetary processes and control over corporate operations that are achieved through measurement systems (Mackay, 2005). The first financial measures were developed centuries ago, when businesspeople had to use financial measures to run their businesses.

There has been an evolution in financial measurement systems as a result of modern organisational structures. By the 20th century, the amount of industrialisation and the mechanisation of systems was commensurate with the industrial evolution that followed on from the industrial revolution of the 19th century (Mackay, 2005:8). It was acknowledged that bureaucracy was a form of organisation that displayed mechanistic concepts of precision, regularity, reliability and efficiency achieved through the division of tasks and rules. Bureaucratic systems encouraged the use of financial performance measures, as these were seen as the only standard units in which corporate performance could be measured. Monetary units represented a common denominator for all business transactions.

Corporate performance has been represented by the financial statements that are produced in annual or interim reports as required by statute for some time. The financial statements come in the form of profit and loss accounts for the profit-making companies or income and expenditure statements for non-profit-making organisations, the balance sheet and cash flow statements.

However, financial measures are past-oriented, as they are largely extracted from financial statements that are produced to reflect the historical performance of an organisation. Historical financial performance aims at establishing a baseline of corporate performance upon which an organisation can aspire to build to improve its strategic direction.

2.10 SIGNIFICANCE AND PRACTICAL USE OF FINANCIAL MEASURES

Financial measures have assisted management and other stakeholders to assess organisational performance for decades. The practical significance of financial measurement systems is analysed below.

2.10.1 Financial measures form a basis for internal corporate performance measurement

It is clear from the comments above that the traditional financial measures have frequently been used to measure the overall performance of an organisation. To ascertain the relative and comparative status of corporate performance in economic and financial terms, business managers use financial indicators, largely financial ratios. Derived from the financial statements, financial measures provide a basis for comparison of the internal operations of an organisation for evaluating corporate performance. For instance, suppliers and customers are usually assessed based on the historical analysis of their transactions to extrapolate the future financial position.

Financial measures provide information on corporate performance for small, medium, and large organisations. For example, Ding, Zhang and Zhang (2008:297-318) performed a study using five financial measures, namely the revenue per employee, the revenue per unit of cost, the net profit per employee, the return on assets, and the market-to-book value ratios to assess differences in the corporate performance of family-owned versus state-owned companies in China after controlling other organisational characteristics such as size, company leverage, sales volatility, company age, innovation and marketing. The study established that family-owned enterprises achieved significantly better performance than state-owned corporations.

The audited financial statements for both private and public institutions provide the most reliable sources of information for various decision-makers. For instance, investors use financial information to make investment decisions. The

most credible source of corporate performance amongst investors is still primarily financial performance measures, rather than non-financial measurement systems (Schwarzkopf, 2007:18-33). Companies still remain focused on traditional financial measures, despite the increasing need for them to engage in a more balanced approach which combines financial and non-financial measures of corporate performance (Chia, Goh & Hum, 2009:618).

Through the use of financial information, shareholders analyse corporate performance in the investment appraisals of their portfolios. A low proportion of investors use auditors' reports and notes to the financial statements, although such sources are more focused than the reported figures in corporate reports (Schwarzkopf, 2007). Schwarzkopf (2007) demonstrates that financial measurement systems play a pivotal role in facilitating management decision-making. However, financial reporting professionals may need to promote the use of valuable financial information sources such as the notes appended to financial statements. The extra financial information would provide better information to different stakeholders who constantly transact with an organisation, allowing them to make more informed decisions.

2.10.2 Financial measures provide a common denominator for business transactions

Financial figures represent a common denominator and are a pillar for any business transaction. Arguably, the accounting and financial statements are the language of every business (Weaver & Weston, 2008). Financial corporate analysis that is based on the use of financial performance measures provides an acceptable basis for decision-making and data source in the business environment.

However, the pool of external stakeholders, which traditionally includes shareholders and creditors, is becoming broader, implying that more financial information is needed for each stakeholder. The pool of such varied interested parties now includes employees and management, shareholders, customers,

suppliers, government, business partners, regulatory bodies, social and environmental partners, competitors, and the community, as shown in the conceptual framework in Figure 1.

Different stakeholders use financial figures for different purposes. For instance, shareholders would be interested in assessing the profitability levels of the company for dividends; customers would focus on the product quality and pricing issues; creditors may be interested in the liquidity and continuity of business; and government would use financial figures for taxation purposes. Although they meet varied needs, financial measures provide a common platform for all stakeholders.

2.10.3 Financial measures are used as a tool to give strategic direction

Based on the common denominator dimension, financial measures provide a relative or comparative basis for comparing the performance of different organisations, usually within the same industry. Financial information thus provides a basis for measuring the performance of organisations within the same industry (Wong & Wong, 2008:28). Financial ratios, for instance, form the foundation on which organisations can benchmark themselves in terms of their overall performance as compared to that of other players from the same industry.

