



Aalto University  
School of Economics

# FINANCIAL RESULTS CONTROL SYSTEMS

Teemu Malmi

Performance Management

# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting

# METHODS FOR FINANCIAL CONTROL?

- How can you control costs in an organization? Give few examples!
- Financial control does not mean only control of costs, but also revenues and profitability!
- If you control revenue and cost, do you "by definition" control also profitability?
- What are the advantages of financial results control systems?

# TYPES OF FINANCIAL RESPONSIBILITY CENTERS

- Investment centers
  - Profit centers
  - Revenue centers
  - Cost centers
- 
- In practice, these can mean different things in different firms, e.g. profitability of a profit center can be measured in many different ways

# AGENDA

- Financial responsibility centers
- **Financial indicators for measuring performance**
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting

# MEASURING PROFITABILITY

- Profit
    - Gross Profit
    - EBITDA
    - EBIT / Operating Profit
    - Net Profit
  - Return on investment based measures
    - ROI, ROIC, ROCE, RONA, ROE, CROI, RORAC, RoEC, etc.
  - Residual income based measures
    - RI, EVA, EP, etc.
  - Cash Flow
-

# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- **What is EVA and why has it been argued to be superior to ROCE?**
- What are the implications of Value Based Management to management system design?
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting

# IN ECONOMIC VALUE ADDED (EVA) COST OF CAPITAL IS DEDUCTED FROM PROFIT

- EVA is net operating profit after taxes minus a charge for the opportunity cost of the capital invested
- $EVA = NOPAT - ((TOTAL\ ASSETS - NON\ INTEREST\ BEARING\ LIABILITIES) \times WACC)$
- EVA is an estimate of the amount by which earnings exceed or fall short of the required minimum rate of return for shareholders or lenders at comparable risk.



# ECONOMIC VALUE ADDED

- EVA = Economic Profit = Residual Income (RI)

$$\text{EVA} = \text{PROFIT} - \text{CAPITAL CHARGE}$$

$$\text{EVA} = \text{NOPAT} - ((\text{TOTAL ASSETS} - \text{NON INTEREST BEARING LIABILITIES}) \times \text{WACC})$$

$$\text{EVA} = (\text{ROI} - \text{REQUIRED RATE OF RETURN}) \times \text{INVESTED CAPITAL}$$

$$\text{NOPAT} = \text{NET OPERATING PROFIT AFTER TAX} = \text{OPERATING PROFIT or EBIT} \times (1 - \text{Tax Rate})$$

