CIMA

Maximising Shareholder Value
Achieving clarity in decision-making

Technical Report

Contents

Preface 2

1 Introduction 3
1.1 Context – conformance and performance 3
1.2 What is value-based management (VBM)? 3
1.3 Shareholder value and the cost of capital 5
Sir Brian Pitman 6

2 Creating Shareholder Value – Strategy 7
David Kappler 9

3 Measuring Shareholder Value – The Metrics 10
3.1 Shareholder value analysis (SVA) 10
3.2 Economic profit (EP) 11
3.3 Cash flow return on investment (CFROI) 13
3.4 Total business returns (TBR) 14
3.5 Conclusions 15
Steve Marshall 15

4 Managing For Shareholder Value 16
4.1 Governance and ownership 16
4.2 Remuneration 16
Jeremy Roche 16
John Barbour 18
4.3 Culture 19
4.4 Structure 20
Charles Tilley 21
4.5 Stakeholders 21

5 Drawbacks of Value-Based Management (VBM) 22

6 Conclusion 23

7 Bibliography 24

Preface

After the market exuberance of the dot com bubble in the late 1990's, the sobering up period that followed the bust brought with it a renewed interest in the concept of shareholder value.

Since then, all kinds of companies have been publicly proclaiming their commitment to increasing long-term value for their shareholders. One look at the statements of directors or chief executives in annual reports can confirm this.

To a certain extent this is old news. We have heard such pronouncements before. The aim of publicly listed companies has always been to increase the value of shareholders' investment.

But headlines such as, "Value is the acid test of good governance", "Is good governance good value?" or "Returning value by governance", all taken from the Financial Times in the last few months, show the influence that accounting scandals and the market downturn of the early 2000's have had on corporate discourse.

The debate is now focused on the interplay between corporate governance and company success. They cross at a point where what matters is whether – and how – a company has created value for its owners. Corporate governance, defined as "the system by which the owners of the corporation ensure that it pursues, does not deviate from and only allocates resources to its defined purpose" (LSE and RSM Robson Rhodes, 2004), has become an ubiquitous topic here in Europe and even more so in the US.

Although CIMA believes this is praiseworthy, there is a danger that companies will assume that, once corporate governance has been sorted out, they will know how to manage for shareholder value. The truth is, many do not. These companies will carry on much like before, only under increased scrutiny from both investors and the public. In fact, many executives see value creation as more of "a corporate rallying cry rather than the goal of serious strategic planning" (Armour and Mankins, 2001).

This briefing is an attempt to draw attention to the context, tools, techniques and philosophy of managing for shareholder value, or value-based management (VBM) as it is sometimes known. It is not meant to be prescriptive. Like other management concepts, managing for value has been adapted by companies to suit their circumstances. There can be no "one-size fits all" model.

In CIMA's Official Terminology, VBM is defined as "a managerial process which effectively links strategy, measurement and operational processes to the end of creating shareholder value".

It is generally understood to consist of three key elements:

- creating value, ie, ways to actually increase or generate maximum future value;
- measuring value; and
- managing for value, ie, governance, management, organisation, culture, communication. (www.valuebasedmanagement.net)

We aim to outline the main features of strategic planning and decision-making, as well as how the chosen strategies can be delivered via integrated performance management systems and changes to organisational culture and structure.

The briefing is divided into three sections corresponding to the main VBM components:

- strategy – for value creation;
- metrics – for value measurement; and
- management – encompassing governance, remuneration, culture, structure and stakeholder relationships.

It also provides insights from senior finance professionals with direct experience of managing for value and a brief discussion of some of the key barriers and drawbacks of attempting to implement VBM programmes.

As this is a briefing from CIMA, it is primarily aimed at those working in finance. Finance professionals and accountants in business should play a key role in VBM implementation. Few other professionals will have the same commercial awareness coupled with a broad understanding of both the financial issues and the business as a whole.

However, the overview of VBM should also prove a useful introduction for anyone keen to gain a basic understanding of the subject.

1. Introduction

1.1 Context – conformance and performance

When corporate scandals started to hit the headlines in the US and, more recently Europe, the legislators' response was swift and efficient. Amid a flurry of reviews, consultations and debates about business ethics, a whole new raft of legislation was introduced in an attempt to restore faith in capital markets.

On both sides of the Atlantic, much of this effort was focused on regulatory and corporate governance issues. This was hardly surprising, considering the nature and magnitude of the problems. What's more, it is unlikely that the focus on corporate governance and regulation is going to wane in coming months, despite the inevitable industry backlash. The reforms continue and, for many, the effects of Sarbanes-Oxley in the US and the new Combined Code in the UK are starting to be felt.

There is a danger, however, that this admittedly laudable attempt to improve the way in which companies are regulated and governed will detract from the basics of value creation. Good corporate governance may be a necessary prerequisite but will not by itself lead to superior performance – which is, after all, what investors want and expect in return for their money.

At the beginning of 2004, the International Federation of Accountants (IFAC), in partnership with CIMA, published a report entitled, "Enterprise governance – getting the balance right". It argued for a more holistic way of looking at companies.

Enterprise governance is defined as:

"the set of responsibilities and practices exercised by the board and effective management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that the risks are managed appropriately and verifying that the organisation's resources are used responsibly".
(Information Systems Audit and Control Foundation, 2001).

It has two dimensions – conformance and performance – which need to be kept in balance. Too much emphasis on one, as the current focus on governance risks doing, may detract from value creation.

This briefing complements the "Enterprise governance" report by acting as a reminder not to overlook the performance side of the enterprise governance framework. It covers the philosophy and practice of managing for long-term value.

1.2 What is value-based management (VBM)?

Defining VBM is not easy. There is, on the one hand, a broad context of generating value for shareholders that is at the heart of the market economy. But there is also a more specific concept that narrows VBM into a management approach, or even a philosophy, characterised mainly by the metrics used to measure performance.

In terms of the former- in the Anglo-Saxon context, the maximisation of shareholder value has been widely accepted as a principal, if not the only, bona fide corporate aim.The concept of "enlightened shareholder value" has been enshrined in the recent UK Company Law Review. The Review explicitly rejected the notion of pluralism – where a company is required to serve a range of interests wider than just those of its shareholders – as being "unlikely to command wide support".

The Company Law Steering Group cited the generation of maximum value for shareholders as the ultimate objective for companies and in principle the best means of also securing overall prosperity and welfare (Strategic Framework, 1999). It was a simple message that emphasised the need to fine-tune the current system, rather than radically change it.

Most UK companies would describe themselves as being in the business of maximising value for their shareholders. But how that value is defined, measured and pursued is somewhat more contentious. The rhetoric of corporate mission statements may be divorced from the reality of firms' day-to-day operations.

We have all witnessed, in the recent accounting scandals, the extremes of how companies can be run for seemingly everything else except their owners' best interests. The collapse of Enron and Parmalat destroyed value for both their shareholders and their stakeholders, such as the thousands of employees who lost their jobs and pensions. There are also companies, such as Marconi, that failed as a result of strategic errors, not fraud.

It is not hard to find less spectacular examples of decisions that do not take long-term value into account. In many cases, value-destroying decisions are not driven by greed or dishonesty. Instead, they are the result of pursuing legitimate business objectives, such as growth or increasing market share. The problem is that managers often lack understanding of the difference between decisions that lead to higher profits and those that create value.

It is interesting to note that 78 per cent of companies interviewed for a University of Washington study (Graham, 2004) admitted to artificially smoothing earnings and sacrificing shareholder value in order to meet, or beat, Wall Street expectations. Fifty-five per cent also said they would avoid initiating a project with a very positive net present value (NPV) if it meant falling short of the current quarter's consensus on earnings.

The picture may not be that dissimilar on this side of the Atlantic. In an attempt to maintain steady earning streams believed to be preferred by equity analysts and investors, some companies seem to forget that their reason for being is to maximise value for investors.

And, because an increasing number of companies are bowing to this pressure, accounting itself can become "unhinged" from value – it is seen as no longer counting what counts (Stewart, 2003). Measures of accounting profit, such as earnings per share, may obscure the true state of the business. Value-based management is a reminder that the way to gauge whether or not a company is generating value for its shareholders is to measure the difference between a return on equity and the cost of capital.

The narrower definition of shareholder value management starts with the same governing objective but adds different ways of measuring and managing value. Sections 3 and 4 of this briefing describe these in more detail.

The basic concept of value can be traced back to 19th century economic theory, which pioneered the idea of residual income. However, the term value-based management and acronyms such as VBM or MSV (managing for shareholder value) were not used until the mid-1990s by authors such as Copeland and McTaggart.