Furthermore, senior managers use quantitative data to analyse organisations' financial strengths and weaknesses (Abraham, 2006:212). Such analyses help business executives to identify anomalies and focus attention on issues of organisational significance. Performance measurement systems rely on the financial ratios that are computed from the reported financial figures. The most common ratios used during such an assessment include those that gauge the profitability, liquidity, activity and financial leverage of an organisation.

In the corporate world, financial ratios are usually used by managers and analysts as tools for mapping corporate performance trends. Through extrapolation, performance trends can be used as predictors of an organisation's

future performance. Usually, creditors such as banks and other financial institutions use past financial information to assess the strategic direction of a client before any lending arrangements are concluded. Moreover, the financial stability of corporations, which can be deduced from an analysis of financial statements, is critical to the banking sector, as well as national and international institutions. As a result, banks and insurance companies use large scale financial indicators for assessing the financial stability of their clients (Mascela & Tomas, 2009:68-76), such as return on equity, solvency and capital accuracy indicators. Within financial institutions, the use of financial indicators is more pronounced when there are fears of credit crunch repercussions, where companies are focused more on stability and the long-term sustainability of their businesses than just on short-term profitability.

It should also be noted that financial ratios are by their very nature inter-related, in that one ratio has a direct impact on the other ratios. The section below presents an analysis of such relationships among financial ratios.

a) Profitability ratios

Profitability ratios measure in relative terms how much a corporation is realising as a net of revenues and costs. Gross profit margin, net profit margin, return on capital employed (ROCE) and earnings per share (EPS) are examples of profitability ratios frequently used in business (Gitman, 2010:56-59). All four ratios are interconnected.

Profitability ratios are the most commonly used ratios in the world of financial information provided through financial statements. For example, in the British food and drinks industry, profitability analyses are frequently applied – the profitability of supplying individual customers is computed by over 50% of the industry (Abdel-Kader & Luther, 2006:350-352).

In manufacturing industries, managers are more concerned with the operating assets and liabilities than with generating operating profits (Pandya & Boyd, 1995:208). This stresses the importance of the return on capital employed as a corporate performance measurement tool.

Profitability is the premise or reason for the existence of any business. The ultimate aim of any company is to generate profits or realise cost savings (Drucker, 1985:40). Thus profit serves as a measure which points towards the net effectiveness and soundness of any business. The net bottom line shows the premium that covers the costs of staying in business and ensures that capital will be available in future. The higher the profitability ratios, the greater the sustainability of an organisation, and the more stakeholders, especially investors, are attracted by the company activities. It follows that when profitability ratios are high, the company may also enjoy high cash flows, due to a continued increase in sales and cash inflows from investors (Mills & Yamamura, 1998:53-59). Ultimately, high cash inflows may culminate in commensurate high liquidity ratios being realised.

b) Liquidity ratios

Liquidity ratios relate to an organisation's capabilities and its ability to meet its maturing short-term debt obligations. Liquidity ratios take into consideration the current assets or cash flows and relate these to the organisation's liabilities and expenses to reflect its capabilities to honour any financial commitments (Correia *et al.*, 2003:512; Gitman, 2010:50).

The broadest view of an organisation's liquidity is captured in the current ratio. The acid test (quick) ratio and cash ratio are examples of liquidity ratios. The higher the liquidity ratio, the better the organisation is prepared to meet its debt obligations (Pearce II, 2007: 253-270). The implication of this fact is that, as the organisation's profitability meets or exceeds organisational

maturity heights, liquidity ratios improve until the company meets or exceeds its peak performance of activity levels.

c) Activity ratios

Activity ratios measure the productivity levels of a company. A company is able to sustain its operations through the earning power of its asset base. The stronger the asset base, the higher the productivity within the company processes. Activity ratios measure how effectively an organisation manages its resources. Consequently, activity ratios are useful, as they guide the future investments of organisations. Activity ratios include total asset turnover, fixed asset turnover, debtors' turnover, and average collection period (Correia *et al.*, 2003:513-514; Gitman, 2010:51-53).

Managers prefer to venture into investments that support future profitability. Only productive assets that generate relatively high levels of net sales of invested assets are considered worth venturing into (Jablonsky & Barksy, 2001). When the asset base is increased faster through such investments than the assets would increase sales revenues, activity ratios deteriorate. When the organisation gains a competitive advantage and establishes its position in the industry, it is more efficient and effective, generates more sales, and activity ratios are bound to improve to the highest levels. Just like other ratios, the activity ratios facilitate assessment of the strategic direction of an organisation. The nature and levels of business activities would determine the levels at which these activities are financed, whether through equity or debt (financial leverage).

d) Financial leverage ratios

Finally, financial leverage ratios measure the structure of a company's liabilities and equity and assets to indicate the degree to which the company relies on debt to finance its activities (Correia *et al.*, 2003:515; Gitman,

2010:54-55). When profitability levels decline, the company's leverage position becomes less favourable, as managers are forced to take on more debt in order for the company to remain competitive and sustainable (Pearce II, 2007). Consequently, excessive debt dilutes shareholders' equity.

