Utilizing Capabilities to Increase Stakeholder Wealth: A Balanced Scorecard Approach

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EXECUTIVE SUMMARY

The balance scorecard can be used to examine the creation of wealth from a stakeholder perspective. While the balanced scorecard is focused upon metrics which measure wealth creation, this study examines what capabilities the firm needs to build to increase shareholder, employee, customer and future wealth. These capabilities have the potential to create heterogeneity between firms by creating future oriented processes which focus upon both financial and non financial activities.

Keywords: Balanced Scorecard; Wealth Creation

INTRODUCTION

The creation of firm wealth is a goal of most for profit firms. From a conceptual perspective the resource-based view has added to your understanding as to how firms can increase wealth (Montgomery and Wernerfelt 1988; Chang and Singh 1999). The resource-based view of the firm has emerged as a perspective by which firms build resource positions which are rare, valuable, non-substitutable and not subject to imitation (Barney, 1991). However, it is not specific resources which lead to wealth creation, it is how these resources are accessed, developed, combined and/or deployed which leads to wealth creation (Moran and Ghoshal, 1999). As such, it is not the firm's resources which provide wealth: it is how these resources are transformed into capabilities which lead to wealth creation.

Capabilities represent the productive services that resources generate and the processes by which resources are developed and deployed over time (Amit and Shoemaker, 1993). A capability is a high-level routine that confers upon an organization's management a set of decision options for producing significant outputs of a particular type (Winter, 2000). A capability is substantial in scale and is reflected in a large chunk of activity that produces outputs that clearly matter to the organization's growth and prosperity (Winter, 2000).

One way of determining how capabilities can lead to wealth creation is to utilize the balanced scorecard. The balanced scorecard consists of the following perspectives (1) financial (2) internal (3) customer and (4) future. (Kaplan and Norton 1992) The financial perspective is concerned with profit and risk from a shareholder perspective. The internal element is focused upon the various business initiatives which create customer and shareholder value. The customer aspect is determined by the value that is realized by customers upon purchase of a firm's products. The future component is focused upon growth and innovation. The balanced scorecard also has disadvantages.

One disadvantage of the balanced scorecard is that only the customer and future perspectives are focused upon the future: the financial and internal components are focused upon historical measures. These historical measures do not address future wealth creation. The balanced scorecard can be modified to focus upon future wealth creation.

This study modifies the balanced scorecard framework by identifying capabilities which have the potential to generate future wealth. These capabilities replaced metrics which have been used to measure historical firm performance. Because the focus is upon capabilities, this approach examines how firms can create future wealth. This focus upon capabilities, instead of metrics, allows for a perspective which provides for incorporation of financial and non financial activities for increasing wealth. This is a perspective which the balanced scorecard does not currently address.

This study proposes modifications to the balanced scorecard. The modified scorecard framework developed in this study focuses upon what capabilities need to be developed to increase wealth from a (1) shareholder (2) customer (3) employee and (4) future positioning perspective. The customer wealth component will be discussed first.

Customer Wealth

Creating wealth for consumers is critical for success. Measuring customer wealth is complicated because firms may have multiple sources of revenue and they may have positions within multiple industries. The first step is to identify what industries a firm is competing within. Industries can be defined by the North American Industry Classification System (NAICS). This industry classification system is used for classifying firms within North America. The International Standard Industrial Classification (ISIC) is used to group international firms outside North America. Once industry boundaries have been identified, it is important to determine how wealth is being created from a customer perspective within each industry.

Increasing customer wealth is dependant upon how much better the firm meets key success factors within each industry compared to competition (Vasconcellos and Hambrick, 1989). Key success factors are those determinants which dictate customer buying decisions (Omhae, 1982; Amit and Shoemaker, 1993). Customers make decisions based upon how well a firm's product meets these factors.

Key success factors are determined at the market level through complex interactions among the firm's competitors, customers, and environment (Amit and Shoemaker, 1993). To determine key success factors, firms engage in market research. Through market research, firms can determine what the key success factors are within each industry, and how firms are positioned with respect to these factors. An analysis of key success factors will determine the relative position of the firm in an industry with respect to competition. It is important not only to determine key success factors within the current time period, but how these factors evolve over time (Amit and Shoemaker, 1993). One of the best approaches to understanding how key success factors change over time is through customer relationship management.