McTaggart defines VBM as:

"...a formal, systematic approach to managing companies to achieve the objective of maximising value creation and shareholder value over time". *(McTaggart et al, 1994)*

Copeland sees value-based management as:

"... an approach to management whereby the company's overall aspirations, analytical techniques and management processes are all aligned to help the company maximise its value by focusing management decision-making on the key drivers of value". *(Copeland et al, 2000)*

Value-based management became popular in the mid-1980s when Rappaport published his seminal text, Creating shareholder value: the new standard for business performance (1986). Companies such as Boots, Lloyds TSB and Cadbury Schweppes were soon making explicit public commitments to increasing value for their shareholders. (For a more comprehensive history of VBM, see www.valuebasedmanagement.net)

Thanks to the good track record of those companies, the ability of VBM to generate superior returns was, for a while, unquestioned. During the latest market boom and bust, however, its image was somewhat tarnished. As early as 1998, an article in the Financial Times (14 May 1998) questioned whether VBM was not simply a product of a 16-year bull market.

Predictably, generating value became a lot more difficult in times of market downturn (although 2002 research from PA Consulting claims that only companies with an explicit VBM agenda manage to create value during bear markets). In addition, recent accounting scandals have led some to regard anything related to making money as somehow suspicious. Most importantly, the early and very successful VBM pioneers have not been immune to strategic and operational problems.

With an improved market outlook, it is easy to see why shareholder value goes back in favour. Also, pledging allegiance to shareholders can be a good antidote for being chastised – often unfairly – for abusing managerial positions for personal gain. After the collapse of Enron, the risk of such accusations has become only too real.

It is perhaps time to investigate whether managing for shareholder value can be a part of the solution to restoring faith in capital markets. Some claim that the performance metrics and the strong emphasis on accountability typical of VBM programmes can reinforce the focus on performance, while enhancing the checks and balances of corporate governance.

According to Ken Favaro, cheif executive of Marakon Consulting, companies that have "gone to the wall in the last few years never had – or had totally relaxed – their standards for growing value over time" (Marakon, 2003). It was not their corporate governance arrangements that were at fault, so fixing those would not necessarily solve the problem. According to Favaro, "making top management more accountable for growing the company's intrinsic value" is the key to protecting shareholder interests.

1.3 Shareholder value and the cost of capital

Despite the lack of universal definitions, all VBM programmes have in common the basic premise that profit needs to be measured in a way that takes into account the cost of the capital employed to generate it.

UK plc has a low debt to equity ratio which effectively means that most of the capital invested in public companies has come from share issues or earnings retained. The investors who purchase shares will only part with their cash on a promise of a higher return. They would certainly expect that return to be higher than what they could get from depositing their money in a bank almost risk-free. They are willing to tolerate the higher risk of equity ownership because of the potentially higher returns.

This fundamental premise at the heart of Anglo-Saxon capitalism contains within it a simple, yet frequently forgotten, notion: that there is a minimum acceptable return on investment. In other words, it is not only the debt capital which is costly – although it is more obviously so because of the interest rate applied by the lender – but the equity capital too.

The cost of equity capital is an opportunity cost and it is this that makes it more difficult to express in simple terms. Unfortunately, this complexity makes it easier to ignore when making profit calculations. But it is no less 'real' for that: if the shareholders fail to get the desired return on their investment, they will eventually invest their money elsewhere.

The basic tenet of managing for shareholder value is that the cost of equity capital must be taken into account when calculating value. That is, a company only makes a real or economic profit after it has repaid the cost of capital that was used to generate it:

"The most egregious error accountants are now making is to treat equity capital as a free resource. Although they subtract the interest expense associated with debt financing, they do not place any value of the fund that shareholders have put, or left, in a business. This means that companies often report accounting profits when they are in fact destroying shareholder value."
(Stewart, 2003)

This happens in some companies today, not just in terms of headline figures reported to markets but at all levels. Managers charged with making decisions about strategic planning or resource allocation may never consider the cost of equity capital.

Instead, their actions will be governed by any number of received business wisdoms about growth, innovation, customer satisfaction, market share, etc. These are the common – and frequently conflicting – choices available. Most managers will struggle to prioritise them (and the different groups of stakeholders they represent) or understand the causal relationships between these objectives and a sustained growth in profits.

Value-based management is an attempt to get back to the basics of value creation and focus on what matters to those who own the companies: an acceptable return on their capital.

CIMA's Official Terminology defines the cost of capital as:

"The minimum acceptable return on an investment, generally computed as a hurdle rate for use in investment appraisal exercises. The computation of the optimal cost of capital can be complex and many ways of determining this opportunity cost have been suggested."

The cost of capital depends on the riskiness of projects being evaluated. Davies et al (1999) define it as "the weighted average of the costs of the various investments of which the company is made up", determined by the risk of the firm's investment opportunities. It consists of the combined costs of equity and debt.

Measuring the cost of capital relates to returns on new investments rather than what happened in the past. The equity part of it will be determined by the risk to which equity holders are exposed (Davies, 1999). Because of this, there can be no exact way of calculating it, especially on the level of company as a whole (see Gregory et al, 1999 and Davies et al, 1999).

Companies should think hard about a precise number for the cost of capital, although the "correct" answer does not exist. Also, an approximate figure applied consistently is better than assuming that shareholder capital has no cost at all.

Sir Brian Pitman, former chief executive and chairman of Lloyds TSB

The ability to generate consistently superior total shareholder returns over time is the best single measurement of corporate management performance, claims Sir Brian Pitman, former chief executive and chairman of Lloyds TSB.

But it is also the most challenging objective that a company can set itself. "It requires delivering outstanding levels of current performance while building a legacy for the future," he says. "Those few companies that achieve it are hailed for their ability, year after year, to generate wealth for their owners in excess of their competitors."

One of the great advantages of shareholder value as a governing objective is that it demands continual improvement, according to Pitman. "There is no time when you can sit back and admire your achievements. The measurement is obvious to all, both inside and outside of the company. There is no hiding place."

It also allows chief executives to raise management performance and create greater involvement and excitement within the company.

"Setting ambitious goals forces the organisation to dig deeper for creative solutions and to rethink how the business should be run. It doesn't permit incremental thinking. The objective is to win, not just improve."

Differentiating the business from the competition is the key to generating greater shareholder returns, PItman says. He cites his time as chairman at clothing retail group Next. "Retail businesses, such as Next, can differentiate themselves through service and the quality of garments. If you are selling a skirt that is different from the competition and the customers like it, then you will win more business."

Price is often a key differentiator, such as with the low-cost airlines. The clever businesses create a product that they sell for a premium, however.

"The retro radio made by Roberts is a good example. People don't buy it just for the sound quality but for what it looks like. And Bang and Olufsen has managed to create a lifestyle around its equipment. People pay money for what is says about them."

By creating this difference, a firm will be more successful and create better value for its shareholders.

Organisations that adopt shareholder value management must revise their pay policies to support the new focus. The aim is for employee and shareholder interests to become inherently similar. Increasing employee ownership of the company's shares, through profit-sharing schemes, share saving schemes and share option schemes, is a key way of achieving this, according to Pitman.

2. Creating Shareholder Value – Strategy

It is one thing to say that companies ought to be managed for shareholder value but quite another to try to provide guidance on the best way of achieving this. Creating value is not about applying a prescribed set of tools or processes but about creating competitive advantage in the marketplace. Strategy lies at the heart of enterprise success: "Managing for value begins with strategy and ends with financial results." (Knight, 1998)

The focus on strategic planning has been one of the hallmarks of managing for value. In VBM, successful strategies don't just happen. They are not the result of good fortune, individual genius or a having a "lucky run". Instead, they are the end product of a structured and disciplined decision-making process.

It is surprising how casual strategic decision-making can be in many companies. Mankins (2004) claims that top management spend less than three hours a month discussing strategy issues (including mergers and acquisitions) or making strategic decisions. Instead, his research confirmed that "80 per cent of top management's time is devoted to issues that account for less than 20 per cent of a company's long term value".

Admittedly, strategy is not something that can easily be taught, despite the proliferation of MBA courses. There will always be room for intuition and "gut feeling". But there are also ways of making the actual process of decision-making – rather then just the outcomes – more structured and explicit. The resulting transparency should help companies understand where value is created and destroyed and pinpoint the real drivers of value.

Understanding value drivers and their interactions is, without doubt, the hardest part of developing strategy. The PwC Management Barometer Survey found that 69 per cent of executives in their sample reported that they had attempted to demonstrate empirical cause-and-effect relationships between the different categories of value drivers and value creation and future financial results. However, less than one third of these felt they had truly completed the task. Sixty one per cent had made at least a modest attempt to combine the numerous cause-and-effect relationships into an overall business model but only 10 per cent felt they had really nailed it.
(DiPiazza et al, 2002)

Instead of having confidence in what is undoubtedly the determining factor of their market success or failure, companies' strategic planning is dogged by uncertainty. One executive involved in McKinsey research about strategic planning called it "a primitive tribal ritual", adding that "there is a lot of dancing, waving of feathers and beating of drums. No one is exactly sure why we do it, but there is an almost mystical hope that something good will come out of it." (McKinsey Quarterly, 2002)

In VBM, the presence of a single, governing objective makes the process both easier and harder.

