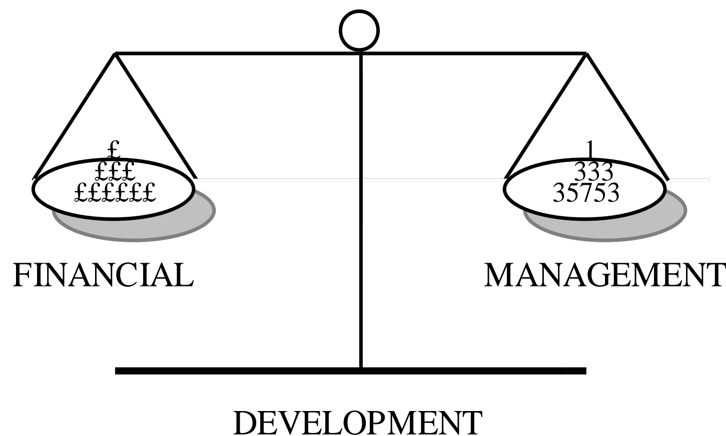
FINANCIAL MANAGEMENT DEVELOPMENT

DISCUSSION TOPICS

NO 802

STAKEHOLDER VALUE ADDED

The answer or the problem?



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.

STAKEHOLDER VALUE ADDED
THE ANSWER OR THE PROBLEM?

THE PROBLEM WITH FINANCIAL TARGETS

Conventional Financial Reporting was designed to provide a recording and control mechanism for economic activity. It provides objective evidence to shareholders and other interested parties on the money managed or mismanaged by business executives. It was never designed to provide a basis for valuation, since that is a subjective activity. Therefore the use of financial results as an indicator or business success is fraught with problems. This paper examines the dangers inherent in the use of Financial Targets in internal goal setting for management, and considers whether an approach based on Stakeholder, Shareholder or Economic Value Added would add value or merely add to the problem.

DEFICIENCIES IN FINANCIAL REPORTING

The three key financial reporting documents are the Profit and Loss Account, the Balance Sheet and the Cashflow Statement. All are based on historical cost accruals principles i.e. transactions are recorded in cash terms when they occur rather than when the cash changes hands. The Balance Sheet shows the Assets and Liabilities of the organisation. The Profit and Loss Account analyses the increase or decrease in the Net Assets over a period of time by identifying income and deducting costs to determine profit. The Cashflow Statement does the same for cash balances by analysing the cash inflows and outflows to determine the net movement.

Bookkeeping as a recording system has changed little since it was documented by the Franciscan Monk Fr. Luca Pacioli in 1494 as “all the rules a good merchant needs”. It allows for the systematic identification of physical and financial assets and liabilities. It records past cash inflows and outflows or accrues their equivalent. There is no need for valuation, estimates or subjectivity - nor any provision to do so. If there is any doubt over the cash value e.g. a provision for possible bad debts - this will be based on a statistical analysis on a basis consistent with previous practice. Accountants know “the cost of everything and the value of nothing” because that is their function.

Unfortunately the absence of values for intangibles - items which have not been explicitly paid for - hinders the use of accounting documents for management decision making purposes. Taking each of the key financial statements in turn, their deficiencies can be highlighted.

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The Balance Sheet lacks the Spark of Life

The value of assets in the Balance Sheet ignores the value arising from a dynamic integrated business. It shows the cost of assets which have been explicitly paid for, but ignores assets which have been acquired “for free”.

“People are our biggest asset” is a common phrase. A glance at the Balance Sheet will show that the value of these same employees is precisely, truly and fairly recorded at..... zero. Arguably the second biggest asset for most organisations is their brand name, image, call it what you will.....I prefer “Goodwill”. A learned Judge described Goodwill as “the likelihood that customers will revert to the existing place of business”. It encompasses customer/supplier/employee relationships and includes knowledge both technical (patents etc.) and practical (Fred works in the Sales Department). Again the Balance Sheet frequently shows this value to be zero. Thus the value of supplier relationships, technical know-how, the knowledge of the business are all deemed valueless.