- NOPAT evaluates profitability as if no leverage is used

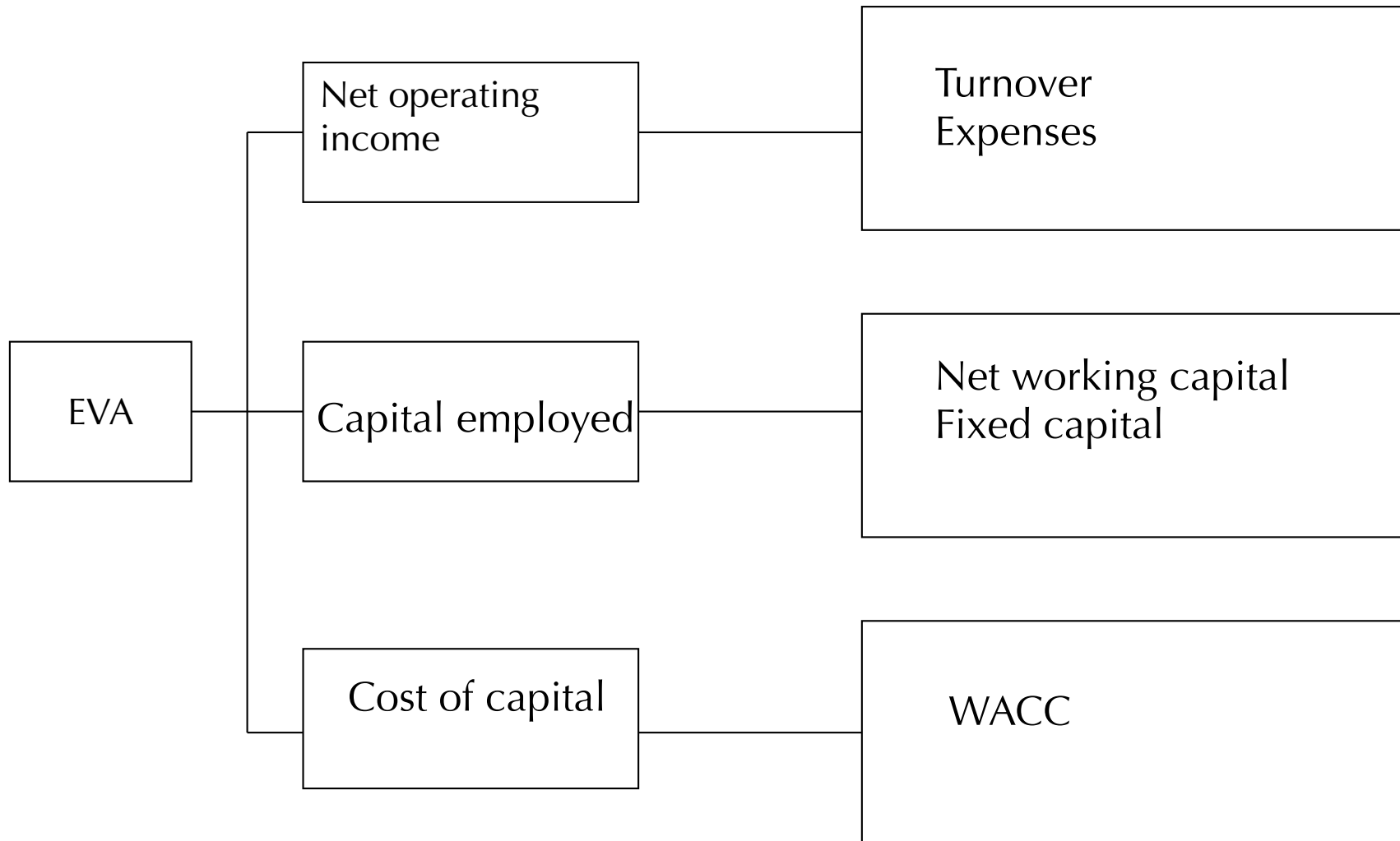
# QUIZ

- Revenue / Turnover 10.000.000
- Cost of goods sold 6.000.000
- Other operating expenses 2.000.000
- Depreciation and Amortization 1.000.000
- EBIT / Operating Profit 1.000.000
- Financial expenses 500.000
- Taxes (20%) 100.000
- Net Income 400.000

# QUIZ

- Capital employed by the unit is 10.000.000
- WACC 10%
  
- What is ROCE and EVA for the unit?
- Is the unit profitable and how would you rate it's profitability?

# EVA in graph



# EVA

- Combines shareholders interest to the control systems
- Adds required rate of return into the calculations, i.e. accounts for risk
- Absolute measure, which is compared with the budget/target.
- Budget/target is defined based on the required rate of return
- Creates correct incentives for SBU managers to invest

# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- **What are the implications of Value Based Management to management system design?**
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting

# VALUE BASED MANAGEMENT (VBM) - BASIC FRAMEWORK

- Choose internal objectives that lead to shareholder value enhancement
- Select strategies and organizational designs that are consistent with objectives
- Identify Value Drivers
- Develop action plans, select performance measures, and set targets
- Evaluate and reward performance
- Assess the ongoing validity of above and modify as required