It is easier because there is no need for the trade-offs between different objectives that encumber traditional strategic planning.

But it is also harder, as the choice that adds the most value may go against the accepted wisdom of what constitutes success. For example, a path that maximises shareholder value may, in fact, depress market share. Many managers would intuitively regard this as a negative outcome.

When Lloyds TSB started managing for value, its board decided to divest some of its overseas businesses. The decision was widely regarded as strategic suicide because the US banks it owned were seen as a springboard into American market. But Lloyds realised that the continuing US presence was a route to the destruction of shareholder value and little else.

It is not only the priorities dictated by the governing objective that make strategic planning more disciplined in VBM companies. It is also the unrelenting focus on good quality performance information and on the creation of alternative strategies and the means of implementing them.

Good quality information is necessary for both strategic and operational decisions. In many companies, time is wasted trying to obtain and reconcile numbers from different systems. This means that there is no integrated, single view about where the value is being created or destroyed in the business. This, in turn, makes the allocation of resources more akin to speculation, rather than strategic choice.

"Most organisations are rich in data and cluttered with incomparable systems. Some are succeeding in extracting the data that they need to make rapid decisions by, for example, building data warehouses. However, the majority are struggling. The information they receive is incomplete, defective or too out-of-date to be useful in making rapid, well-informed decisions about the future. Often, they are unable to interpret the data or its implications. At the same time, the pace of change is accelerating. The environment in which firms must operate, and its impact on their organisation, is becoming less predictable and more threatening. Lack of correct information, combined with rapid change, makes effective decision-making even more critical."
(Fahy, 2001)

For some companies, improving information quality will require a large one-off investment in information technology infrastructure. However, managers should be warned against spending large amounts of money in a quest for 100 per cent accurate reporting in real time. In many cases, having the right technology is nowhere near as important as building a supportive culture or fostering effective communication that will facilitate the more informal sharing of knowledge.

In addition, some research shows that high-performing companies do not necessarily have better information than their competitors – they just do more with it. In his management blockbuster "Good to Great", Jim Collins (2001) claims that the key lies in installing "red flag" mechanisms that transform available, although imperfect, data into relevant information that cannot be ignored.

Generating the relevant information for decision-making is only the first, relatively simple, step in the process of strategic planning. The most difficult part is devising successful strategies that are going to give a company its competitive edge in the marketplace.

In VBM companies, managers are frequently expected to come up with several strategic options, rather than one "answer". These are then discussed before the option with the best strategic fit is chosen. Importantly, the choices presented have to be considered and realistic, not chosen for their ability to make the preferred option look better. Mankins (2004) argues that "they must be real alternatives, not just minor variations on a single theme".

While at Lloyds TSB, Sir Brian Pitman used to tell his managers that "there is always a better strategy than the one that you have; you just haven't thought of it yet". He required them to produce at least three different strategic options.

His view is echoed by John Barbour who, during his presentation at the CIMA 2003 conference on shareholder value, reminded the delegates that strategy is never a simple matter of choosing from a yes/no proposition.

Barbour also pointed out that companies need to come up with not only different strategic solutions but also different approaches to implementation. There is rarely only one indisputably and absolutely superior way of doing things. Most of the time, there are different (and sometimes competing) choices, including decisions about when and where different options ought to be pursued and what the resource requirements of decisions are likely to be.

The case of SmithKline Beecham, as described by the Harvard Business Review (March/April 1998), illustrates the potential benefits of a structured approach to strategic planning and resource allocation.

Any large company with many different projects can struggle to establish clear priorities for funding. The problem can be particularly acute in pharmaceutical companies with different drugs in the pipeline. It is practically impossible for one person to have a complete overview of every project or drug being developed, especially considering the scientifically complex nature of the industry.

In SmithKline Beecham, each project champion used to present his or her own case for funding. Inevitably, decision-making became heavily politicised as the final choices about resource allocation owed more to the advocacy and political skills of project champions than to the project's inherent worth to the company. Even when there was an attempt to evaluate individual projects, there was no real transparency to the process. No one could be sure that the assumptions and the quality of thinking that went into the evaluations were at least consistent, if not always good.

SmithKline Beecham's approach was to get project teams to create watertight alternatives to current plans. They had to consider what their strategy would be if they had less, more or the same amount of funding, as well as if the project was abandoned but they had to preserve the value earned so far.

Once this was done, the alternatives were presented to a peer review board, which tested the fundamental assumptions of each scenario. The teams then revised them, as appropriate, before they were reviewed again, this time by senior managers.

The strategic options were created and reviewed before any evaluation took place. SmithKline Beecham maintained that premature evaluation had a detrimental effect on creativity – which is crucial in R&D. The evaluation was conducted later, using consistent methodology throughout the process. Project teams were also asked to provide sets of clearly documented and comparable information, originating from a reliable source. The assessments then underwent further peer review before a portfolio was finally created and resources allocated.

Such a structured, phased and documented approach facilitates a shared understanding of all of the factors that drive value. Importantly, it also creates an audit trail for each project pursued or abandoned. The consistency of information collected along the way allows anyone to examine the data and the assumptions that went into choosing a portfolio.

There is a danger, however, that approaching strategic planning in such an analytical way runs the risks of "over intellectualising" decision-making. The exercise of strategic planning may eventually get in the way of running the company. This is precisely what Boots – one of the VBM pioneers – had been accused of doing by its new chief executive (Financial Times, 26 October 2003). Shortly after his appointment, Richard Barker was reported to be dismayed at finding very few real retailers within the company's staff, while analysts were questioning the need for 7,000 staff at its Nottingham headquarters.

Finally, strategic plans can never be accurate predictions of the future, despite the rigour of VBM. Perfect forecasts remain impossible and VBM is no guarantee of success. All it can do is to make the various assumptions that normally go into decision-making a little more explicit. And this, in turn, means that decisions about investments or resource allocation can be better explained and justified, both within the company and externally to investors.

What investors want to know is not just how the company performed in the past but how it is likely to perform in the future. They can glean this from the quality of its management and its strategic capability. After all, this is what separates the excellent from the merely good.

To conclude, VBM does give "greater realism to otherwise vague strategies" (Johnson, 2002) even if it does not remove all of the inherent uncertainties of strategic planning.

David Kappler, former chief financial officer, Cadbury Schweppes

Shareholder value is technically reinvested dividends and share price appreciation but how this links into a business is rather judgmental, says David Kappler, Cadbury Schweppes' former chief financial officer.

Cadbury Schweppes considered growth in economic profit as the key driver to creating shareholder value.

Some firms regard free cash flow as the driver and this is broadly similar to economic profit. However, economic profit is more useful, argues Kappler.

"It's transferable to individual businesses and unit levels, whereas cash flow is a corporate number. But in choosing a measurement you can't be over academic. You have to be pragmatic, with a basis of science underpinning the method."

Kappler argues that a shareholder value measurement must allow the firm to drill down and translate that measurement to individual business units.

"Growth in economic profit is a metric that individual managers can see and measure. For example, if the board decides it wants to increase economic profit by 15 per cent, then they can pass that figure down to individual businesses and get them to increase economic profit in their businesses or divisions."

Economic profit can also be easily linked to incentive and remuneration plans. At Cadbury Schweppes, for example, economic profit is the major element in the annual incentive plan at group and business level.

But growth in economic profit is not going to increase the share price on its own, as the share price is based on more subjective things than that.

"You need an investor relations programme to explain strategy, long-term investment decisions, and mergers and acquisitions activity, as all these are linked to the growth of economic profit and it all builds shareholder value," he asserts.

3. Measuring Shareholder Value – The Metrics

Written by Stuart Cooper,
lecturer in finance and accounting,
Aston Business School and
Matt Davies, senior consultant of
The Financial Training Company

Throughout the late 1980s and 1990s there have been a growing number of concerns raised about traditional accounting measures. These criticisms are primarily concerned with the scope for subjectivity that even the most comprehensive accounting standards allow. A number of consultants, such as Rappaport (1986) and Stewart (1991), recognised these problems. As a result, they turned to the concept of shareholder value and how this can be created and sustained. This has, in turn, led to the development of a number of "value metrics", the most significant of which are:

- shareholder value analysis (SVA)
- economic profit (EP) and economic value added (EVA®)
- cash flow return on investment (CFROI)
- total business returns (TBR)

Each of these types of metrics is advocated by a number of consultants and has been adopted by companies in the UK and elsewhere. It is argued that these metrics can be used for numerous purposes, including valuation, strategy, evaluation and the monitoring of performance. There are significant differences between the different value metrics but in each case it is agreed that the primary objective of a company should be to maximise shareholder wealth. Therefore, each of the metrics attempts to measure value creation for shareholders.

