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Shareholder Value Reviews

BY BARTLEY J. MADDEN

In theory, the primary fiduciary responsibility of a firm's board of directors is to ensure that shareholder value is maximized over the long term. This wealth-creation process requires that management promote a long-term culture of ethical behavior both internal and external to the firm.

The Challenges

In practice, in varying degrees around the globe, boards have been accused of putting the interests of management ahead of the interests of shareholders, most notably in failing to adequately tie management's compensation to wealth creation.

Management and boards often adopt a decision-making framework that assumes shareholder value is best handled by "managing" in a way that meets/exceeds market expectations for short-term accounting earnings. To no surprise, managements of firms that have gone private invariably extol the benefit of being freed from the pressure to meet short-term earnings targets. They say this has led to more economically sound, long-term investments.

Meanwhile, at an accelerating rate, wealth creation has become tied to investments in the *intangible assets* that drive innovation. Corporations tend to agree with accounting rule makers about the need to evolve a new accounting system attuned to intangibles as assets. But, at the present time, the role of corporations in this process isn't clear.

A Single Solution

An article of mine in the Fall/Winter 2007 issue of the *Journal of Applied Finance*, "Guidepost to Wealth Creation: Value-Relevant Track Records," lays out a market-based, nonregulatory solution to the above dilemmas. A market-based mechanism that addresses corporate governance has the inherent advantage that it *evolves over time due to the continuous learning and adaptation it promotes*. In this spirit, institutional money managers could require of the boards of publicly traded firms an explicit demonstration of how they are fulfilling their fiduciary responsibility. A Shareholder Value Review (SVR) in the annual report is an ideal way to meet this objective.

There are three steps in constructing an SVR:

- A description of the valuation framework used to guide management decision making.
- Value-relevant track records that chart the wealth-creation/-dissipation performance for each of the firm's major business units.
- A description of each business unit's strategy and the related rationale for planned reinvestment.

SVRs address the bedrock problem that management and boards have implicitly defined value creation as meeting or exceeding quarterly earnings expectations. But this myopic valuation framework, focused on maximizing short-term accounting earnings, is deeply flawed.

There are ways to boost accounting earnings in the near term that are detrimental to long-term shareholders. For example, currently in the U.S., intangible investments such as research and development (R&D) expenditures are expensed when they should be treated as assets. Therefore, substantially reducing R&D boosts near-term earnings but is likely to seriously degrade a firm's long-term competitiveness. As for intangibles, the main point is that SVRs engage a company in the measurement and management of intangibles in a value-relevant, economic way.

Making Capitalism Work Even Better

Over the long term, the general public greatly benefits from wealth created by a free-market, capitalistic society in which corporations play a central role. On the one hand, the benefits of the process of innovation and reallocation of resources to more efficient uses tend to be invisible to the general public.

On the other hand, there are those highly visible, enormous CEO paychecks that are often unconnected to wealth creation. There also exists the popular, but wrong-headed, perception that to understand shareholder value (the stock market), you need a short-term lens. This view incorrectly emphasizes that value is created by managements' closing plants and firing employees. In fact, the good news is that the most successful companies prove the opposite—that customers, employees, and shareholders have long-term, mutual interests.

It is to everyone's advantage, including corporations, that the *wealth-creation process be widely understood and dealt with in a transparent way* so that free-market capitalism can function even better and earn more respect from the customers it serves.

If implemented, SVRs would put corporations on a new evolutionary path that achieves this end. Potential benefits include:

- An SVR would expedite management and board learning about how firms' economic performance connects to shareholder value.
- An SVR would expand the role of CFOs and their staffs as they construct value-relevant track record displays and organize related supplemental disclosures that provide insights about intangible assets and other important issues.
- There would be a more productive dialogue among boards, management, and investors that would lead to quicker and better decisions that maximize shareholder value.
- Management would have a greater willingness to commit to long-term, value-creating projects that may reduce near-term earnings and to explain these decisions to shareholders in the SVR.
- Accounting rule makers would pay more attention to the experiences of primary users of accounting data, and this would align the accounting system more closely with the wealth-creation process.

Knowledgeable investors rely on a *firm's competitive life-cycle framework* for understanding levels and changes in stock prices over the long term.

Evolutionary Path

Note that SVRs put the spotlight on important technical issues in measuring wealth creation, but they don't mandate any specific way of doing them. The idea is to evolve best practice over time and be free to experiment. Experimentation is definitely warranted for handling intangibles.