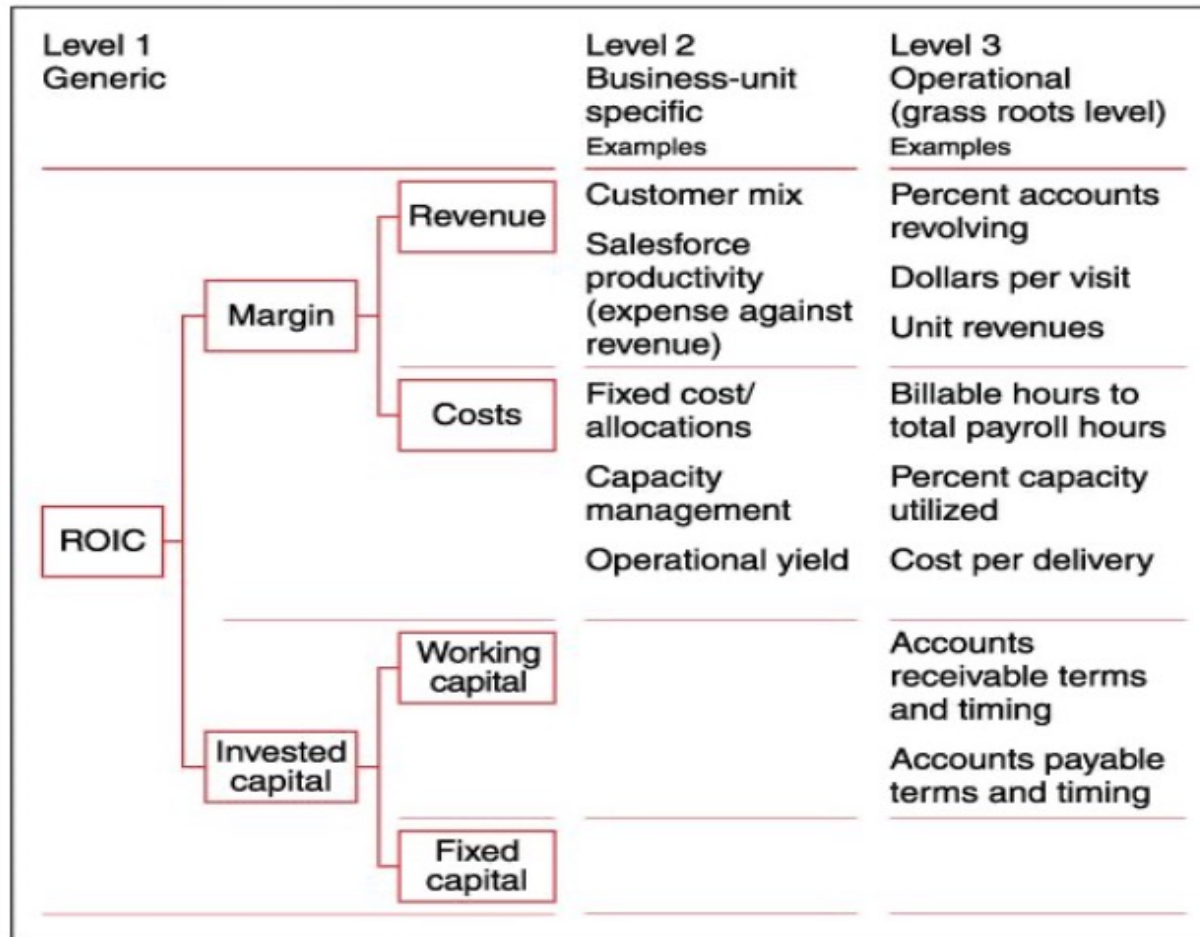
# VALUE DRIVERS

- <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/what-is-value-based-management>

“A value driver is any variable that affects the value of the company”

