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The Institute of Certified Management Accountants

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What's On?

March 4-15, 2009, Beirut, Lebanon
5th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by HBS for Training & Certification and www.cmamena.com

March 8-15, 2009, Mumbai, India
11th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by www.cmaindia.net

March 10-16, 2009, Dubai, U.A.E.
4th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by www.cmadubai.org

April, 2009, Bandung, Indonesia
2nd CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by UNPAR University www.unpar.ac.id

July 18-26, 2009, Colombo, Sri Lanka
12th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by ICBS www.cmasrilanka.com

On Target

Newsletter of the Institute of Certified Management Accountants Feb/Mar 09 Volume 13 Issue 1

Inside this issue:

The Institute For The Advancement Of Corporate Reporting And Assurance

...Another ICMA Initiative

At the recent AGM it was announced that a new Institute under the patronage of ICMA has been registered. Many at the AGM wanted to know more about this ICMA initiative. The principal object of the IACRA is to develop, manage and maintain a comprehensive independent rating system that measures, evaluates and reports a listed company's 5-STAR performance against national and internationally accepted reporting benchmarks and standards; and is designed to recognise and encourage transparent reporting of economic, environmental, social, governance and empowerment practises and standards. This follows the extensive research conducted by the ICMA and published in both **On Target** and its research journal, the ***Journal of Applied Management Accounting Research***.

The principal objective of the IACRA is to establish performance management objectives, measures and targets to assess and rate the level of 5-STAR performance of organisations and industries. IACRA will provide a framework for measuring and reporting 5-STAR performance against accepted key economic, environmental and social, governance and employee empowerment indicators.

To undertake such a task, IACRA researchers will collect and disseminate data from a range of publicly available information sources including annual reports, to evaluate an organisations, mission, objectives, key strategies, policies, implementation practices and results achieved in an organisation's 5-STAR reporting practises; in order to assess the quality of the reports and to ensure overall integrity and credibility of data.

It is clear that to implement such a rating regime, external assurance of the information and data collected for the purpose of 5-STAR performance rating and reporting will be required, whether directly or through external competent groups or individuals. Thus IACRA will establish an education and training program to provide its members with the necessary resources, technologies and information to enable them to participate in, and have the benefit of, an independent, reliable and easily accessible **5-STAR Reporting Index™.**

IACRA hopes to educate, train and certify individuals so that they can professionally collect and disseminate data from a range of available sources including analysis of internal audit systems including key strategies,

CMA not just the numbers

policies and practices to ensure overall integrity and credibility of reported data in organisations. These certified professionals will also be able to advise on technical, administrative and regulatory issues related to the 5-STAR Reporting Index™; undertake 5-STAR performance monitoring and to provide an independent forum to canvas and consider regulatory proposals, policy and best practices related to the 5-STAR Reporting Index™. They will also aid organisations in the development of facilities, methods and systems to achieve an efficient, independent and reliable 5-STAR Reporting Index™ rating.

IACRA hopes to conduct public programs including education programs, social and community programs and research programs in fields relevant to the 5-STAR Reporting Index™; and to produce, edit, publish, issue, sell, circulate and preserve reports, periodicals, books, circulars and other literary matters as are conducive to the principal object of the IACRA.

This will require close collaboration and the establishment and maintenance of relationships with corporations, entities, associations, foundations, institutions, organisations and groups including Federal, State and Local Government instrumentalities, authorities and professionals that have related interests to the IACRA and utilise their resources and facilities to provide and achieve the principal object of the IACRA.

Snapshot Series 2

Performance Measurement Metrics

On Target continue another series of Snapshots on a particular theme over many issues.

Traditional Financial Accounting Based Measures

"Business performance measurement used to be a simple affair. Aggregate financial measures such as ROI and EPS provided simple, if crude, indicators of a firm's achievements"

Traditionally, performance measurement has emphasised accounting earnings with the argument that a firm's earnings is an indicator into its current and potential cash generating ability. However, many criticise these as being flawed because they do not consider the capital and resources needed to generate that income. To overcome this issue, companies began calculating Return on Investment (ROI) which compares operating income to invested capital linking the Income Statement with the Balance Sheet.