Financial managers use debt/equity ratios as a basis for various management decisions. The composition of debt/equity, referred to as the capital structure, has a direct influence on corporate performance (Modigliani & Miller, 1958:261-297). Debt/equity ratios shape the capital structures of individual organisations, as well as of industries. Financial leverage ratios have also been used to determine and predict the expected performance of organisations (Abor, 2005; Berger & Bonaccorsi di Patti, 2006; Esperance, Ana & Mohamed, 2003; Hall, Hutchinson & Michaelas, 2004).

Thus, for example, most microfinance institutions in Ghana employ high financial leverage in their corporate planning and measurement systems. One study indicates that they finance their day-to-day operations with long-term debt, as opposed to the commensurate short-term debts (Kyereboah-Coleman, 2007:68). With long-term borrowing, the financial institutions are able to reach out to more clients, do more business, enjoy economies of scale and realise better performance than institutions that are not highly leveraged. The Ghanaian financial institutions are able to aggressively exploit long-term debts to finance short-term operational activities for their long-term corporate sustainability.

The above analysis indicates that management decisions about the use of debt and equity composition must be balanced in such a way that the bottom line and corporate sustainability are both maximised. Debt should be used in the hope of higher returns, balanced against the increased consequences that an organisation faces when it is unable to honour interest payments or maturing obligations. Used in a rational way, an analysis of financial ratios would provide a solid foundation for extrapolating the strategic direction of an

organisation, such as the assessment of a strategic position and its effect on business development.

2.10.4 Financial measures are used in product life cycle and portfolio analyses

Financial measures also signal corporate status in respect of whether an organisation is in the growth, maturity, decline or turnaround phases. In other words, a business as a portfolio can be analysed through the use of financial measures to determine whether the corporation can be categorised as a problem child, star, cash cow or dog, in terms of the Boston Consulting Group (BCG) matrix (Walker, 1984:65-66).

More specifically, financial ratios are useful to managers and other stakeholders because they enable a better understanding of whether corporations are doing well or are in the decline phase, or indeed whether corporations are achieving any recovery or turnaround (Pearce II, 2007: 253-270). The literature indicates that through critical financial analysis, corporate managers who are equipped with financial information run their organisations better than those who do not have that financial information. Financial measures also serve as a management tool to extrapolate strategic programmes, including the feasibility of future projects.

2.10.5 Financial measures form a basis for economic and financial feasibility studies on projects

Financial information is used as a tool for examining the different strategic thrusts of organisations. Before any project is embarked upon, financial managers carry out economic and financial feasibilities, based on the provision of financial information. There are currently computer models that generate several alternative courses of action upon which business managers can base their decisions (Laudon & Laudon, 2006). After several alternatives have been generated and analysed, the best option is then chosen for implementation. The

profiling of financial measures with the implementation processes is included as a way of determining factors relevant to the overall corporate performance.

However, the provision of financial projections may be difficult for capital budgeting decisions involving large organisations, such as a multinational company that performs complex activities with a range of intra- and inter-organisational coordination issues (Miller & O'Leary in Chua, 2007:488-489) and operates in a complex set of environments.

Financial information, as facilitated by modern information technologies, has become very valuable, as it enables managers to measure the consequences of a particular strategic and tactical option proactively. Financial measures provide actionable feedback for the immediate improvement of organisational operations as well. Through effective feedback control systems, financial information provides a platform for effective communication to management and employees.

2.10.6 Financial measures provide a basis for reward and motivational systems

Based on corporate performance, the reward systems of different organisations usually hinge on the use of financial measures. Staff promotions, bonuses and other reward systems have been made more effective through the use of financial measurement systems (McNamee, 1993). Corporate financial performance can be measured in terms of the degree of achievement on the overall financial goals and quality of a company's financial performance relative to that of the competition.

The above literature review indicates that corporate strategies depend on the traditional performance measurement systems that an organisation uses. However, the fact still remains that traditional financial measures are lagging as they are based on past performance. Therefore, financial measures cannot conclusively foretell, with accuracy, the future performance of individual organisations. The usefulness of financial measures in isolation in the modern

business environment is therefore questionable, as financial measures are limited in many dimensions.

2.11 LIMITATIONS OF FINANCIAL MEASUREMENT SYSTEMS

Although the use of financial measures as a basis for assessing corporate performance is well established, there is much debate about their authentic usefulness in a modern business environment. The following section reviews literature on the limitations of the use of financial measurement systems.