We will consider how each metric is calculated and identify some of the key difficulties in using them in practice.

3.1 Shareholder value analysis (SVA)

The shareholder value analysis (SVA) approach was developed by Alfred Rappaport in the 1980s. It can be used to estimate the value of the shareholders' stake in a company or business unit, and can also be used as the basis for formulating and evaluating strategic decisions. The value of the operations of a business is determined by discounting expected future operating "free cash flows" at an appropriate cost of capital. In order to find shareholder value, the value of "marketable securities and other investments" must be added to, and the value of debt must be subtracted from, the business valuation.

Free cash flow reflects the cash flow from the operations of a business for a period, i.e. before taking into account any financing-related cash flows, such as those relating to share or debt issues, dividend and interest payments, etc. Free cash flow can be derived as per Table 1 (below).

Table 1: Derivation of free cash flow

Sales	X
Less: operating costs	(X)
Operating profits	X
Add: depreciation	X
Less: cash tax on profits	(X)
Operating profits after tax	X
Less: investment in fixed capital	(X)
Less: investment in working capital	(X)
Free cash flow from operations	X

Technically, in order for the value of the business to be accurately determined, free cash flow for all future years should be estimated. In practice, however, a short-cut approach can be applied, whereby the future cash flows are divided into two time periods: those that occur during, and those that occur after, an explicit "planning horizon". This can be represented as follows:

> **Value of Operations =**
>
> PV (present value) of free cash flows during planning horizon +
>
> PV of free cash flows after planning horizon ("continuing value")

The PV of free cash flows during the planning horizon

The operating free cash flows during an explicit planning period can be determined by estimating future values for each component, separately, on a year-by-year basis. It may not always be necessary to apply this more detailed approach. The SVA value driver approach provides an alternative simplified method, which may give a sufficiently reliable approximation in many situations. This simplified approach involves using the "seven value drivers" to estimate the value of the operations during the planning horizon, which is the number of years into the future that sales growth is forecast. The "seven value drivers" are:

- the percentage annual sales growth rate
- operating profit margin (before non-operating items such as interest payable and tax)
- cash income tax rate (that excludes deferred tax)
- incremental fixed capital investment rate
- investment in working capital rate
- planning horizon
- cost of capital

The first five value drivers can be used to calculate the free cash flow for each year throughout the planning horizon. These are then discounted at the company's cost of capital. For consistency with the definition of cash flow used (which reflects total cash flows available to the total investment in the business), the appropriate discount rate to use is the weighted average cost of capital (WACC). The WACC weights the returns of equity and debt investors according to the relative proportions of equity and debt invested in the company.

The PV of free cash flows beyond the planning horizon
The second component of the valuation of the operations of a business is the present value of operating free cash flows that arise beyond the planning horizon. This value is often referred to as the "continuing" or "terminal value". For most companies operating in competitive industries, it is unlikely that a business that is generating excess returns on capital will be able to sustain this for an extended period of time. A point will be reached when returns have been driven down to the cost of capital, and a "steady-state" situation is reached. An assumption is usually made that in the post-planning period, the business will earn, on average, its cost of capital. In other words, additional investment would neither create, nor destroy, value and so the effect of new investment beyond the planning horizon can be ignored. As a result, an assumption often made with SVA is that the cash flow arising in the final year of the planning period will continue to arise into the future, to infinity.

The advantages and disadvantages of SVA
As seen above, SVA can be used to value a business. It can also be used to evaluate alternative strategic decisions, by comparing the pre- and post-strategy value of the business. Furthermore, the simplified approach, which emphasises the seven key value drivers, lends itself to "sensitivity analysis". (Sensitivity analysis involves assessing the effect of changes in assumptions on the value of a business or strategy. It can be a particularly useful way of identifying the critical variables that affect shareholder value.)

Shareholder value analysis can also have relevance in an operational context. The seven key value drivers can be broken down into more detailed and practical performance measures and targets, so that managers are encouraged to act in ways that are consistent with the ultimate objective of creating shareholder wealth. The most significant problem with this technique is predicting the variables required in the analysis.

3.2 Economic profit (EP)
Another method for determining shareholder value is by using the economic profit (EP) approach. Economic profit has been used, usually under the name "residual income", as a means of measuring divisional performance for more than 30 years (see Solomons, 1965).

The basic EP approach, however, can be traced back to the work of the economist Alfred Marshall (1890).

This section first considers the basic EP approach. It then examines how this has been refined by the US consultants, Stern Stewart, to produce Economic Value Added or EVA®.

Economic profit describes the surplus earned by a business in a period after the deduction of all expenses, including the cost of using investors' capital in the business. The accounting measure of net profit does not gauge this, since although there is a deduction for the interest charged on debt capital, the cost associated with using equity funds is ignored. Advocates of the EP approach argue that net profit is misleading and that some companies that are apparently profitable, based on accounting profit, can be shown to be economically unprofitable using the EP measure. Economic profit is the difference between the return on capital and the cost of capital and can be calculated in two ways, as shown below:

1 EP = Invested capital x (return on capital – WACC)

2 EP = Operating profits after tax less capital charge

The first approach clearly demonstrates that EP represents the amount of capital invested in a business multiplied by the "performance spread", which represents the difference between the return achieved on the invested capital and the weighted average cost of capital. The second approach deducts a capital charge (calculated as invested capital x WACC), from operating profits after tax. Operating profits refer to the profits of a business before deducting non-operating items, such as interest receivable, investment income and interest payable.

It is tempting to think that operating profits after tax are simply profits, before interest, less the taxation charge. This, however, ignores the effect of the above non-operating items on the tax charge for the business. Under the UK taxation system, interest payable is a tax-deductible expense, whereas as a general rule, interest receivable and investment income is taxable income. In other words, for a company with a net interest expense, the tax charge in the profit and loss account has been reduced by the tax shield effect of interest.

To arrive at the true after-tax profits from operations, the tax charge must first be adjusted to reverse this effect. This can be estimated by multiplying the net interest payable figure in the profit and loss account by the marginal rate of corporation tax.

The adjusted tax charge effectively represents the tax payable by the company if it had been entirely equity-financed, and had no non-operating income. If this adjustment is not made, the way in which a company has been financed will distort the calculated return.

EP as a valuation tool
Although economic profit may appear to be a short-term, single-period measure, an important feature of this approach is that it has a direct link with long-term value based on the free cash flow approach.

In mathematical terms, long-term value (the present value of expected future free cash flow) equals the sum of the present value of all expected future economic profits, plus the initial capital investment. In other words, the economic profit approach can be used as the basis for corporate or business unit valuations. This property of economic profit was recognised by O'Hanlon and Peasnell (1996), who state that:

"... even if accounting book values and profits bear little resemblance to economic reality, EP numbers can be used within a valuation model that has just as strong a theoretical basis as the standard dividend capitalisation model".

The advantages and disadvantages of EP
As shown above, EP can be used to value businesses. It can also be used to measure and evaluate performance and to fulfil a more strategic role. The introduction of EP would also be relatively straightforward, as it requires two adjustments to reported operating profit, to adjust the tax charge and to deduct a charge for the cost of capital. At the business level, EP can be used to set the performance targets for the business, and providing that the balance sheet information exists, performance against these targets can be tracked via the established accounting system.

The use of traditional accounting numbers, based on the same rules, conventions and policies that govern the production of published accounts is, however, a significant drawback of this approach. For example, the distorting effects of inflation and depreciation could well undermine the validity of the calculations.

As with the SVA approach, it is possible to identify a number of value-drivers that can be used to develop more detailed specific performance targets and indicators. There are three key factors that influence economic profit:

- the return on capital achieved;
- the cost of capital; and
- the growth of new capital.

It is useful to recognise that the return on capital generated by a business depends upon the combination of profit margins achieved relative to turnover ("margin") and the ability of the business to generate turnover from capital invested ("efficiency'"). In other words, an improvement in the return on capital requires an improvement in the combination of "margin" and "efficiency" for the business. (Return on capital can be further analysed into its constituent elements via what is known as the 'ROCE tree', or DuPont chart.)

Economic value added (EVA®)
Economic value added (EVA), as explained by Stewart (1991), is effectively a refined version of the basic EP approach discussed above and is demonstrated by the formulae below.

EVA = Adjusted invested capital x (adjusted return on capital – WACC)

EVA = Adjusted operating profits after tax less capital charge

EVA = Adjusted operating profits after tax less (adjusted invested capital x WACC)

Generally speaking, Stern Stewart suggests that the basic EP calculation is undermined by three distorting factors. These are the effect of:

- non-cash, accruals-based bookkeeping entries, which tend to conceal the true "cash" profitability of a business;
- the fundamental accounting concept of prudence, which tends to lead to a systematic conservative bias affecting the relevance of reported accounting numbers;
- "successful efforts accounting" whereby companies write-off costs associated with unsuccessful investments, which tends to understate the '"true capital" of a business, and also potentially subjects the profit and loss account to one-off, non-recurring gains or losses.