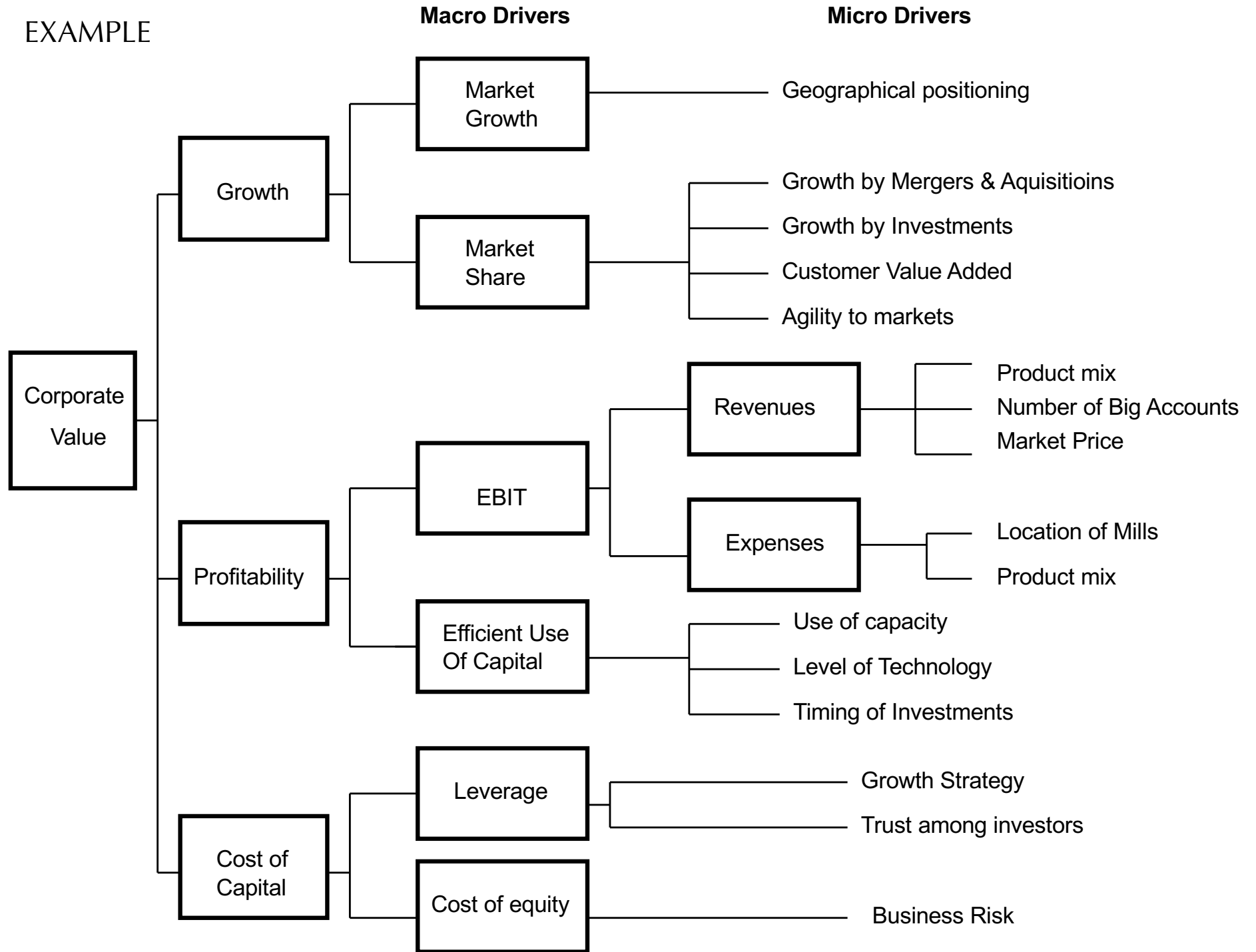


### Levels of value drivers



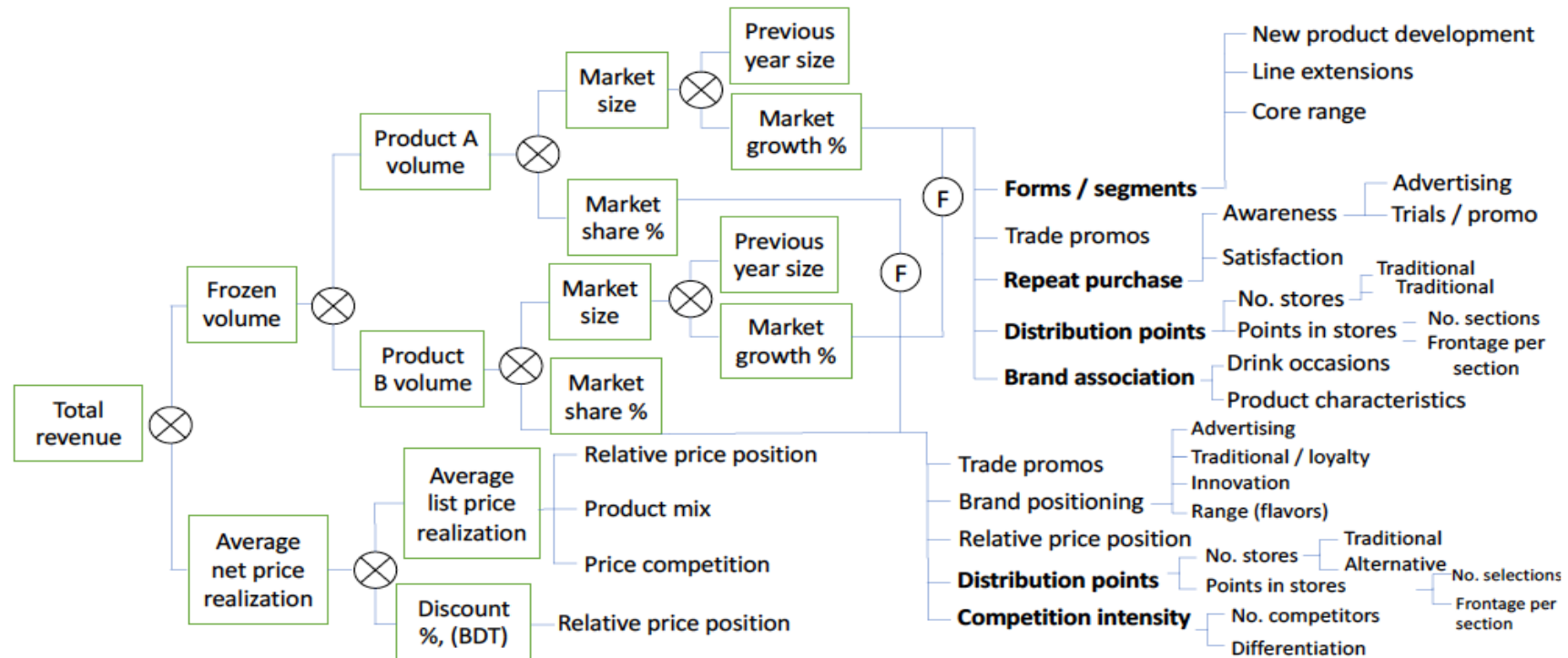
Source: Koller 1994

EXAMPLE



# VALUE DRIVERS ARE IDENTIFIED THROUGH MAPPING

Example: Revenue Drivers of a Consumer Products Manufacturer