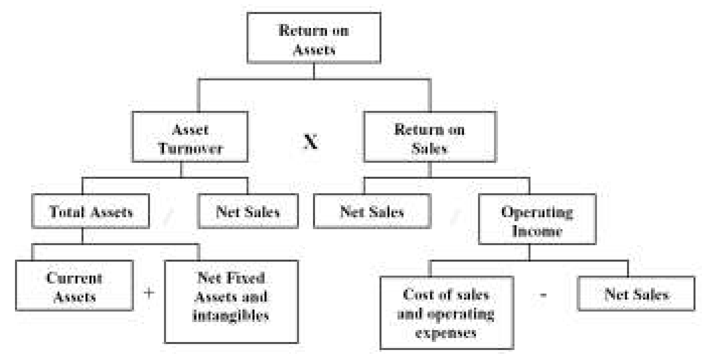
In calculating ROI, accountants consider two types of investment: Equity and Total Assets. Return on total assets is a wider measure than Return on Equity that can be represented by Equation 1 :

Equation 1:

ROA = Net Income / Average Total Assets

The benefit of the ROA measure is that it incorporates the operating aspects into a single performance measure. The company Du Pont introduced the ROI measure in the early 1900s and developed what has become known as the Du-Pont Ratio Tree (See Figure 1) from which managers are able to identify the means to improve their ROA statistic, and the subsequent decisions for improving their performance as measured by ROA.

Figure1 : Du-Pont Ratio Tree



Though return on investment is a fundamental measure of performance that has become a primary criteria in investment and management decisions, the use of these traditional accounting-based measures has some fundamental problems with respect to the way they are reported in financial statements, and, may lead to some behavioural problems with respect to the managers who are measured against them. Management incentives are often linked to management's ability to beat ROI, but this lacks a mechanism for judging whether their activities create returns to shareholders.

Value-Based Measures

The value of a firm is a function of future cash flows and the cost of capital. While, the accounting based measures of performance reward managers for exceeding a budgeted ROI or Net Profit targets, this can often be achieved by making decisions that do not optimise value. Value based measures have become popular because they reward managers for investing in projects where the expected future cash flows exceeds the cost of capital, and since this, by definition, means that the returns will be better than the returns shareholders can get in any 'risk' comparable investment, then shareholder wealth will be maximised. Three popular measures, Net Present Value (NPV), Economic Profit (EP) and Residual Income (RI) are briefly summarised now.

Net Present Value (NPV)

The first value measure to address is Net Present Value (NPV) which, is a capital investment tool used to discount the future cash flows of an investment into present day dollars by applying a discount rate equal to the weighted average cost of capital (WACC). Comparing this calculated NPV with the initial capital outlay determines whether the investment creates value or not. The importance of this to performance measurement is that since the primary goal of an organisation is to maximise shareholder value, the fundamental method of calculating value is by incorporating a NPV model into the decision making process. It is here that the future oriented role of the management accountant is highlighted in the area of performance management, in providing decision making information to enhance future net-cash flows and obtain finance at the lowest possible cost.

Economic Profit (EP) and Residual Income (RI)

EP as defined by economists is total revenue minus opportunity cost where opportunity cost is the explicit (accounting costs) and implicit costs, which are the costs of not pursuing the next best alternative. In the business world, these implicit costs are generally considered to be the cost of capital (Kimball, 1998). Peter Drucker nicely summed up the difference between accounting profits and EPs when he said, "*What we generally call profits, the money left to service equity, is usually not profits at all. Until a business returns a profit that is greater than the cost of capital, it operates at a loss*." EP is a dollar (or absolute) measure calculated as shown in Equation 2

Equation2 :

*EP = after-tax operating income - (capital invested * cost of capital)*

EP differs from Net Income because it includes the total cost of debt and equity whereas Net Income includes only the interest expense associated with debt. Therefore, the significance of EP to financial performance measurement is that it reveals the net contribution to value.

Residual Income is an accounting application of the EP concept. McKinsey and Company use EP as a performance measurement. It can be shown the way they define EP (Equation 3) is that it can be estimated by the difference between ROI and the cost of capital and is essentially a version of Residual Income:

Equation 3 :

*EP = (ROI –Cost of capital) * Capital Invested = Residual Income.*

The popular Economic Value Added (EVA®) measure developed by 1980s by New York consultants Stern Stewart and Co as an indicator of returns to shareholders is often seen as an extension of the EP concept. These 'Value-Metric' performance measurement approaches will be discussed in the next issue of On Target.

In the next issue of On Target we will explore Value Metrics