To overcome these distortions, Stern Stewart advocate that up to 164 adjustments be made to the measure of operating profits and capital, on which EVA is based. These adjustments are applied, where appropriate, to both operating profits and capital to ensure consistency in the calculation of EVA. Perhaps the two most common adjustments are to add cumulative goodwill written off and the present value of capitalised operating leases to the value of capital.

Advantages and disadvantages of EVA
The EVA approach possesses all of the key advantages of the basic EP approach. In addition, the adjustments required for EVA described above seem to address some of the accounting-related weaknesses with the basic approach.

Making all of the recommended adjustments, however, could be a time-consuming and costly exercise involving some rather arbitrary judgements. To be fair, Stern Stewart do not recommend that all 164 adjustments are needed for every company.

"In most cases, we find it necessary to address only some 20 to 25 issues in detail – and as few as 5 to 10 key adjustments are actually made in practice. We recommend that adjustments to the definition of EVA be made only in those cases that pass four tests below.
– Is it likely to have a material impact on EVA?
– Can the managers influence the outcome?
– Can the operating people readily grasp it?
– Is the required information relatively easy to track or derive?"
(Source: Stewart, 1994)

3.3 Cash flow return on investment (CFROI)

In essence, CFROI is a "real" (i.e., adjusted for the effect of inflation) rate of return measure, which identifies the relationship between the cash generated by a business relative to the cash invested in it. It is argued that CFROI provides an accurate measure of the economic performance of a business, free from potential accounting distortions relating to issues such as inflation and variations in asset ages. As well as providing a "superior" measure of current performance, it is also promoted as "the performance measure which best predicts future cash generation" (Braxton, 1991).

In its more sophisticated form, CRFOI incorporates the principles of the internal rate of return (IRR) concept, which is more often associated with the appraisal of capital investment opportunities. Specifically, CFROI represents the "discount rate" that "discounts" the future annual cash flows that are expected to arise over the average life of a firm's assets, back to current cash value (i.e. adjusted for inflation) of the firm's net operating assets.

The calculation requires three important stages:

- First, accounting profit is converted into "real cash flow" for the period. This involves adjusting for non-cash profit and loss account items and non-operating items.

- Secondly, the balance sheet value of the capital invested in the business is converted into an inflation-adjusted measure of investment in the business, described as "gross assets at current cost". Gross assets include off-balance sheet assets, but exclude goodwill. The inflation adjustment returns assets to their full historical cost. This is then adjusted for the effects of general price inflation.

- Finally, the annual cash performance is converted into a measure of economic performance over the average life of the firm's assets, using the principles of IRR. This requires the average life of the firm's assets to be known and, in addition, the value of non-depreciating assets (such as land and working capital, which are assumed to be released at the end of the firm's life) to be estimated. Once this information has been obtained, an IRR calculation is performed to determine the discount rate ("r") that solves the following equation.

Gross operating assets (current prices) =

$$\frac{CF_1}{(1+r)} + \frac{CF_2}{(1+r)^2} + \ldots + \frac{CF_t}{(1+r)^t} + \frac{NDA}{(1+r)^t}$$

Where:
CF_n represents the real cash flow in each year for the average life of the firm's assets.
NDA represents non-depreciating assets.

With this approach, CFROI measures the cash profitability of a business for a specific year, and represents the average projected rate of return from all of a business' existing projects at a particular point in time. It can be calculated separately for each year using the above approach, enabling the trend in CFROI performance to be analysed. Furthermore, CFROI can be compared to the company's "real" cost of capital to identify the CFROI performance spread. As we saw with EP, investing at a positive performance spread will create value for shareholders.

CFROI and valuation
Cash flow return on investment is a performance measure and no more or less a valuation technique than EP or SVA. Advocates argue that CFROI provides a superior basis for predicting future cash flows that can then be input into conventional cash-based valuation methods, thereby producing more accurate valuations.

There are two key features of the CFROI approach to valuations.

1 The valuation process is separated into two component elements:
- the value of cash flows arising from existing assets; and
- the value of cash flows arising from future investments.

The cash flows from existing assets can be expected to "wind down" over the remaining life of these assets and, at the end of this period, cash flows relating to the release of non-depreciating assets will also arise.

For future investments it is assumed that the rate of return on new investments and the rate of growth of new investment will, as a result of competitive forces, regress towards the long-term "economy wide" average levels. Or, in other words, cash flows arising from new investments are determined by "fading" future CFROIs and capital growth rates so that they approach long-term market averages.

2 A company-specific cost of capital is applied to discount future cash flows. However, here the most popular approach for defining the cost of capital – the capital asset pricing model (CAPM) – is rejected and an alternative approach is advocated.

"We derive investors' required returns from the observed relationship over time between stock prices and expected cash returns. Put simply, the investors' required return is the discount rate which, when applied to a company's forecast cash flows, best fits its stock price history. For most firms, the company-specific discount rate lies within a percentage or two of the market's required rate of return."
(Braxton Associates, 1991)

Advantages and disadvantages of CFROI
Advocates claim that CFROI is a superior measure of performance that provides the basis for more accurate business valuations. The key justification for using this approach is the argument that of each of the metrics available, it most accurately reflects the way in which the stock market judges a company's performance. One of the key advantages of CFROI as a measure of performance is that, unlike the EP/EVA®, models, it is neither distorted by the effect of inflation nor depreciation.

There are, however, some practical difficulties with the CFROI calculation.

Arguably, the calculations required are time consuming and costly to apply. Determining the appropriate inflation adjustment to apply to fixed assets, for example, requires an estimate to be made of the average age of assets and an appropriate inflation factor. Furthermore, the time period referred to as the "normal life of assets" for the business, which represents the time period over which CFROI is calculated, is very subjective.

The assumption that current cash flow is sustainable over this time period is, again, open to question. In addition, the cost of capital and "fade rate" assumptions that are made when CFROI is used as a valuation technique are also subjective.

3.4 Total business returns (TBR)
Total business returns (TBR) is the internal equivalent of the external total shareholder returns (TSR) measure, which considers capital gains and dividends received by shareholders. This approach is advocated by Boston Consulting Group, who explain the approach as follows:

"It measures the capital gain and dividend yield of a business unit or company plan as if the plan were known by the market or the business unit were publicly traded."
(Boston Consulting Group, 1996)

The approach is claimed to overcome the principal weakness with any short-term performance measure (including cash flow, EP/EVA®, and CFROI), as it incorporates the long-term effect on the value of the business of decisions and actions taken in a particular period. This is because TBR combines the cash flow performance of a business with the change in value that occurred during the period.

Effectively, TBR represents an internal rate of return measure that equates the beginning value of a business with net free cash flows arising in the period, plus the value of the business at the end of the period. The accuracy of TBR therefore depends upon the accuracy of the valuation of the business at the start and end of the relevant period.

It is often used in conjunction with CFROI, in which case valuations can be based on the application of the CFROI valuation methodology referred to above. Sometimes, however, a simplified valuation approach is applied, using a formula that incorporates the "CFROI spread" currently generated by the business and an appropriate multiple that reflects expected market growth. Although TBR is often used alongside CFROI, there is no reason why TBR cannot be used with other value metrics. (In fact, Unilever has used TBR as a key strategic measure with an EP-type measure as the key measure for monitoring short-term performance.)

Advantages and disadvantages of TBR
The key justification for TBR is that, by incorporating the effect of changes in value as well as "delivered" performance in a period, it represents the closest measure of the true economic performance of a business.

The main problem with TBR relates to the difficulty in accurately measuring opening and closing business valuations for a particular period. These can be based on managers' forecasts, which are inevitably subjective. Alternatively, some form of pre-determined formula can be used, which may improve objectivity but potentially at the expense of accuracy.

3.5 Conclusions

There is a great deal of consistency between the measures but also significant differences that have been identified above. One of the common arguments in favour of each metric is on the grounds of its superior power to explain the way the stock market actually measures shareholder wealth.

The empirical evidence is, however, inconclusive with independent studies generally showing lower levels of correlation than those suggested by the consultants.

Furthermore, each of the metrics suffers from a potential lack of objectivity in calculating the cost of capital and other key value drivers. Another potential problem for each of the metrics is whether managers find them to be understandable. In this respect, perhaps it could be argued that EP/EVA® is relatively easily understood, but even here the level of understanding will depend upon the complexity of the adjustments and valuations performed.

Finally, potentially significant measurement costs will be incurred in implementing the metrics, which should be considered to ensure that any benefits are not outweighed by the related costs.