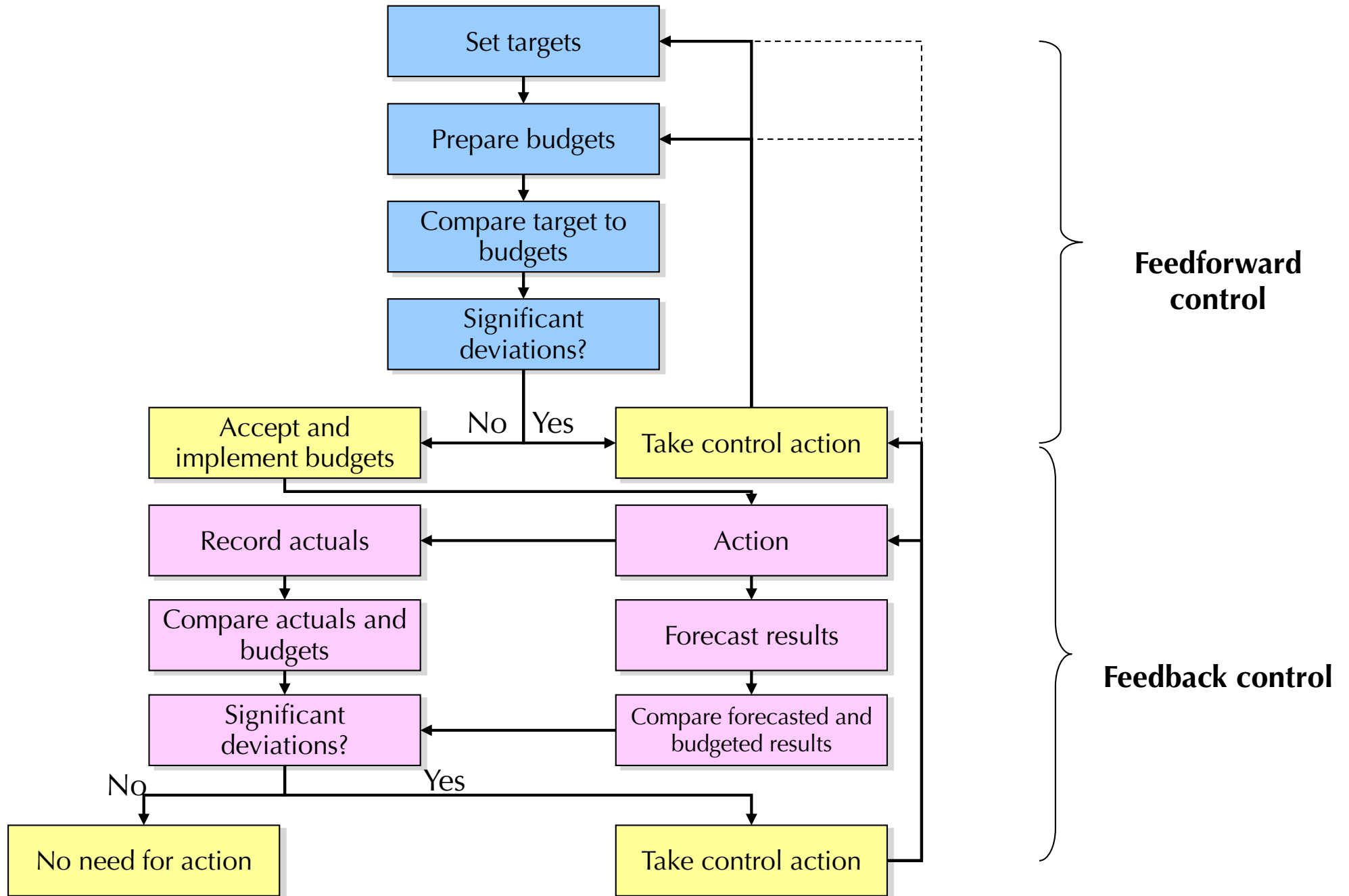


# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- **Purposes of budgets**
- **Problems with traditional annual budgeting**
- Beyond Budgeting