Customer relationship management is achieved through maintaining long-term connectedness to customers over time. As key success factors change over time customers may require new benefits from existing products and services. As a firm continuously adapts its product offerings to changing customer preferences, firms can create greater wealth than competition (Peteraf and Barney, 2003). Firms may choose to allocate more resources to those industries which create more wealth. Without this assessment on an industry-by-industry basis, the firm may engage in reactive as opposed to proactive decision-making. One reason is because of customer cost.

Customers incur several costs from a purchase perspective. Money is usually what is exchanged when purchasing a product. However, customers can incur significant non-monetary costs. One such cost is time. Time can be divided into two primary elements (1) amount of time consumers spend on learning about a product/service and (2) the physical time it takes consumers to stop what they are doing and purchase the product/service (Peter and Olson, 2005). The perceived customer benefits plus the consumer costs will determine the price the consumer is willing to pay for the product/service. If the sales price is higher than the sum of consumer costs and customer benefits, the consumer will not engage in the transaction. Reducing customer costs results in additional benefits created for customers and increases the likelihood of engaging in continuous transactions with customers. A second element of firm wealth is the creation of shareholders wealth.

Shareholder Wealth

Most firms are in business to increase shareholder wealth. In other words, the price of the firm's stock needs to appreciate. There is a good reason for increasing the wealth of shareholders. If wealth is not created, shareholders will invest in other firms. Because increasing shareholder wealth is important, more firms are beginning to compensate senior management based upon shareholder performance. (Norton, 2005) Cisco compensates all of its senior management team based upon changes in shareholder wealth (Norton, 2005). This approach to compensating senior management tends to reduce agency problems between senior management and shareholders.

Several firms have implemented processes for linking shareholder wealth to senior management compensation. Caterpillar initiated a new type of management reporting in 2004. Called Transparent Financial Reporting, it aligns the company's internal management reporting system more closely with shareholders' returns. "It's much more 'live' in terms of what's actually happening as a shareholder would see it," stated Mr. Doug Oberhelman, the group president of Caterpillar who has oversight responsibility of the finance operation (Norton, 2005).

Procter & Gamble uses a model for calculating shareholder wealth called Total Shareholder Return (TSR). This model evaluates management performance by calculating bonus payments for senior managers based on firm performance (Norton, 2005). One measure of existing shareholder wealth is obtained by examining financial ratios.

Financial ratios are important because they measure a firm's current and historical performance. Financial ratios can be classified into the following groups: (1) liquidity ratios, (2) asset management ratios, (3) debt management ratios, and (4) profitability ratios (Brealey, Myers, and Marcus, 2004). Liquidity ratios measure the firm's ability to convert assets into cash quickly and at low cost. Asset management ratios measure a firm's effectiveness at managing its assets. Debt management ratios measure the extent to which a firms uses debt financing. Profitability ratios represent how well a firm is allocating its resources.

Ratio analysis should be conducted with respect to historical firm values, industry averages and competitor's ratios over time. Internal capabilities need to be developed to analyze the financial results by comparing the firm's performance to the performance of competition and the industry averages. While ratio analysis is beneficial for determining a firm's current performance, these financial measures cannot be utilized to determine a firm's future wealth. What shareholders desire are increases in wealth. Because shareholder wealth is based upon the future stream of cash flows, it cannot be calculated based upon historical performance. Shareholder wealth can be defined as the present value of the anticipated stream of cash flows added to the liquidation value of the company. As long as the returns from the firm exceed its cost of capital, the firm will add to shareholder wealth.

Most profitability ratios only focus on the cost of debt, not the cost of equity. Economic value added (EVA) focuses on debt and equity (Brealey, Myers, and Marcus, 2004). EVA is an estimate of a firm's economic profit for a specific year. EVA represents the income after the cost of debt and the cost of equity have been deducted. It measures the extent to which the firm has added to shareholder wealth (Brealey, Myers, and Marcus, 2004). EVA is a measure that enables managers to determine whether a firm is earning an appropriate return on capital (Brealey, Myers, and Marcus, 2004). One benefit of EVA is that it is a single performance statistic. It also tends to align the interests of shareholders and management because it reflects how effectively management uses capital.

Fletcher and Smith (2004) believe that EVA is also primarily based upon historical financial measures. One approach to the utilization of the EVA is to base the statistic on both financial and non-financial metrics. Processes need to be developed to identify value drivers. Only then can EVA be used as a measure for managers to ascertain if the firm is achieving the target level of return on capital (Fletcher and Smith, 2004).