2.11.1 Financial measures are lagging indicators with a past orientation

The financial measurement systems are based on historical data; hence they are lagging indicators. Traditional financial measures focus on the past, as they inform the users about where an organisation has been. It has been observed that the lagging effect provides information that often comes too late to prevent disappointing results (Ghalayini & Noble, 1996:77-78; Niven, 2006:iv-xii). Thus, traditional financial measures provide data that are outdated. Financial measures are a result of past decisions that are not necessarily related to future corporate strategy. Financial indicators thus lack the capability to foretell the future performance of an organisation with reasonable accuracy or certainty.

Regardless of the validity of the forecasting technique that may be used, usually financial ratios and ratings are not indicative of future performance, as they continue to reflect the historical performance of organisations (Russel, 2006:85-89). Because of the historical nature of financial measures, an over-reliance on financial measures may foster false confidence among naive managers and even among existing and potential investors. Furthermore, the provision of historical financial information may mislead other stakeholders, such as creditors, customers and business partners. Because of this historical orientation, institutions have started using non-financial measures to complement financial measures.

2.11.2 Financial measures exclude strategic non-financial measures

Although non-financial performance measures seem to have no intrinsic value for other stakeholders, they can still be used as leading indicators of future corporate performance that is not contained in the traditional financial accounting measures. In marketing systems, for instance, a fruitful stream of research has identified a strong positive link between customer satisfaction, market share and profitability (Bryant, Jones & Widener, 2004:128-129). As leading indicators, such non-financial measures play an important role in contributing towards positive corporate performance.

Non-financial indicators such as customer satisfaction would determine corporate sustainability. When customers are satisfied with products and services, organisations are able to retain these satisfied customers, which ultimately also brings more customers into the business (Kaplan & Norton, 1996b). Continuing with this trend, the customer base increases, which in turn results in more frequent sales and bigger volumes of products and services that are purchased. The ultimate organisational goal of wealth maximisation can be achieved through the realisation of huge profits that come through big volumes of sales from satisfied customers. Therefore, information on the measurement of customer satisfaction is vital in highlighting the significance of non-financial measures that enable organisations to create a sustainable competitive advantage.

2.11.3 Financial measures tend to focus on the short term rather than the long term approaches

Performance measurement systems affect the behaviour of people inside and outside an organisation (DeBusk *et al.*, 2009:19-20; Otley, 1999:380-381). The performance of a manager or a department or indeed the entire organisation is usually assessed using a known set of parameters such as profitability levels, which are measured in the form of return on capital employed.

For argument's sake, as the plant and machinery book value continues to depreciate, the total capital base (denominator) diminishes. Eventually a low

denominator would boost profitability ratios. Consequently, senior executives may be tempted to avoid investing in strategic state-of-the-art but expensive assets which could significantly increase the book value on plant and machinery and would ultimately diminish profitability indices. For manufacturing companies, it is even possible that managers can deliberately hold back inventories in order to reduce cost of sales and hence report high gross and net profit margins at the end of the accounting period.

The use of financial measures can be a recipe for corporate “short-termism”, sacrificing long-term competitive advantage and sustainability. Traditional financial measures tend to rely excessively on cost information and other financial data, which are short-term in nature. Little or no attention is given to strategic value-creation activities that could generate future growth for an organisation (Jusoh, Ibrahim & Zainuddin, 2008:119). Usually, such strategic activities tend to be intangible, for example, the accumulation of intellectual capital.

By focusing solely on financial measures, business managers may avoid investing in strategically critical expenditures such as human resources training, organisational restructuring and business process re-engineering (PBR), research and development (R&D) and marketing surveys, in order to improve the company’s profitability levels in the short term (Kaplan & Norton, 2008c:28; Soltani & Wilkinson, 2010:365). Such actions are aimed at gaining short-term financial gains and the commensurate rewards at the expense of the long-term viability of an organisation. Such short-term approaches would sacrifice the long-term realisation of the organisational objectives of sustainably maximising shareholders’ wealth.

The prevailing belief is that if individual employees and companies pursue their self-interest at the expense of the overall organisational vision and goals, corporate performance outcomes are suboptimal (Colby & Rubin, 2005; Liker, 2004). When self-interest is pursued for short-term economic benefits, the dark

side of such an approach is eventually manifested, as in the Enron Corporation insolvency and other corporate scandals, leading to extreme distrust in the morality of corporate executives, even in large and reputable corporations (Newman, 2007:97). The long-term organisational sacrifice can lead to millions of people being retrenched as a result of an economic downturn that is signalled by the demise of the companies concerned.

Thus, “short-termism” would be exacerbated by limiting critical value-adding expenditures such as marketing, training, research and development, and the promotion of activities that have a long-term impact on internal business processes and ultimately on volumes of sales; hence on overall corporate performance (Kaplan & Norton, 2008c). An overemphasis on achieving and maintaining short-term financial results can cause companies to overinvest in short-term ventures and under-invest in long-term value creation. Such myopic approaches can have disastrous consequences for the organisation, as it then fails to cope with the future challenges. The emphasis on a short-term approach only cannot be financially sustainable in the longer term, as the recent global credit crunch has demonstrated.