# FOR WHAT PURPOSES ORGANIZATIONS DO BUDGETS FOR?

# Budgetary control



# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Purposes of budgets
- **Problems with traditional annual budgeting**
- Beyond Budgeting

# *Budgets cause wrong behavior*



## How to win the budget game

- Negotiate lowest targets/highest rewards
- Always make the bonus, whatever it takes
- Never put customers above sales targets
- Never share knowledge and resources
- Always ask for more than you need
- Always spend what's in the budget
- Always explain away adverse variances
- Never provide accurate forecasts
- Always meet, never beat the numbers
- Never take risks



# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Transfer pricing
- Purposes of budgets
- Problems with traditional annual budgeting
- **Beyond Budgeting**

# BB:Leadership vision

## Predictive & Centralised

1. Climate

*Performance contracts*

2. Motivation

*Plans & incentives*

3. Devolution

*Constrained to plan*

4. Empowerment

*Bureaucratic 'red tape'*

5. Organisation

*Centralised hierarchy*

6. Information

*Closed & controlled*

## Adaptive & Devolved

*Competitive success*

*Responsibility for outcomes*

*Freedom to decide*

*Capability to act*

*Customer focused teams*

*Open & "one truth"*

# BB: Finance vision

## Predictive & Centralised

### 1. Targets

*Negotiating fixed targets*

### 2. Rewards

*Paying individual incentives*

### 3. Strategy

*Centrally driven, annual event*

### 4. Resources

*Allocated annually thru budgets*

### 5. Coordination

*Predetermined by central plans*

### 6. Control

*Top-down thru variances to plan*

## Adaptive & Devolved

*Setting relative measures*

*Recognising team-based success*

*Devolved, inclusive & continuous*