One way to determining value drivers is to utilize Porter's (1985) value chain. Value chain analysis consists of developing capabilities which can create value from both financial and non financial processes. Examples of processes which can be measured from a financial perspective would include automation or the efficiency gains from total quality management (TQM) initiatives. Processes such as (1) developing an integrated inbound and outbound logistics network (2) utilizing technology to develop new products, or (3) developing a global communication infrastructure, are activities which can be implemented to create value from a non financial perspective.

Employee Wealth

Another group which the firm needs to create wealth for is employees. The firm wishes to retain employees because of two primary reasons. The first reason is economic. If an employee leaves, the firm will spend time and money to recruit and train a replacement. Since the firm has already trained the employee leaving, a competitor will not incur training costs. The second reason is knowledge transfer.

If employees do not perceive that wealth is being created for them, they may decide to leave the firm and work for a competitor. All experience and knowledge that has occurred within your firm will now be available to competitors. This is important because employees build relationships with customers over time. As a result of these relationships, customers may switch to the firm that the employee is moving to. In this case, the revenue that is lost to your firm goes immediately to the firm the employee moves to. The firm the employee is moving to may generate this additional revenue at minimal cost. Creation of employee wealth is crucial for other reasons.

Because employees represent the most important asset of any firm (Barney, 1991), succession plans must be developed to retain high performing employees. Most employees in firms want to advance. Many times succession planning only addresses the CEO and senior management team. These plans should include general parameters for all employees. If employees are unaware of how they can advance within a firm, they may leave and join competitors that have more fully developed succession plans.

Succession planning affects many levels within a firm. Assume a new CEO is chosen from within the firm. Further assume that the former job of the new CEO was chief operating officer (COO) and the new COO was the chief financial officer (CFO). Assume that the new CFO was vice president of North American operations. The selection of an internal CEO puts in place a domino effect that impacts the entire organization. Employees perform important roles within firms

Employees dictate the long-run performance of the firm (Penrose, 1959). Therefore, it is of critical importance that a firm generate wealth for and retain employees. Employee satisfaction surveys, which should be distributed and scored without reference to specific employees, can be a measure of employee satisfaction. Employee turnover by department needs to be closely analyzed. In general, turnover should be approximately the same for each functional group. If it is not, a closer analysis of those departments generating higher turnover is required.

One of the best ways of retaining employees is to make them shareholders. Each year, United Parcel Service (UPS) rewards managers based upon how well the firm has performed during the year. Because these rewards are stocks, employees have an incentive to maximize shareholder wealth. This reward system links the compensation of employees to stock price changes because all employees are rewarded for stock appreciation. If the company has a bad year, all employees within the firm aggressively search to find the source of the stock decline and implement corrective action quickly. These actions increase wealth for external shareholders and all managers within the firm. The fourth element of firm wealth is an assessment of what will determine future wealth.

Positioning for Future Wealth

For the firm to create future wealth, it must design and implement its strategic plan. Some of the issues that need to be addressed are (1) expansion within domestic and international markets, (2) selection of firms for acquisitions and mergers, (3) costs and anticipated benefits of acquisitions, (4) restructuring, (5) resource utilization and (6) creation of strategic alliances.

Positioning for future wealth creation is due, in part, to identifying, acquiring, and implementing acquisitions. The price paid for each target firm needs to be evaluated versus the actual benefits (e.g. cost savings) realized. To determine changes in wealth, the wealth of the firm before the acquisition is compared to the wealth created after the target is totally integrated within the acquiring firm. Due diligence is a crucial component of a firm's acquisition strategy.

Due diligence is a comprehensive complete analysis of an acquisition opportunity. It is a third party's independent, objective view of the value of an acquisition target. This process should be performed for every acquisition opportunity. Consulting firms and investment bankers conduct due diligence because they have substantial industry experience. These firms perform many tasks. Some important due diligence functions are; (1) determining whether the acquisition will be friendly or hostile, (2) what is the maximum than that the acquiring firm should offer to make the acquisition opportunity profitable, (3) will the acquiring firm have to divest unwanted business sectors of the target firm, (4) what realistic cost savings will be realized as a result of the acquisition, (5) what is the likely reaction of investment bankers, (6) what has been the financial performance of the target over time, (7) what levels of funds will be needed to make implementation successful,(8) should the management team of the target be retained,(9) what type of R&D capabilities does the target firm have that can be utilized by the acquiring firm and (10) what are the cost and timetable for the integration process. If effective due diligence is not completed, acquiring firms may pay too much for acquisition targets or inappropriate targets may be selected.