The global experience of the effects of a large-scale credit crunch is a good example of short-termism within financial institutions, especially in developed economies. Through the credit systems, financial institutions gave massive and unrated credit and loans to their clients in the hope of short-term massive profitability (BBC, 2008; Budworth, 2010). The reports of massive profitability netted equally massive bonuses for senior executives in these institutions, which led to the creation of more credit. Ultimately, the heavily indebted clients could no longer service their huge loans, with the result that a credit crunch arose where lending institutions became too conscious to give out more loans. Lack of credit (credit crunch or credit squeeze) affected both local and global economies.

It is worrying that in 2001, most senior managers in organisations still ranked short-term financial measures fifth, after four non-financial measures, in

perceived importance (Iltner & Larcker, 2001:373). These non-financial measures are customer relations, operational performance, product and service quality, and employee relations. Innovation and community relations also received relatively high importance scores.

Some studies have focused on how managers should comprehend value creation. Organisational value is created from within by means of the identification, measurement and management of the drivers of long-term shareholder benefits. In terms of corporate financial analysis, corporate reporting systems that look at earnings neither reflect corporate long-term sustainability nor give a complete picture of corporate financial health (Boerner, 2006:53). The famous earnings per share ratio is not an accurate measure of long-term sustainable performance or growth.

Furthermore, senior managers have to recognise that traditional financial accounting measures, such as return on capital employed and earnings per share, can give misleading signals which may undermine continuous improvement and innovation activities to meet the demands of today's competitive environment (Boerner, 2006:53). Modern financial analysts are sometimes unable to reason beyond the short-term approach adopted in many financial measurement systems that act as beacons of corporate performance.

The above discussion demonstrates that it is important that information as to whether an organisation is making any progress in its long-term strategy is made available within its reporting framework. Such vital information should be effectively communicated, so that it is more easily understood by different stakeholders, who may use it in their decision-making processes. As observed in the literature review, corporate performance measurement systems affect the behaviour of management and employees; and such behaviours can lead to an overemphasis on achieving and maintaining short-term financial results to the detriment of long-term corporate sustainability. When focusing on long-term

issues, cognisance should also be taken of the transformation of economies within the corporate world.

2.11.4 Financial measures do not consider the transformation of economies

Over the years, organisations have evolved to transcend ancient agrarian economies to become part of industrial and manufacturing economies, and eventually of modern knowledge-based economies (Laudon & Laudon, 2006; Wheatley, 2000). The first transformation occurred during the industrial revolution, when economies moved from being purely agrarian to a manufacturing base. Industrial economies emerged with the industrial revolution in the late 18th and early 19th centuries. With the advent of the use of modern information systems and information technology, economies evolved further to become knowledge-based (Drucker, 1992:95; 1999:79-80)

Most people today are working in sales, education, telecommunications, health care, banks, insurance companies, law firms, accounting and auditing firms, and they provide business services such as copying, computer software/hardware systems and deliveries (Cotora, 2007; Tan, Plowman & Hancock, 2007; Voelpel *et al.*, 2006; Wheatley 2000). Operationally, the new business age, which is widely referred to as an “information age”, has shifted the emphasis from a mechanistic and bureaucratic economy with tangible assets to knowledge-based organisational systems with many intangible assets.

The financial models of the future will need to reflect contemporary organisational thinking. Whereas 20th century financial accounting systems reflected “top-down” control and the influence of tangible assets such as premises, buildings and machines, 21st century financial systems need to consider more intangible assets, such as employee knowledge, information and core business competencies (Drucker, 1999; Mackay, 2005).

The traditional financial performance measures worked well for the industrial era, when much of the emphasis was on the performance of tangible elements. But now, financial measures have outlived their absolute usefulness with the skills and competencies that organisations are trying to master in the modern global economy (Chenhall, 2005; Drucker, 2002a; Kaplan & Norton, 2008a).

Executive managers may be tempted to overinvest in short-term ventures and underinvest in long-term value creation in order to save on expenditures. In many cases, the underinvestment is in the intangible and intellectual assets that generate future growth and competitive advantage for the organisation. Moreover, the pressure to increase short-term financial performance can cause companies to reduce their spending on intangibles such as new product development, customer care and satisfaction programmes, process improvements, human resources development, information technology, databases, and systems related to market development. Ignoring such strategic investments in intangible assets could be suicidal for an organisation in the long run (Kaplan & Norton, 2008c).