Steve Marshall, former chief executive of Railtrack

Many company boards are fixated by short-term financial results and ignore long-term issues. This is detrimental to shareholder value, argues Steve Marshall, former chief executive of Railtrack.

"They concentrate on short-term financials, what the market expects, what dividends are expected and other short-term issues. These are a proxy measure of shareholder value and not the whole picture."

By looking at short-term issues, however, Marshall claims that firms are not intentionally neglecting shareholder value. "This sort of behaviour is not a lack of intent to create value for shareholders," he says. "Rather, it is a blurred attitude to what actually generates shareholder value."

When businesses get into trouble, he adds, it is rarely down to a failure of corporate governance or a breach of financial controls. "Instead, boards tend to sleepwalk into unwise decisions. Often a decision is made by default because no-one realised that a decision had to be made to get out of a certain situation."

Marshall argues that the recent changes to corporate governance are helpful but will only solve around 10 per cent of problems – the remaining 90 per cent would be solved by boards "upping their game".

"Many non-executive directors are at fault for failing to put enough time into understanding the business and what are the firm's key value drivers," he says. "Boards must ensure that they have the skills to tackle each issue they are confronted with and this may mean that the board composition has to change as the company tackles new challenges."

4. Managing for Shareholder Value

4.1 Governance and ownership

At the heart of managing for value lies a problem common to many large – and particularly listed – companies. This is the so-called "agency problem" created by the separation of ownership and management. Owners effectively delegate the day-to-day running of the company to paid managers who act as their agents. The result can be a lack of alignment between the interests of the two groups.

The people likely to have the biggest impact on value creation are managers in charge of running the company. Yet, there is a risk that they may not always make decisions that have shareholders' best interests at heart. They – like all other market participants – can be governed by self-interest.

As executive tenures get shorter and executive pay packets get bigger, it is hardly surprising that some try to make their spell at the top as profitable as possible. In extreme cases this can go as far as aggressive earnings management. But there are other, more benign, ways of temporarily boosting the share price and thus the size of the reward linked to it. Most of those are designed to work in the short-term and could end up destroying shareholder value.

There are, of course, barriers in place to prevent managers from abusing their positions. One of these is the threat of reputational damage to their future employment prospects. There are also other safeguards, in the form of corporate governance codes and practice.

Making sure the owners' and managers' interests are aligned entails fostering open and honest communication and active interest from shareholders. Commentators have been complaining for a while now that fewer and fewer shareholders are committed to the companies they own. Instead, "giant mutual funds buy and sell millions of shares every day to mirror impersonal market indexes" (Mintzberg, 2002). Some critics go as far as to say that the recent accounting scandals in the US are a direct product of a lack of ownership. They lay the blame squarely on investors' lack of involvement in the companies they own.

But this apparent apathy is not new. As far back as 1990, an article in the Economist remarked that there were few real owners left and most of those who buy and sell shares are in effect "punters, not proprietors".

Although there is some truth in this, large funds do not usually trade with such haste or impulsiveness. Recent events have shown that shareholders are making their views known and are willing to get involved in companies they own. Some examples of shareholder activism include ITV – where the disgruntled shareholders prevented the appointment of Carlton's Michael Green as the chairman of a new, merged business – and J Sainsbury – where shareholders successfully blocked the appointment of Ian Prosser as the new chairman. Share ownership is now effectively concentrated in the hands of relatively few institutional investors who can wield a significant amount of power in the boardrooms, should they choose to do so.

In addition, many funds – either because they track an index or because they feel they need to be invested in certain major stocks – are obliged to have significant holdings in many quoted companies. In other words, they have no real "choice" about whether or not to hold. In the absence of the option to buy or sell, they must instead use their holding to influence company strategy and performance.

Few would contest the investors' right to have a say in issues of boardroom constitution or governance arrangements. However, the force and extent of recent shareholder activism seem to have caught many by surprise. So vocal have shareholders become in recent months that their efforts have been labelled "megaphone diplomacy" by some of the largest UK companies. Executives complain of having too many corporate governance codes forced onto them and accuse the investors of micro-managing and meddling in the day-to-day affairs of the company. Some have even hinted at exiting equity markets and going private.

Whether this "new City", as one of the institutional investors called the trend during the Carlton/Granada merger, really is a taste of things to come remains to be seen. What is clear is that corporate governance has come a long way, and only partly because the government has threatened legislation should investors choose to remain passive. Companies that ignore this new reality may risk negative publicity, as well as shareholder hostility.

4.2 Remuneration

Jeremy Roche,
CEO, financial software firm, Coda

"Remuneration policy must be performance-related and linked to other parts of the business and also to the goal of managing for shareholder value. Otherwise, you end up with the situation that a new, big order might be good for the sales team's objectives but creates problems for other parts of the organisation, which causes shareholder value to fall."

The paradox of agency, described above, can be a major stumbling block for companies committed to value-based management.

"Shareholder value (...) drives a wedge between those who create the economic performance and those who harvest its benefits. (...) Those who create the benefits are disengaged from the ownership of their efforts, and treated as dispensable, while those who own the enterprise treat that ownership as dispensable and so disengage themselves from its activities."
(Mintzberg, 2002)

It has even been suggested that what really matters in companies today is not the financial capital provided by the shareholders but the intellectual capital of employees. In other words, it is the knowledge and the creativity of people working for the company that are the real assets in the so-called knowledge economy.

Value-based management agenda must include an attempt to align – or at least reconcile – the interests of the two parties. The most obvious way in which this can be done is by allowing employees to share directly in the benefits they helped create. This effectively means paying them in a way that makes them behave more like owners, by linking their rewards to a long-term growth in value. In practice, this equates to remuneration structures that include some form of equity-linked compensation.

This is why remuneration policies frequently form a central plank of VBM programmes. In fact, some believe they represent the biggest missed opportunity. PA Consulting examined the correlation between total shareholder returns and the remuneration practices commonly associated with VBM. They examined the following practices:

- The bonus system rewards improvement at any level of performance – there is no cap on the bonus payable.
- Staff are in a shareholder value-based bonus system.
- The business defers part of the bonus pay out over several years.
- Many staff have built up shareholdings in the business, through purchases or bonuses, which are a significant part of their total wealth.

They found the most significant positive correlation with the last two points, which seem to deliver additional total shareholder returns of 2 and 4 per cent per annum, respectively.

The link between reward and motivation is far from straightforward, despite the widespread recognition that pay is one of the main influences on how people behave at work. The sheer number of motivational theories is enough of a testament to this, as is the complexity and sometimes opaqueness of remuneration packages awarded (to directors and executives in particular). It is hardly surprising that a whole industry has mushroomed around remuneration consulting and that the subject continues to provoke an emotive response from companies, investors and the general public alike.

Remuneration can take many forms. Employees can be paid in cash, including basic salary, bonus and pension, or through various forms of equity-linked compensation, such as shares or share options. All can be awarded in different proportions and can be either fixed or variable. They can also be subject to different timing restrictions in terms of when they can be exercised.

As the table above shows, over a five year period, incentives such as shares or share options represented the bulk of overall executive pay, while the basic salary formed a relatively small proportion.

CEO Pay Mix

Long-Term

Year	Salary	Bonus	Incentives
1998	20%	18%	62%
1999	20%	17%	63%
2000	18%	17%	65%
2001	16%	13%	71%
2002	16%	16%	68%

(Mercer consulting, from Institute of Management and Administration Pay for Performance report, 2003)

Although the idea of paying employees in equity sounds straightforward, it has not been without problems in practice. This was partly due to the dot com bubble; employees who chose to cash in their share options benefited from a phenomenal rise in global equity prices. This effectively severed the link between pay and performance and led some commentators to brand options as "legalised looting at shareholders' expense" (Plender, 2003).

This was exacerbated by the fact that accounting standards did not require options to be treated as an expense. However many options a company awarded, the cost to the company – i.e. shareholders – went unrecorded. At best, share options may have featured in notes to the accounts but there has generally been very little transparency about their use. Some argue that, despite this, the stock market has already factored the disclosed cost of options into today's value (Watson Wyatt, 2003) but others estimate that reported profits may be as much as 30 per cent lower if the options are expensed.

Recently, more and more companies have chosen to stop issuing share options altogether. J D Wetherspoons, for example, announced it would abandon the practice because it lacked transparency. Microsoft, a company whose success was undoubtedly, in part, based on incentivising people with equity, also decided to stop issuing options.

Others are beginning to expense options through their profit and loss accounts to reflect their true cost. From 2005, all European listed companies will be forced to do so in any case, following the introduction of international accounting standards.

In February, the International Accounting Standards Board (IASB) published a reporting standard entitled Share-based Payments (IFRS2). The objective of IFRS2, according to the IASB, was

"to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, the IFRS requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees."
(www.iasb.org)

The IASB acknowledged that the lack of transparency in share-based payments has attracted criticisms from investors and raised corporate governance concerns. The new standard, it hopes, will go some way in addressing these and preventing any possible "economic distortions".

