

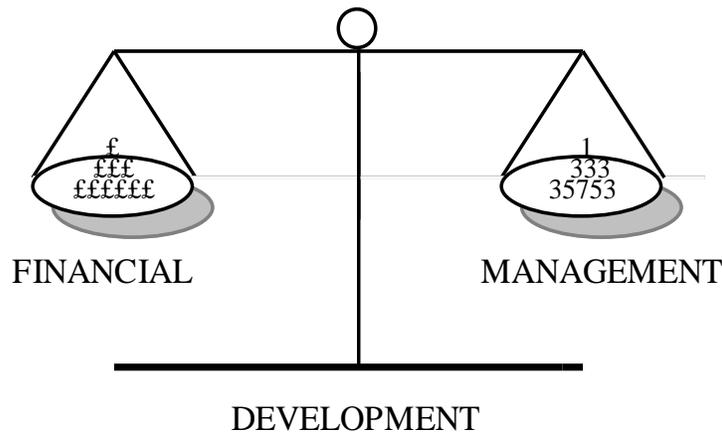
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Reviewing Financial Data

NO 132

CASHFLOW RETURN ON INVESTMENT AND TOTAL SHAREHOLDER RETURN



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT
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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CFROI AND TSR

CASHFLOW RETURN ON INVESTMENT AND TOTAL SHAREHOLDER RETURN

WHY USE CFROI AND TSR?

The traditional measure of business performance was the level of profit as disclosed in the Profit and Loss Account. As financial control systems developed it became obvious that managers also needed to consider the assets employed in the business because:

- a. The amount of profit does not indicate whether the return on funds invested is adequate.
- b. The profit figure can be artificially inflated at the expense of Balance Sheet e.g. Capitalisation of costs; allowing debtors too long a credit period; over production of stocks etc.

Thus organisations moved to measures of performance which related the Profit and Loss Account to the Balance Sheet i.e. Return on Capital Employed (or Return on Net Assets).

In recent years ROCE has been criticised because:

- a. Profit remained susceptible to manipulation
- b. Asset values in the Balance Sheet did not reflect their true value, merely their unexpired cost.
- c. Shareholders were not convinced by paper profits, they wanted cash.
- d. ROCE tends to show organisations who do not reinvest in new technology in too good a light.

WHAT ARE CFROI AND TSR

Cashflow Return on Investment is a measure of the cash produced from operating activities over the real value of the assets employed in producing it.

Profit is not cash! The main differences are:

Depreciation which is charged against profit but is not a cashflow
Movements in Working Capital (Debtors, Creditors, Stock)

Thus the cashflow is Operating Profit plus depreciation after allowing for movements in Working Capital (including tax)

The assets employed are valued at their current value. This could be market value (if available) or some form of depreciated replacement cost. The Net Book Value in the Balance Sheet is unlikely to be appropriate for fixed assets. Thus the Investment is the current value of Net Assets.

The end result CFROI should give an acceptable return sufficient to compensate for risk and to allow for reinvestment in the future.

Total Shareholder Return is a measure of shareholder wealth creation. Most shareholders want capital growth i.e. a higher share value as well as a stream of Dividends. Some major U.S. companies have never paid a dividend. The conventional measure of Earnings Per Share does not include any capital growth. The Price/Earnings Ratio is a useful measure but only of comparative, not absolute performance.

TSR seeks to include Capital growth in the income line. Thus the Total Return is the Gain in Market Value plus any cash receipts and it is compared with the Market Value at the start of the period.

For Business Units the Market Value may not be available and it is common to use the Net Present Value of the future cashflows to give an approximate market value.

THE USEFULNESS OF CFROI AND TSR

CFROI and TSR are both measures to be used to supplement ROCE as ways of

1. Comparing different businesses or business units.
2. Considering impacts of Strategic decisions.

They are both high level indicators and are not designed for tactical decisions.

Discounted cashflow techniques are preferable for Investment and Project Appraisal.

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).