Most corporate financial reporting systems thus tend to neglect intangibles which are very important organisational resources, such as time, reputation or goodwill, human resources and information. For instance, it has been established that human capital that comes in the form of intellectual capital has a major impact on the profitability and performance of organisations (Drucker, 1999; 2002a; 2002b; Kamath, 2008), but, despite its significance for corporate performance, intellectual capital is not reflected or even mentioned in most financial statements reports.

Studies indicate that human capital, which consists of three elements (the economic value of individuals - first kind; the economic value of groups or teams - second kind and the economic value of total human capital or organisational culture -third kind) influence the financial bottom line (Flamholtz, 2001:272-273, 2005:88-90). More specifically, culture, which is a part of the human capital of the

third kind, is a significant component of overall organisational success (Flamholtz & Kannan-Karasimhan, 2005:63). Organisational culture acts as a bridge between a corporation and its stakeholders and thus facilitates organisational relationships with the stakeholders. Ultimately, organisational culture and relationships encompassing cultural elements with internal and external stakeholders influence corporate performance in terms of the bottom line. The relationships and culture are a strategic element that is also recognised in the conceptual framework of this study.

Organisational survival is largely based on the knowledge of workers. The traditional financial measures fail to measure the performance and value of people, who make up the bulk of the value of knowledge-based organisations, which constitute the greatest part of the labour force (Laudon & Laudon, 2006; Tarantino, 2005). Any human-intensive service organisation requires unique knowledge, unlike a machine-intensive organisation (Cotora, 2007; Drucker, 1999; Gerstner, 2003). The more advanced a company is in the development of human capital and its measures, the higher the corporate performance (Gates & Langevin, 2010).

Organisational effectiveness is a stronger predictor of strategic decision-making process dimensions than of financial and business performance (Elbamna & Naguib, 2009). Therefore, the learning capability of managers should be considered a basis for the organisational capabilities required to efficiently and effectively accomplish organisational processes, products and overall value creation.

A greater emphasis on measures that include intangibles would improve management decisions and thereby improve corporate performance. For example, positive cash flows and operating profits could be a result of managerial actions, such as upgrading employee skills or implementing programmes to improve customer satisfaction (Ittner & Larcker, 2001:370). Such managerial actions and decisions can lead directly to higher operating profits, or

they can lead indirectly to higher operating profits through their impact on other areas of operations.

Modern smart organisations are searching for ways to incorporate intangibles into their performance measurement systems (Ittner & Larcker, 2001:370). These measures include elements such as quality management, customer retention, intellectual capital, organisational competitiveness, research and development and innovation – ideally, all these and more should be included in regular organisational performance evaluation.

2.11.5 Financial measures are mismatched with contemporary business systems

With a major shift from the industrial economy towards an economy that is now predominantly characterised by intangible assets, such as information, knowledge and innovative capability, the traditional financial measurements do not cover critical off-the-balance-sheet items (Bible, Kerr & Zanini, 2006:18). Such factors would include the skills and competencies of human resources, the motivation of employees, customer satisfaction, supplier relationship management systems, innovative product development, databases and information technologies, efficient and responsive operating business processes, innovations in products and services, customer loyalty and relationships; and political, regulatory and social approvals.

It is also contended that financial measures are rarely integrated with one another or aligned to the organisational vision, strategies and processes, and that financial measures are often poorly defined by organisational managers (Abraham, 2006; Neely, 1998). The traditional financial measures which organisations still use do not fit in well with the new business environment and current competitive realities (Busi & Bititci, 2006).

Because modern organisations are so often defined in terms of the type of products and services they market, market leaders have traditionally focused

their innovation strategies on providing better products and services than the competition (Pohle & Chapman, 2006: 34-40). A good example is the IBM Corporation, which was traditionally associated with mainframe computers, but later transformed itself into an innovative company through the introduction of more portable and powerful computers within its product lines.

Technological advances and globalisation are presenting new opportunities and threats as well. Senior managers can use their SWOT analyses to review their organisational models in order for them to create sustainable competitive advantage and differentiation in their marketplaces (Pohle & Chapman, 2006:34; Porter, 2008:80; Voelpel *et al*, 2006:43). Organisations generate goals and formulate strategies that are aimed at dealing with local and global challenges that surface in the form of external opportunities and threats. Such information is not available from the financial statements produced by companies.

Lately, there has been rapid growth in innovative values, both in the products and in the services offered, and ways of conducting business are changing. Several technological innovations, such as the advent of the internet, enterprise systems including customer relationship management systems (CRM), supply chain management (SCM) systems and knowledge management systems have changed the way modern organisations have to be run (Laudon & Laudon, 2006). Electronic innovations, which include e-business and e-commerce, have globally transformed the business processes of modern organisations.

Currently, some organisations are demolishing physical brick-and-mortar settings and are instead replacing them with digital systems (Laudon & Laudon, 2006). Geographically, organisations have been transported into a global village where organisations are able to partner one another and transact globally. Modern organisations, especially multinationals, are also constantly undergoing dynamic and unpredictable socio-cultural transformations to meet the demands of their respective markets.