Even for those assets where a value is shown there is an underlying assumption regarding their use which can be misleading. Under normal accounting conventions if property is revalued it is shown on the basis that it continues in its current use. There is no indication of its value if sold for a different purpose. Thus the Triang factory bought by Slater Walker in the 70’s was worth little as a factory - but the site was worth much more as housing land. This is a fact which those responsible for Privatisation in the UK Government appear to have forgotten, because they have no Balance Sheet (succeeding Governments exploited this failing further through Private Finance Initiatives or "Fraud on the Taxpayer" as the NHS are now discovering.

In many industries, particularly those which are people or knowledge based, the true value of the organisation is worth many times the value of the dead assets as shown in the Balance Sheet. Zeneca had a stock market value of £24bn when it merged with Astra, 10 times the value of £2.4bn which was the value of the net assets in the Balance Sheet.

The Profit and Loss Account fails to account

The basis of the true value of assets in the Balance Sheet leads to an absence of any cost for their use. No account is taken of using up Goodwill e.g. cutting wages will give short term profit but destroy employee value; completely if they leave, partially if they stay but are discontented. Even worse, investment in Goodwill is shown as a cost. Training costs, Research costs, Marketing costs are all charged as incurred and yet they represent investment for the future. Income may be high because prices are too high and Customer goodwill is rapidly expiring.

Cashflow is Unreliable

In business, there are times to invest and times to reap rewards. Frequently investment is necessary to improve poor results when times are difficult. When times are good there is less need to invest. Attempts to produce the even cashflow, beloved by financial commentators, will result in the opposite.

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FINANCIAL TARGETS ARE DANGEROUS

Return on Capital Employed expresses profit as a percentage of Capital Employed (or the value of the Net Assets for those who recall that the Balance Sheet Balances). Based on the above it is unlikely that it will be a reliable indicator of business performance, which is why Shareholder Value and Economic Value Added indicators have been invented. At this point it is worthy of note that since ROCE can be improved by reducing the value of assets in the Balance Sheet perhaps the best policy is to cease any capital investment and allow the existing assets to depreciate in value. British......Coal, Docks, Leyland, Rail, Steel etc. showed the results of such a policy.

Profit and Cash can be manipulated by increasing or decreasing discretionary spending on training, marketing, research, stock items written off etc. etc. The public sector is riddled with the problem of "spending up to budget" in March; normally on tyres, stationery, computer consumables and the like. (The obvious solution of allowing carry forward of surpluses has yet to occur to UK Government PLC). However, it must be noted that this is not a problem confined to the Public Sector. I know of one Director of Finance who was reduced to counting the contents of the Stationery Cupboard to provide additional value to hit a profit target.

ROCE is widely used as an indicator of business performance and it is seriously flawed.

SHAREHOLDER VALUE TO THE RESCUE

Those responsible for investing in companies have long since recognised the problem. The solution for Quoted companies is simple. Take the Market Value of the Company at the Year End, deduct the Market Value at the start of the Year and you have the increase in Shareholder Value. Add any Dividends paid and you have Total Shareholder Return. Express this amount as a percentage of the Opening Market Value and you have a "proper" Return on Investment.

In a perfect world, with perfect knowledge this would be a true reflection of management's activity. However, we live in an imperfect world and it would be hard to blame the Directors of a company whose share value has fallen because of a recession, or because their industry falls out of favour when a competitor does badly, or their company falls out of favour when a competitor does well (a Catch 22 situation) or because money has moved abroad because markets or exchange rates are better elsewhere.

Although Shareholder Value is a useful tool it cannot separate external causes of value changes from those due to management action. Thus Economic Value Added was born. This looks at the value invested in a company (the capital) and charges for it at an appropriate rate. Simple versions charge for the Capital shown as Shareholder's Funds in the Balance Sheet. These suffer from the same deficiencies as ROCE. Better versions take the Share Value i.e. Market Capitalisation and charge for its use at a rate that reflects risk.