Despite the pitfalls, the basic concept of tying remuneration to an increase in company value seems a sensible way of aligning owners' and managers' interests. This is especially true in the case of small companies, where the link between individual performance and company success is visible and relatively straightforward.

In any case, it is important to install the processes and structures which safeguard owners' interests against possible abuses of power. In this context, the importance of strong remuneration committees cannot be stressed enough. For those below the board and senior management level, there need to be clear and documented remuneration policies and procedures.

Professor John Barbour,
founder of consultancy Corporate Value Improvement

Managing for shareholder value is as much a frame of mind as a technical issue, says John Barbour, founder of Corporate Value Improvement, a consultancy which helps top businesses deliver superior returns to shareholders.

"When companies start thinking about what shareholder value entails, they need to start thinking beyond financial measurement", he says. "A business is like a horse. The head is the board, setting the objectives and deciding the best way to go. The four legs are the company's strategy, finances, organisation and its people. The horse will go as quickly as the slowest leg allows. So if you concentrate everything on financial metrics and ignore your people, then the horse will lag behind in the shareholder value stakes."

Barbour argues that shareholder value has to be led from the top. "If the top team does not change the way it does things, then the drive for shareholder value will fail. People do what their bosses do and the board has to lead by what they are doing, not what they're saying."

The CEO may become the spokesperson on the issue but it is often the finance director who, by doing lots behind the scenes, can end up making a lot happen. Financial visibility and performance are a key part of managing for shareholder value and often the strategy side of the business fits in well with the finance director's role.

Many firms bring in large teams of consultants to set up a programme to manage for shareholder value. But Barbour argues that there are pros and cons to getting in consultants.

The advantage is that you engage professionals whose focus is to change the organisation and gear it towards managing for shareholder value. However, it can be hard to keep that change sustained after the consultants have left.

Barbour recommends hiring a small number of consultants who show the staff how to change the organisation rather than do the work for them. "You learn by doing and that way the company is experienced at doing it once the consultants leave," he says.

The finance department has a key role to play in helping a firm manage for shareholder value, according to Barbour. Firstly, the function has to find a way of delivering the department's outputs – the financial transaction processes, for example – at a lower economic cost. This can be either through streamlining and making the internal service more effective and efficient, or outsourcing it to expert operators.

Once this has been achieved, the finance department needs to develop as an "internal consultant" for the organisation, looking at areas such as the impact of mergers and acquisitions, long-term strategy and investments.

"Becoming an efficient information machine, while acting as a business partner to the board, will be a major challenge for many finance departments," acknowledges Barbour. "But if they are successful, then their survival is guaranteed."

The business itself will be more successful, as a result. An integrated finance department, acting as an internal consultant, can help a firm improve its value to shareholders.

4.3 Culture

Creating value is not a one-off event that comes about as a result of a major strategic breakthrough. It is a continuous cycle, supported by the sum of strategic and operational decisions made throughout the company. For it to be effective, each one of those decisions, however small, needs to be informed by principles of VBM. And the only sustainable, organic way to make this happen is if VBM is embedded into company culture, to the extent that it becomes second nature.

In some companies, VBM begins and ends with changing performance measures. Managers assume that if they start measuring and reporting economic profit, the performance itself will somehow improve and the markets will reward them accordingly.

In reality, a high level decision to change the metrics should be a part of an overall change in competitive strategy. In isolation, it is likely to mean little to most employees – a focus on measurement means VBM may become dominated by complicated financial analyses that cannot be translated into actions that are meaningful or applicable in "ordinary" jobs.

Companies can not only measure too much, they can also measure the wrong thing. Benson-Armer et al (2004) claim that many companies fall into the trap of focusing measurement too much on historical returns, which are easily quantified, and too little on the more forward-looking contributions to value: growth and sustainability. They cite the example of a consumer goods company that was able to demonstrate strong economic returns for five years as measured by economic profit. "But because it delivered growth by increasing prices,", Benson-Armer et al argue, "it ultimately damaged its customer franchise and could not sustain its growth rate."

Companies implementing VBM should be cautious about giving their finance department full ownership of the change programme. The rest of the organisation may dismiss the programme as having no relevance outside of the finance function. A widespread buy-in will be difficult to obtain.

In their seminal article for the Harvard Business Review, researchers from the INSEAD business school concluded that the key to successful implementation of VBM is a focus on culture rather than finance.

Culture encompasses all of the implicit norms and ways of behaving that direct employee actions. These tend to have more influence on what happens day-to-day than official edicts from senior management, which may not get past a read and forgotten all-staff memo. That is why change, particularly cultural change, is so difficult to get right.

The study highlights five elements of cultural transformation shared by companies where VBM programmes have been successful.

- Nearly all made an explicit commitment to shareholder value.
- Through training, they created an environment receptive to the changes that the programme would engender.
- They reinforced the training with broad-based incentive systems that were closely tied to the VBM performance measures and which gave employees throughout the company a sense of ownership in both the company and the programme.
- They were willing to make major organisational changes that would allow their workers to make value-creating decisions.
- The changes they introduced to the company's systems and processes were broad and inclusive rather than focused narrowly on financial reports.

Of course, a level of financial expertise is necessary if concepts such as discounted cash flow or the cost of capital – which represent the theoretical core of VBM – are to become properly understood. Most companies have to run extensive training and education programmes tailored to different levels of employees.

Interestingly, some research has actually shown that the difference between companies that succeed in becoming value-aligned and those that fail is not the size of their investment in training. The difference is statistically significant but not that large. What matters most is the effort and consistency put into communicating financial results, both internally to staff and externally to investors and other stakeholders.

In other words, briefing the board and senior managers is not enough. There needs to be a comprehensive and regular communication programme involving all employees. Value is created throughout the company, not just at the top, so the relevant aspects of VBM need to be adapted to the individual context of a particular role.

Visible leadership and strong commitment at the top is essential. In fact, in successful companies, VBM has often become explicitly associated with a few key senior individuals. This is not surprising – they have the authority to make the necessary changes. Buy-in at the top means staff further down the hierarchy are more likely to change their behaviour.

However, while personal belief and commitment are clearly crucial, no company can consistently increase its value through one person alone. He or she may provide the initial impetus and the motivation to keep the programme alive but VBM needs to be embedded into decision-making at all levels. Some companies, like Cadbury Schweppes, chose to appoint the so-called "value champions" – managers throughout the business who act as role models to other staff and lead by example.

To conclude, changing the way performance is measured and reported is largely a contained – if not entirely straightforward – exercise. Yet, it is only a relatively small part of VBM implementation. Changing the culture is a lot more open-ended and potentially messy. It is also the only way companies can inspire the kind of commitment necessary to make VBM more than a passing fad.

4.4 Structure

The depth and scope of change engendered by VBM implementation is usually extensive. It is likely to have an impact on most aspects of organisational life, including structure.

In most companies, structures evolve over time in response to immediate strategic priorities. As a result, they frequently do not map the current decision processes or paths of value creation which, in large companies in particular, are likely to be very complex.

Comprehensive restructuring may seem to be too onerous in light of all the other changes likely to be going on but, if companies are to ensure clarity in decision-making, they need to know precisely where in the organisation value is created and destroyed.

When Barclays Bank implemented VBM, it re-organised the four banking divisions into 23 strategic business units. It then identified value drivers and put strategies in place for each one of them (*Financial News*, 18-24 June 2001). This transformed the structure of the business entirely. Some units centralised previously disparate activities, some were exclusively devoted to particular customer groups and some activities were dropped altogether when it was established that they were, in fact, destroying value.

The issue of structure is a lot more than cosmetic. It is about trying to align different parts of the organisation with the overall strategic direction and doing so in a way that makes strategic choices visible. This is why Marakon Consulting talks about structure in the context of corporate governance and accountability.

"Determining the best organisational structure enables managers to achieve the greatest clarity in deciding where, how and how much value is being, or could be, created within each business unit and within the company's total portfolio. Determining the right roles and responsibilities enables managers to achieve the highest degree of accountability for creation and destruction of value."
(www.marakon.com)

Furthermore, Marakon contend that managing companies is extraordinarily difficult in any case but becomes practically impossible if there is no consensus about what the company ought to be doing and who is responsible for results. Companies may end up in a position where the only person seen to have full responsibility for VBM is the chairperson or the chief executive – as if value generation just happens without the rest of the company having anything to do with it.

Research has confirmed that a shared commitment to the VBM philosophy plays a key role in promoting inter-functional co-ordination in companies (Roslender and Hart, 2003). It requires different functions to move away from their exclusive or silo approaches to managing the organisation in favour of a more inclusive perspective.

Charles Tilley, chief executive, CIMA

Keeping stakeholders happy is essential to create shareholder value. However, boards must not get sidetracked by stakeholder issues to the detriment of shareholders, says Charles Tilley, chief executive of CIMA.