The literature reviewed above demonstrates that organisations should adopt more holistic performance measurement systems, rather than focus exclusively on traditional financial measurement systems based on single measures.

2.11.6 Many financial measures are based on a single performance measure

The fundamentals of organisational systems have changed considerably in that they are more complex and have become multidimensional. Practically, traditional performance financial measurement systems fail to measure and monitor multiple dimensions of performance by concentrating almost exclusively on financial measures (Kocakular & Austill, 2007:72; Laitinen, 2004:22-23; Rich, 2007:9-11; Thomas, 2007:41-42).

Scholars and business practitioners have been challenged in coming up with the best and most effective way of measuring corporate performance. As Tinker (1985:81) observes, financial measures or accounting practices should provide a means of resolving social conflict, a device for appraising the terms of exchange between social constituencies, and an institutional mechanism for arbitrating, evaluating, and adjusting social choices. Therefore, to understand the character of social disciplines such as financial accounting, they should be contextualised in the social circumstances that gave rise to them (Gouws, 1996:113-129). What is important in this argument is how a society is organised to produce what is necessary for its stakeholders and how the wealth that is created is shared or distributed to the participants in that value creation.

Apart from information on an organisation's financial performance, which tends to satisfy shareholders, there are multiple performance measures that have to be taken on board. Organisations have a duty to satisfy stakeholders other than just shareholders, such as customers, employees, creditors, government and the community, to ensure the organisations' long-term sustainability. When employee and customer variables are incorporated, allowing corporate performance to be

viewed more holistically, many financial measures tend to become less important (Kocakular & Austill, 2007).

In addition, Gouws (1996) observes that accounting practices are based on a Western orientation that is generally capitalist and cannot be fully understood within an African framework. A good financial measurement system should take cognisance of the interconnectedness of functioning constituents and should note that financial measures should assess the interdependence of different stakeholders to create a working entity where each stakeholder can get a sense of participation because each is aware of the social goals and objectives of the organisation, as well as of other stakeholders and their goals and objectives.

Furthermore, modern organisations manage by dealing with increasing levels of business complexity, mobility and uncertainty about the future endeavours. Because of the high level of volatility, modern organisations are operating amidst a great deal of risk and uncertainty (Busi & Bititci, 2006; Neely & Najjar, 2006; Voelpel *et al.*, 2006). The ability to manage knowledge-based intellectual capital is critical in modern organisational settings (Drucker, 1999; Kamath, 2008). Apart from managing intellectual capital, socio-cultural aspects are also vital in modern corporate settings.

Furthermore, studies show that there is no correlation or only a small but positive correlation between corporate social performance and corporate financial performance (Aras, Aybars & Kutlu, 2010:229; Pelozo, 2009:1518). This suggests that there is also little guidance on how managers should measure the financial impact of their corporate social responsibility strategies. Commonly used performance measures such as share price or any other financial measures such as return on capital employed are affected by many variables within and outside an organisation. Thus, traditional financial measures would not provide the necessary level of detail for managers to establish an optimal level of corporate social responsibility investment.

2.11.7 Financial measurement systems are faced with ethical reporting and corporate governance challenges

As financial measures are largely dependent on financial statements, there is an excessive focus on certain components, such as earnings per share, by some corporate stakeholders, such as shareholders or potential investors of business. Such a focus could create an incentive to senior executives to misstate and windowdress these components for short-term gains (Du Plessis & Prinsloo, 2010:159). To eliminate such potential malpractices by senior management, the King III Report on governance for South Africa recommends that corporate reporting should be integrated across all areas of corporate performance. The reporting should also include economic, social and environmental issues (Institute of Directors in Southern Africa, 2009:109).

This challenge has a direct bearing on financial reporting systems, as well as on the accounting profession, as the Trueblood Report of the American Institute of Certified Public Accountants notes. The Trueblood Report recognises that the objective of financial statements is to report on those activities of the enterprise that affect society which can be determined or measured and which are important to the role of the enterprise in its social environment (American Institute of Certified Public Accountants, 1973 in Wold, Tearney & Dodd, 1974). It is expected that the accounting profession will have to extend its scope of services to include socio-ethical and environmental accounting issues, apart from the traditional financial accounting measures (Rossouw, 2010c:166). It is therefore not surprising that the accounting profession has taken a leading role in developing the triple bottom-line accounting and reporting systems.

2.11.8 Financial measures distort product costing

Finally, the financial measures are not in themselves adequate to portray a sound and good costing of a product or service. Distortion in costing also distorts product pricing, which may place an organisation in a very awkward position in terms of its competitiveness within the industry. Traditional financial performance

measurement systems have led to the distortion of product costing through the failure to provide adequate information for control and the absence of long-term performance measures that are linked to corporate vision and strategies (Johnson & Kaplan, 1987:1-4). The financial information that is generated for external stakeholders is inadequate and insufficient for the purposes of internal management use.