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A simple example using Zeneca's market capitalisation of £24bn may help. A shareholder in 1998 could say that with Bank Rate at 7.5% it was reasonable to want a return which includes a premium for risk, say an additional 2.5% (probably too low but the numbers are easier!). Thus unless Zeneca produces post tax profits of £2.4bn (i.e. 10% of £24bn) it has not added Economic Value. Zeneca's profits in 1997 were £0.7bn. The management might defend themselves by saying "yes, but the Share Price will have increased". At this point we are back to the problem of the Share Price movement not necessarily being the result of the action of Zeneca's management. However, to use EVA on the net assets in the Balance Sheet for Zeneca i.e. £2.4bn and state that the target is to produce a return of more than 10% of that, i.e. £0.24bn, is definitely wrong. Its current market capitalisation (2012) is £38bn so it has increased in value by £14bn in 14 years. As this is an increase of about 4% pa it has probably just about matched inflation!

SUMMARY

1. Historic Cost Accounting is good for control and not so good for performance measurement.

2. Conventional Balance Sheets exclude many valuable assets and therefore conventional Profit and Loss Accounts exclude a charge for their use, but conversely include investment in those assets as costs.

3. Financial Ratios based on "Profit" and "Net Assets" e.g. ROCE, ROS (Return on Sales) etc. are therefore potentially misleading.

4. Attempts to value an organisation using Market Value fail because "Beauty is in the eye of the beholder". Thus if the eye is distracted, beauty becomes relative. Prices move because of external factors.

IS THERE AN ANSWER?

There is no perfect system of reporting performance but ROCE is as good a start point as any. What any organisation should do is to identify their intangible assets and devise approaches to measure the causes of changes in value. It may not be necessary to identify the value itself. If it is easy to do so then fine. If not it is not essential.

For example, a mail company's reputation for delivering 1st Class Mail the next day is a valuable asset. As an accountant I could devise a model that valued a 10p premium over 2nd class (after appropriate costs) as a stream of net income over say 10 years (the time it would take to build such a reputation). Say, this came to 2p. I can then value 2p times 7 billion items for 10 years and come to a figure of approximately £1.5 billion as the value of the brand name for first class. I could build in assumptions on the impact of losing the whole price or just the premium. I could employ a team of statisticians to value and revalue this figure on a monthly basis. As a rational manager I wouldn't.

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I would adopt a measure which concentrated on the cause of any loss of reputation e.g. the percentage delivered on time. Set an appropriate target (not an unachievable 100%) and then monitor performance. As an informed, rational manager I would realise that someone has already done this; hence the Quality of Service Statistics, which are publicly quoted and used by the Postal Services watchdog to assess Royal Mail's performance.

Benchmarking and outside advice are helpful, but every organisation needs to develop its own “Balanced Scorecard”. Examples are:

Employee Satisfaction	-	Staff Turnover
Customer Satisfaction	-	Complaints
Innovation	-	New Products Launched
Employee Skills	-	Training days (skills acquired)

The management reporting system then needs to incorporate these. Thus comments such as “Profit is down because we spent extra on solving the cause of complaint” will be rewarded and “Profits are up because we cancelled all training” will be penalised.

If it is helpful the above could be given an approximate monetary value: e.g. a one point improvement in customer satisfaction leads to additional sales of £10 million and therefore profit of £1 million; or a one percent reduction in staff turnover saves recruitment, induction and training costs of £2 million.

This is Management Accounting at its best and a good illustration of how to “Embed Finance in the Business”. It adds value by assisting decision making; it uses approximations; it helps the direction (in both senses of the word) of the business. Stakeholder Value and Economic Value Added are concepts which can be applied at the macro, Board level. For most managerial decision makers the principles are valid but their application at the micro levels may involve a discontinuity. Whilst it is difficult to directly connect Quality of Service with sales volume and income, it is reasonable to assume there is a connection and act appropriately.

ROCE, ROS and similar ratios are useful but not perfect as guides to management decision making. They are appropriate as indicators of past performance and will probably improve if action is taken to enhance the value of the business. However they are high level, long term indicators and can therefore be misleading in the short term. I can improve return on sales as a percentage by refusing to supply all but the highest yielding products. This will almost certainly result in lower profit for the organisation. Any spending on training, marketing etc. in March will be likely to adversely affect all the targets. A move to Stakeholder Value or Economic Value Added concepts will not necessarily help the situation. A review of the real i.e. including intangible assets of the business, and the creation of a Balanced Scorecard for each operating unit is more likely to produce tangible improvements in Business Performance.

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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).

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