"Keeping employees happy is critical to creating shareholder value, although it may not be a company's main priority," Tilley says. "Businesses are faced with all sorts of issues from stakeholders, including employees, customers and environmental groups, but they must deal with them in such a way that maximises shareholder value."

Creating shareholder value is all about managing risk; no more so than in motivating employees. "You don't want to overpay your employees, as that takes money away from shareholders but you also don't want to underpay them and risk losing them, as that damages the business and therefore shareholders' investment."

This is a critical issue at the moment, says Tilley, as firms struggle with pension schemes. "Judging the impact on staff motivation is not black or white", he adds.

Boards face similar challenges when dealing with environmental stakeholders, he argues. "They must continually gauge the reaction of environmental groups to certain issues and strive to pursue a route which appeases these stakeholders without adding unnecessary cost to the bottom line."

Tilley uses the example of oil giant Shell's decision to sink the Brent Spar oil platform. Environmental group Greenpeace did a very effective job in mobilising the general public against the move, leading to a swift volte-face that ended up costing Shell's shareholders more money.

The challenge in managing for shareholder value is to drill down the concept into everyday decision-making, he adds.

"It's relatively simple for the board to manage for shareholder value but the difficulty is cascading this down the organisation so that every decision that the company makes – however small – is made with the idea of maximising shareholder value," he says. "Firms need a clear and simple strategy that is easily understood by everyone in the organisation. People need to be able to easily identify the sorts of actions they can take in their roles to maximise shareholder value."

4.5 Stakeholders

Although VBM may seem to be all about shareholders, the actual process of value maximisation cannot bypass wider stakeholder concerns. In an age when an increasing number of companies is being scrutinised for their environmental and social track records, it is important to remember that these companies can only really increase wealth for their shareholders if they produce outputs that meet the needs of society.

The recent review of UK Company Law explicitly supported the notion of "enlightened shareholder value" but its status as the ultimate business goal has been increasingly questioned in recent years. The advocates of a more pluralist approach have queried the legitimacy and morality of companies' rights to ignore wider stakeholder interests.

The governing objective of shareholder value may preclude the need for stakeholder trade-offs but ignoring stakeholder concerns carries penalties. Companies that bore the brunt of protesters' wrath in the last few years, such as Nike or Shell, know this only too well. The damage incurred – largely reputational in their cases – is a risk like any other so it needs to be considered from the outset.

In that sense, explicit commitment to value cannot be a substitute for sound managerial judgement. This is not assenting to pluralism but simply being aware of the whole portfolio of risks material to the business.

Recent research has tried to examine the link between value maximisation and stakeholder theories. Unsurprisingly, it concluded that those companies that fail to add value to their shareholders would also fail to satisfy other stakeholders. The reciprocity of the relationship is apparent – 'companies generally do well by being good – but at the same time, they must also do well to be able to do good." (Wallace, 2003)

Value-based management supporters would say that the focus on a single objective allows a company to dispense with multiple aims and objectives characteristic of pluralist approaches, as those lead to "managerial confusion, conflict, inefficiency, and perhaps even competitive failure" (Jensen, 2001).

Some would go as far as claiming that tools such as the ubiquitous balanced scorecard add to the confusion instead of making performance management more comprehensive. Although the discipline of understanding value-drivers is essential, allowing scorecards to function as performance management systems, rather than using them as analytical tools, results in a dilution of focus due to the inevitability of trade-offs between the four quadrants (*ibid.,* 2001). At the heart of VBM, on the other hand, seems to be more of an all-or-nothing proposition and a single-minded pursuit of value.

5. Drawbacks of VBM

Many companies have tried and failed to implement a structured value maximising programme. The Ernst & Young 2003 survey of management accounting showed that only 30 per cent of companies claim to use VBM extensively and roughly the same number have tried and subsequently rejected it. Why is the first figure so low, considering the success of some VBM programmes?

Put simply, VBM is not easy, either conceptually or in practice. For a start, most companies have competing priorities, which makes the discipline of VBM difficult to apply. Because of this, it may not be possible to avoid the trade-offs altogether. Plus, as mentioned already, VBM does not make strategic planning any more predictable. It is not "a crystal ball" or "a replacement for management judgement" (Knight, 1998).

For example, Howard Dodd, Boots plc finance director, recently explained why his company had been forced to make amendments to its previously successful VBM programme (Dodd, 2004). The focus on maximising net present value (NPV) meant that many projects with high NPVs but long paybacks and poor short-term returns were accepted by the company. This in turn meant that there was under-investment in the core retailing businesses since returns here were judged to be too low in comparison.

In addition, many companies find they lack the resources, or the commitment needed, to make any real headway. Implementation is usually costly. Most boards initially employ consultants, which is a significant expense. Then there is investment in training and the opportunity cost of time devoted to the programme.

Also, like any culture change, VBM implementation is disruptive, especially if there is a need for extensive restructuring. Deliberately creating a spotlight designed to expose those parts of a business that do not create value is going to generate fear and disquiet among staff. This is why tacking cultural issues from the outset is crucial.

Even for companies that do experience success in implementing VBM, sustaining initial gains is a challenge. It is easy to lose focus and go back to the old ways of managing. If the process of implementation is drawn out and comes in a long line of initiatives, there is a risk of change fatigue setting in. Staff can become cynical and view VBM as just another consultant-driven fad.

Doing well also means raising City expectations so analysts learn to expect superior performance. Struggling to meet those expectations runs the risk of making the share price – rather than long-term value – an end in itself.

Cooper et al (2001) summarise the advantages and disadvantages associated with the adoption of the techniques of VBM, as outlined below.

Advantages	Disadvantages
Provides a common language – usable internally and externally	Different forms of VBM and methods complicate task
Powerful comparative tool – in terms of benchmarking competitive performance	Relatively disappointing at the subordinate business level because of the difficulty of forecasting value
Useful for resource allocation – better discrimination between value-creating and value-destroying investment	Managerial costs of implementation
Positive effect on financial performance – achieved through reductions in capital base	The degree of complexity in the calculation was a limitation
Powerful strategic tool	Difficult to translate the financial measures into operating customer measures
Regarded as very useful tool to help management focus upon value drivers	Technical measurement difficulties –such as the cost of capital
Helps create more shareholder value by getting more accountability for discrete business units	

6. Conclusion

In companies such as Lloyds TSB or Cadbury Schweppes, among others, VBM programmes have been credited with delivering exceptional value for shareholders. For example, Lloyds TSB doubled its shareholder value every three years after implementing VBM. Well-implemented VBM programmes typically deliver a 5-15 per cent increase in bottom-line results (Benson-Armer et al, 2004).

But value-based management is about more than the headline performance measures. It has been defined as "a holistic management approach that encompasses re-defined goals, re-designed organisational structures and systems, rejuvenated strategic and operational processes and even revamped human resource practices" (Haspeslagh et al, 2000). In other words, it is about comprehensive organisational change.

Although it can help maximise value, VBM is no simple panacea for superior performance. In reality, many companies successfully use different mechanisms to achieve the same goal. CIMA-sponsored research (Cooper, 2001) examining the gap between companies' stated objectives and their practices found that most have a "pick-and-mix" approach, irrespective of whether they see themselves as shareholder or stakeholder oriented.

The previously discussed example of Boots illustrates this. The current finance director has been quoted as saying that VBM seems to have led the company away from core retailing, which in turn produced poor results. In 2002, Boots decided to adopt a new approach which "blended cash-based valuation with accounting performance measures" (Dodd, 2004). These resulted in a better understanding of the risk and returns of a project and capital allocation back to the core retailing business. In other words, the company adopted a more contingent approach, which may epitomise the reality of management today.

Whichever approach to performance measurement a company adopts – and indeed whether it chooses to dilute the all-or-nothing VBM methodology – the basic principles remain fundamental. Managing for value starts off from the premise that equity capital has a cost and that a company only makes a profit after it has taken it into account. It serves as a reminder that capital is not difficult to obtain; it is readily available – but at a cost.

Value-based management thus places the interests of owners of companies back in the centre of decision-making. This in turn means those investors can rely on more than just the instruments of corporate governance to protect them from the possible conflicts of interest arising from the split between ownership and management.

In this way, managing for value has the potential to bring the two sides of the enterprise governance framework closer and join them in a more comprehensive approach to management.

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Writers:
Danka Starovic CIMA
Stuart Cooper Aston Business School
Matt Davis The Financial Training Company

Contact:
Danka.Starovic@cimaglobal.com

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The Chartered Institute of Management Accountants
26 Chapter Street
London SW1P 4NP
United Kingdom

T +44 (0)20 7663 5441
F +44 (0)20 8849 2262
E technical.services@cimaglobal.com
www.cimaglobal.com