In general, the above analysis of the limitations of financial measures reveals that financial measures are lagging and backward looking, as they focus on activities that have already been completed only and are unable to reflect contemporary value-creation for the organisation in future. These insights should serve to caution managers as to the extent to which they can use the available financial information, which has nothing to do with future projects.

As noted above, the traditional financial performance measures worked well during the industrial era, but they have now outlived their relevance for modern business applications. For example, financial measures are out of step with the skills and competencies that organisations are trying to master in the current turbulent business environment.

Ittner and Larcker (2001:349) summarise the limitations of financial performance measures as being related to the fact that they are lagging, too historical and backward looking, lack predictive ability to explain future corporate performance, encourage short-term rewards and also influence management behaviour to perform sub-optimally, are not actionable, and fail to give timely signals required for continuous improvement. Financial statements provide information that is too aggregated and summarised to guide any meaningful managerial action.

The above analysis also demonstrates that financial measures tend to ignore cross-functional processes and focus only on functional or departmental operations, whilst giving inadequate guidance on how to evaluate intangible assets, which is contrary to modern knowledge-based systems (Ittner, 2008:261-

272). Thus financial measures lack the organisational focus and robustness needed for internal management and control (Atkinson, 2006:1453-5). Hence, the use of financial measures only may not address many of the challenges that modern organisations face.

The above literature review on and analysis of the significance and limitations of financial measures as a means of assessing corporate performance are summarised in Table 2, below.

Table 2: Significance and limitations of financial measures

Significance of financial measures	
1.	Financial measures form a basis for internal corporate performance measurement
2.	Financial measures provide a common denominator for business transactions
3.	Financial measures are used as a tool to give strategic direction
4.	Financial measures are used in product life cycle and portfolio analyses
5.	Financial measures form a basis for economic and financial feasibility studies on projects
6.	Financial measures provide a basis for reward and motivational systems
Limitations of financial measures	
1.	Financial measures are lagging indicators with a past orientation
2.	Financial measures exclude strategic non-financial measures
3.	Financial measures tend to focus on the short term rather than the long term approaches
4.	Financial measures do not consider transformation of economies
5.	Financial measure are mismatched with contemporary business systems
6.	Many financial measures are based on a single performance measure
7.	Financial measurement systems are faced with ethical reporting and corporate governance challenges
8.	Financial measures distort product costing

Source: Own observation

The above analysis has disclosed a number of important issues regarding the significance and shortcomings of financial measures as a basis for corporate

performance assessment. The recognition that modern organisations are experiencing rapid technological changes with the emergence of collaborative commerce and enterprise systems is critical: purely financial measures are of little significance in estimating future corporate performance.

The increase in the stakeholder pool should also serve as a serious challenge to financial measures and financial reporting systems. Financial measures will need to be redesigned so that they show the reality of the current business framework. Issues relating to intangible assets such as intellectual capital, information, knowledge, and the incorporation of corporate citizenship or corporate social responsibility have become more prominent and have to be addressed in corporate reports that are produced annually, semi-annually or quarterly. Different stakeholders would be guided by this kind of information if it is provided for them to make informed decisions about the performance status of an organisation.

2.12 CONCLUSION

In Chapter Two, a detailed review and analysis of the literature on corporate performance and measurement systems and traditional financial measures has been presented. The chapter looked at the significance of performance management systems for organisational improvement and the use of such systems. Challenges surrounding the use of performance management systems in the modern business environment have also been reported upon.

The chapter has also reviewed in detail the traditional financial measurement systems – their background, significance for and practical application in the decision-making process of organisations. Financial measures are important, amongst other things, because they form a basis for performance measurement, are a tool to determine strategic direction, and form a platform for reward and motivational systems.

However, the application of traditional financial measures has serious limitations, especially as the traditional financial measurement systems are out of step with the demands of a modern transformed organisation. Limitations on the use of financial measures include the fact that they are based on historical (lagging) data; they are short-term oriented; they do not consider the transformation of economies; they are based on single performance measures; they focus on tangibles rather than intangibles; and they can also distort product costing.

Based on the value of financial and non-financial performance measures, various business models have been developed. These models have a broader approach, in that they each incorporate both financial non-financial measures. Amongst these models, the Balanced Scorecard model is considered to be most widely applied by many organisations in the world (Bourguignon *et al.*, 2004:107; Kohnen, 2008:76-77; Niven, 2008:x-xii; Paladino & Williams, 2008).

The next chapter reviews the literature on the Balanced Scorecard model and analyses its perspectives. It notes, in particular, the fact that the Balanced Scorecard model takes a more holistic approach than a purely financial-based system, because both financial and non-financial measures are incorporated in the model.