In order to fund acquisitions, a firm may need to restructure existing businesses. The wealth created, as a result of the acquisition, needs to be compared to any restructuring that was needed to fund the acquisition. In general, acquisitions should add wealth to the firm, while restructuring should not result in decreases in wealth.

The number of strategic alliances a firm has entered into is another measure of future wealth. Alliances may allow firms to generate increases in future wealth more quickly than other modes of growth (e.g. internal development) (Yip, 1982; Chatterjee, 1990). Scale alliances allow firms to combine similar resources to lower costs by increasing utilization of assets. Scale alliances allow firms to combine similar resources to grow quickly. (Dussage, Garrette, and Mitchell, 2004). Scale alliances are also less expensive than acquisitions. In general, costs may be reduced because each firm is using the resources of partners without acquiring them.

Link alliances are formed by firms combining different resources to create new products/services. (Dussage, Garrette, and Mitchell, 2004). Because firms are combining different resources, new sources of wealth may be created because the alliances generate new resources. New resources, or new combinations of existing resources, provide new productive services which creates additional wealth for the firm. (Penrose, 1959; Moran and Ghosphal, 1999).

New sources of wealth creation can be identified by conducting environmental scanning (Garg, Walters and Priem, 2003). Environmental scanning is the means through which top managers perceive external events and trends (Hambrick, 1981). Scanning is the first link in the chain of perception and actions that permit an organization to adapt to its new environment (Hambrick, 1981). This link is important because scanning identifies changes that are occurring in the environment. The better the firm is at ascertaining the changes, the greater the probability that the firm may be able to develop capabilities to capitalize upon these changes.

The environment is made up of factors, external to the firm, which firms have little control over. Sometimes these external factors exert great influence on the firm (Daft, Sormunen, and Parks, 1988). As such, environmental scanning is utilized to provide the firm a better picture of the environment in which it operates (Ginsburg, 1988). The ability to determine the requirements for change and the necessary adjustments depend on the ability to scan the environment, to evaluate markets and competitors, and to quickly accomplish reconfiguration and transformations ahead of competition (Teece, Pisano and Shuen, 1997).

Environment scanning is a necessary but not significant condition for generating wealth. The development of resources and capabilities to match changing environmental conditions is necessary to achieve environmental adaptation. Firms must continuously scan internally to develop resources and capabilities to respond to changes in a firm's external environment. Both external environmental and internal scanning are necessary for effective environmental adaptation (Garg, Wacters and Priem, 2003).

One quick way of creating greater wealth is to capitalize upon competitor's mistakes. Downsizing may be a weakness of many firms. By focusing on downsizing, as opposed to downscoping, firms are only addressing internal cost measures. By General Motors eliminating approximately 25,000 jobs per year, the firm is not addressing changing consumer needs. In many cases, downsizing results in a reduction of human resources. This reduction in resources may create a situation where wealth is reduced because of loss of intellectual capital. By reducing wealth, firms may have less revenue. With less revenue, the firm must cut additional resources. The cycle can continue indefinitely.

Another restructuring approach is downscoping. Downscoping does address changing consumer needs because it focuses resources on the profit generating segments of a firm's businesses. For example, Gillette generates its greatest profits from (1) blades and razors and (2) batteries. It is quite likely that Procter & Gamble will allocate more resources to these lines of business than other Gillette lines.

CONCLUSION

All elements of the modified balanced scorecard framework are linked to each other over time. Increase in shareholders wealth is a result of meeting consumer needs over time. Employees create wealth by building long-term relationships with customers and suppliers. By understanding how consumer needs change over time, the firm's senior managers can design and implement new strategies to increase shareholder wealth. Increases in shareholders wealth result in funds to invest in customers and future wealth initiatives. Increases in employee wealth allow the senior management team to focus upon increases in customer wealth and developing future wealth. As wealth is increased from a shareholders perspective, firm may have additional funds available to invest in the development of capabilities to generate future wealth. As employees become shareholders, they become more cognizant of how the firm can increase its wealth over time. The senior management team may then have funds to begin to generate additional sources of wealth for the firm and its employees. As the firm successfully positions for the future, customer, shareholder and employee wealth should all increase.

By utilizing the modified balanced scorecard over time, the firm can continue to create wealth. This is because the development of specific capabilities can lead to a source of firm heterogeneity over time (Penrose, 1959; Barney, 1991). If the firm is not engaged in the development of specific capabilities, other firms will take customers, employees, and market positions from firms that are not developing these capabilities (Hamel, 2000). This modified balanced scorecard framework awaits empirical testing.

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