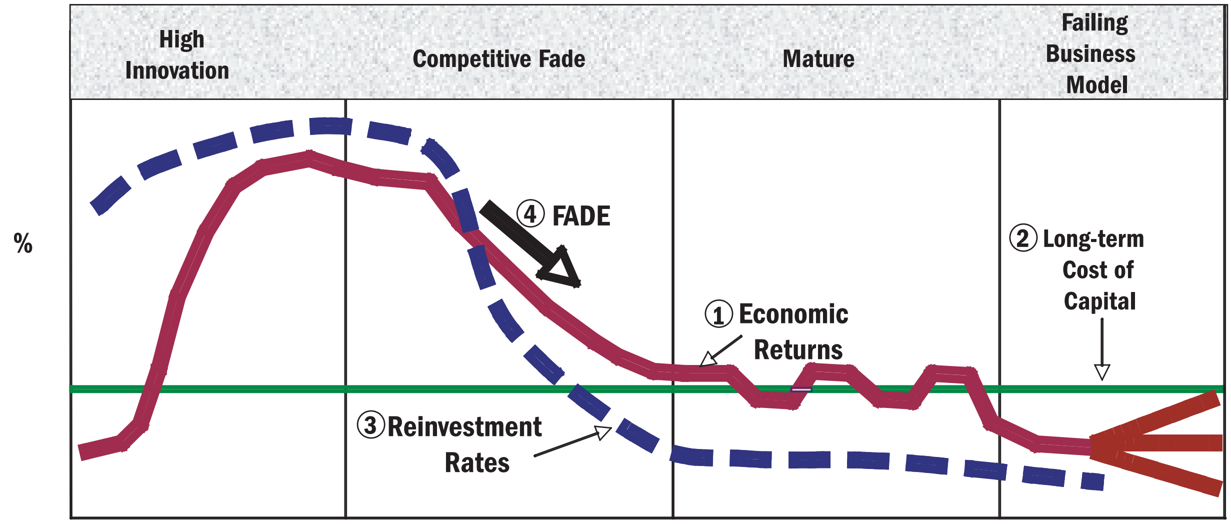
Management would probably follow the path taken by institutional investors who have been steadily improving their valuation skills for decades. Knowledgeable investors rely on a *firm's competitive life-cycle framework* for understanding levels and changes in stock prices over the long term.

All conceptually sound discounted cash flow valuation models are rooted in the four life-cycle variables of economic returns, cost of capital, reinvestment rates, and competitive fade (see Figure 1 for the life-cycle framework). Over the long term, because of competition, economic returns tend to fade toward the cost of capital, and reinvestment rates tend to fade to slower rates as firms mature.

For a completed project, the economic return is the achieved internal rate of return based on cash outflows and cash inflows. For ongoing firms and business units, economic returns are typically approximated as return on net assets (RONA), cash flow return on investments (CFROI®), and the like. Also, the life-cycle variables are sometimes compressed into a single Economic Value Added (EVA®) metric.

It is highly likely that management, with the board's concurrence, would construct business unit track records similar to the life-cycle display in Figure 1, which has earned wide acceptance and use by portfolio

Figure 1: Firm's Competitive Life Cycle



managers. This type of track record display could be the common wealth-creation template and language that would provide the opportunity to create what is now missing—a substantive dialogue between management and the capital markets.

Life-cycle terminology would be the antidote to the pervasive and too *simplistic* focus on a quarterly earnings number. The life-cycle framework helps address the *complex* managerial tasks involved with achieving both satisfactory near-term operating cash flows and securing long-term competitive advantage.

Over time, value-relevant track records would help boards in their oversight of key management decisions. That is, management decisions would be consistent with the following three wealth-creation principles:

- Avoid investments in businesses likely to earn economic returns below the cost of capital.
- Reinvest in businesses likely to earn economic returns above the cost of capital.
- Develop strategies that can realistically produce favorable long-term fade rates.

SVRs are designed to do exactly these things, thereby enabling boards to perform to the ultimate benefit of shareholders.

Shareholder Value Reviews

For boards to serve shareholders better, SVRs need to become a standard part of every corporate annual report. How could this be done? Institutional shareholders could lead corporate boards to produce SVRs in order to *demonstrate* the steps taken to ensure that management is on a path of maximizing shareholder value.

In addition, on a voluntary basis, boards and managements could conclude that SVRs make eminent sense because SVRs benefit shareholders, society, and corporations themselves. This change is needed because, in the end, power without effective accountability is unsustainable. ■

Bart Madden is an independent researcher in Naperville, Ill. Additional material about the points covered in this article is contained in his monograph, Maximizing Shareholder Value And The Greater Good, *which can be downloaded from his website at www.LearningWhatWorks.com. You can reach Bart at bartmadden@yahoo.com.*

[PERSPECTIVES] *cont'd from p. 6*

is a significant and time-consuming commitment. But it's clear that it pays lasting dividends, and sometimes it isn't as hard as it may appear. An article in the Winter 2008 issue of *Management Accounting Quarterly* ("MBA, CMA, and CPA: Natural Partners in the 150-Hour Requirement," available at www.imanet.org/publications_maq_back_issues_winter2008.asp) details a rigorous study regimen that combines college course work with exam preparation materials to enable students to complete both their CMA and CPA examinations within a year of earning their MBA. Now that's planning ahead.

I welcome your comments at fschea@imanet.org. ■