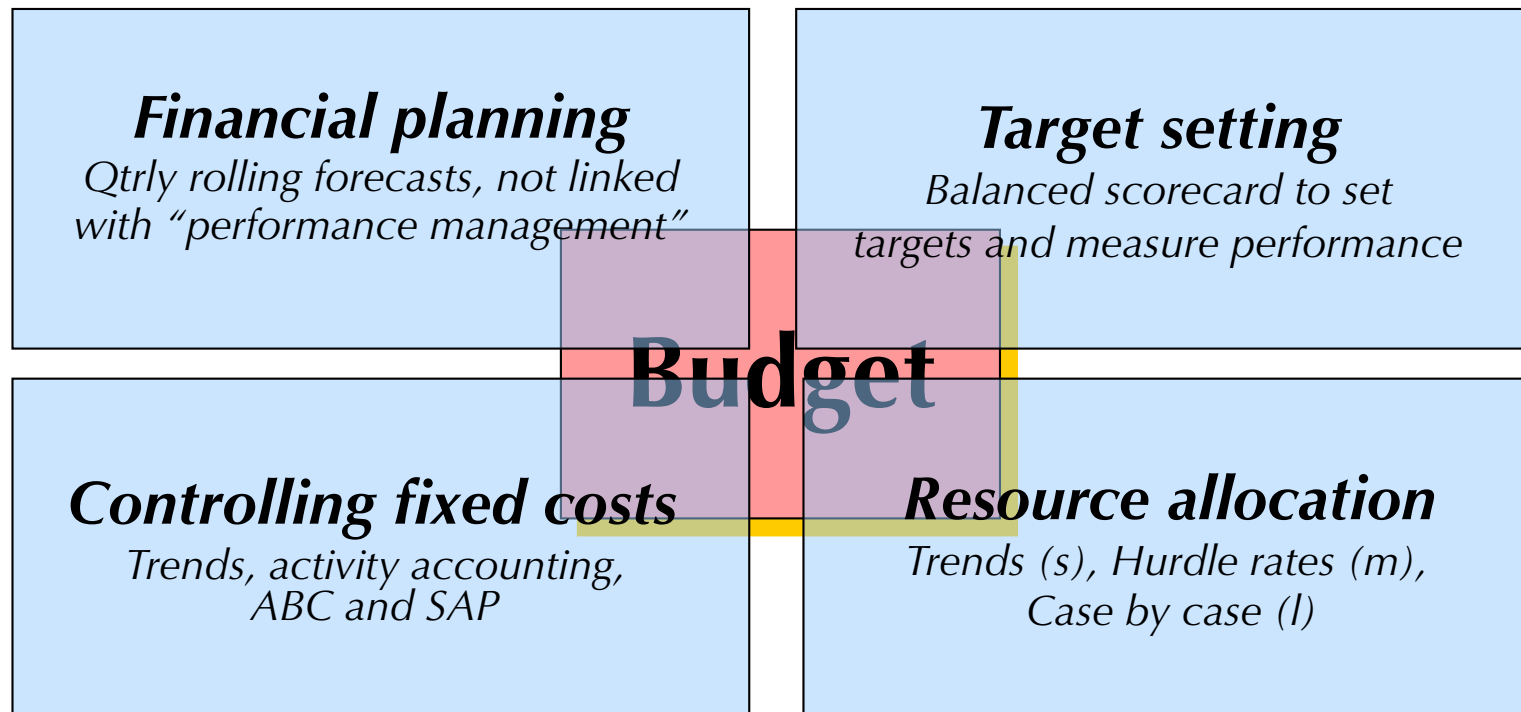
*Free access with accountability*

*Dynamic market-like processes*

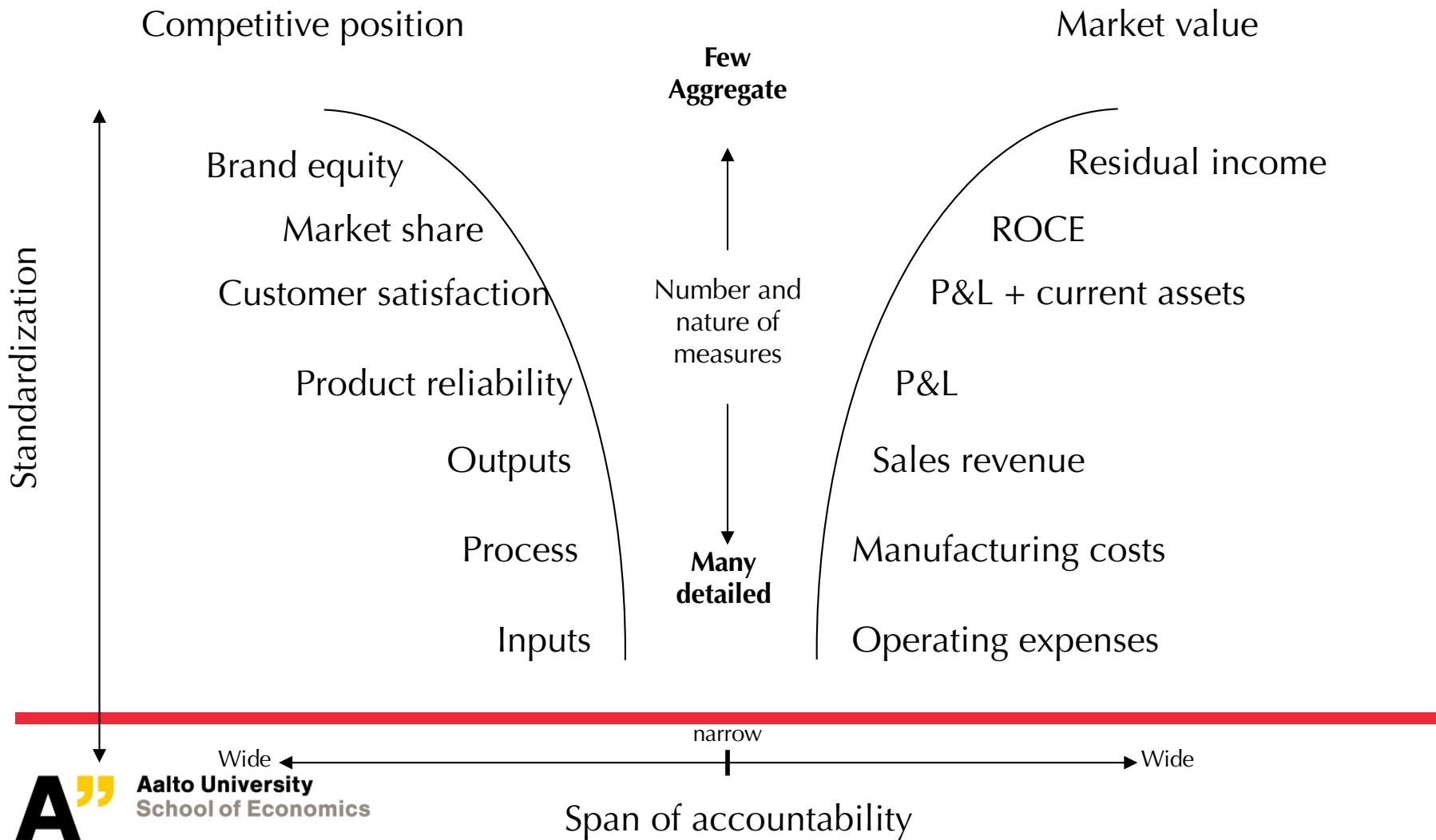
*Multi level, fast and open*

# Tools in use

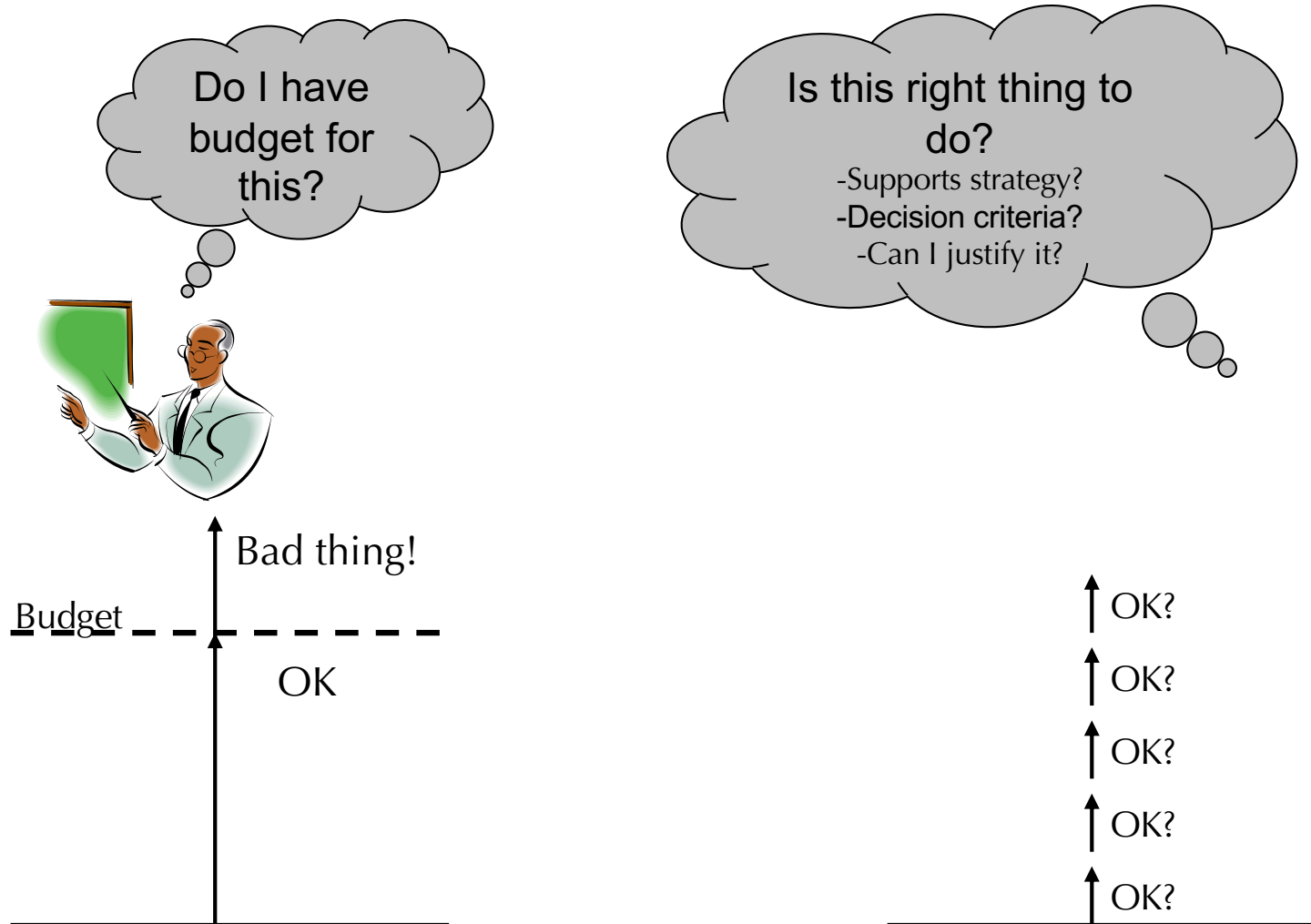
Borealis - Europe's 2nd largest petrochemical company.



# Performance measures



# Dynamic resource allocation



# AGENDA

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Transfer pricing
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting

# SUMMARY – WHAT DID YOU LEARN FROM THESE TOPICS?

- Financial responsibility centers
- Financial indicators for measuring performance
- What is EVA and why has it been argued to be superior to ROCE?
- What are the implications of Value Based Management to management system design?
- Purposes of budgets
- Problems with traditional annual budgeting
- Beyond Budgeting