Controversies over the Value Creation Process at the Level of Enterprises

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Abstract: *The main goal for any enterprise is to create value. In the specialized literature scholars talk about the necessity of management to create value for shareholders. In this paper we shall try to point out the importance of value creation both for shareholders as well as for other parties involved. The instruments used by the classical VBM system are based only on financial and accounting data while other information such as that on the market, customers, suppliers or employees being totally ignored. In our opinion, a management system based on value creation should take into account all data coming from within the enterprise as well as from the outside. Also, those variables that the enterprise can influence to create value must be identified too. This fact has pointed out the necessity to reconsider the VBM system and to sort out some aspects which have not been sufficiently debated on by the specialized literature.*

Keywords: value creation, Value Based Management, stakeholders, shareholders, key value drivers.

JEL Classification: G00, M00

1. Introduction

The major goal of any enterprise is to reward its shareholders, in other words to create wealth for them. Hence, creating value for shareholders has become the enterprises' reason for their existence. Due to the development of analysis techniques based on EVA, cash-flow, MVA etc., managers benefit from a wide range of instruments allowing them to identify in the business they are running those elements that create or destroy value for shareholders. At the same time, these elements help to identify new value-creation strategies.

But over the course of time, it has been noticed that the techniques and instruments promoted by the VBM system are not sufficient to create wealth for shareholders. Just like other value-creation models (Total Quality Management, Reengineering), the instruments used by the VBM system are based only on financial and accounting data while other information such as that on the market, customers, suppliers or employees being totally ignored. This fact has pointed out the necessity to find new instruments that can satisfy the interests of all parties involved. Also, the classical VBM system is applied by top managers and they are regarded as the only ones who create value through their decisions, which we do not fully agree on.

This work was co-financed from the European Social Fund through Sectoral Operational Program Human Resources Development 2007-2013, project number POSDRU/159/1.5/S/140863, Competitive Researchers in Europe in the Field of Humanities and Socio-Economic Sciences. A Multi-regional Research Network

From our perspective a management system based on the creation of value should take into account all data coming both from within as well as outside the enterprise.

At the same time we find it necessary that all employees be involved in that all persons contributing to the creation of value within the enterprise are to be motivated and rewarded.

Another problem of the classical VBM system resides in the fact that it focuses only on the creation of value for shareholders. From our point of view a modern management system based on the creation of value must comply with the satisfaction of all parties involved: employees, customers, suppliers, state etc. We consider that customers play a crucial role in the existence of an enterprise as it would not exist without them and for this reason the management system based on value creation should focus more on the customers' needs. The VBM system recommended by us does not imply the use of new instruments for the creation of value but it involves a reconsideration of the management philosophy by reinventing the way in which value can be created for the enterprise.

The success of a VBM system does not reside in the instrument used but in the way its components are combined to generate an additional value as a result of the synergetic effect. We consider that the main objective of the VBM system is to concentrate and coordinate the enterprise's all amount of resources for those activities that generate value both for shareholders as well as for the other parties involved such as customers, employees, suppliers, creditors, state, environment etc.

2. Introspection in the specialized literature

The VBM system has been defined in various ways in the course of time by specialists in the field depending on the goals at stake and the instruments used. The VBM is a management system whose aim is to measure and sustain the process of value creation within the enterprise.

In order to understand what VBM is and what it implies, it is necessary to find out the opinion of other authors on the VBM system.

The VBM is defined by business dictionary as "Identification and husbandry of factors that create or destroy value (such as assets, policies, and process) to maximize shareholder value."

Marsh (1999) considers that Value-based management is oriented to create superior long-term value for shareholders and its main purpose is to manage a business. Also the rewards are measured in terms of enhanced share price performance and dividend growth.

Condon and Goldstein (1998) define Value-based Management like "a management philosophy which uses analytical tools and processes to focus an organization on the single objective of creating shareholder value."

According to Christopher and Ryals (1999) "Value-based Management is a new way for managing, focused on the creation of real value not paper profits. Real value is created when a company makes returns that fully compensate investors for the total costs involved in the investment, plus a premium that more than compensates for the additional risk incurred."

In the opinion of Koller (1994) „The value of a company is determined by its discounted future cash flows. Value is created only when companies invest capital at returns that exceed the cost of that capital."

As it can be seen, all definitions are based on one principle: creating value for shareholders.

The only definition identified by us, close to what management should be is the following: “An approach to management whereby the company’s overall aspirations, analytical techniques and management processes are aligned to help the company maximize its value by focusing management decision making on the key drivers of shareholder value.” (Institute of management accountants, 1997)

From the above definitions we can note the main characteristics of the VBM system:

- VBM is a management that involves using the enterprise’s resources to achieve main objectives;
- VBM is a process lieing at the basis of all decisions made within the enterprise
- VBM aims mostly to satisfy shareholders by creating wealth.

One of the most important predecessors of VBM, Alfred Rappaport introduced in his 1997 book called “Creating Shareholder Value: A Guide for Managers and Investors” a series of new principles regarding the creation of value, such as the use of planning in the management process, the use of specific instruments to measure the enterprise’s performances or the identification of signals offered by the capital market, but he also analyzed the effects generated by company buyouts or company mergers. The author aimed at treating the concept of shareholder value creation from the perspective of the factors behind the creation of value, such as the cost of capital, the operating profit margins or sales-growth rates, trying to have a vision different from the other researchers who placed value on indicators such as the price-to earnings ratios or the return on investment. In his research, Alfred Rappaport has a more philosophical approach, trying to find answers to s series of questions such as: “Which is the optimum performance level that needs to be reached so that shareholders can be satisfied?”, “Which is the most appropriate instrument to measure wealth created within the enterprise?”, Which should be the relationship between rewards and performance?

The main critique brought to Rappaport’s research lies in the fact that he did not create a proper management system that could help enterprises implement and develop the process of value creation, and on the contrary, he focused more on the theoretical aspects rather than the practical implementation of the VBM system.

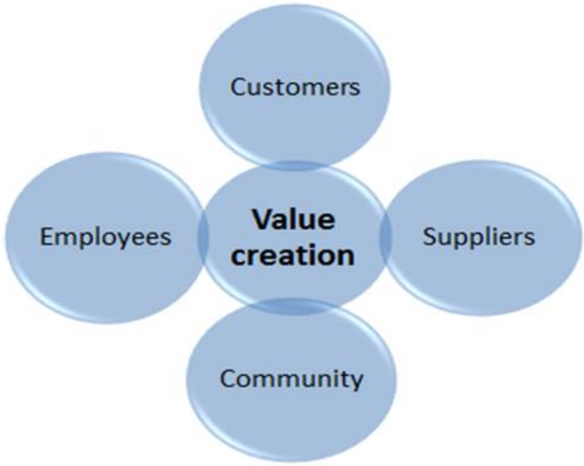
A new vision on the VBM system was offered by researchers Kaplan and Norton who appreciated that any enterprise could and should have at the same time a single strategy oriented towards value creation. Unlike Alfred Rappaport, they placed emphasis especially on the VBM’s implementation part, creating a successful instrument, namely the Balanced Scorecard. This instrument could be used both at the levl of the organization as well as at individual level. The Balanced Scorecard played a role in guiding easily the individual or the organization to achieve set standards in a brief period of time and with a minimum effort. The only disadvantage was that it did not give pertinent information on the creation of value.

Another researcher, Peter Doyle, tried to treat the VBM concept differently from the other recognized authors in the field. He place emphasis especially on marketing, considering the enterprise’s marketing strategy as the one which gives birth to the premises of shareholder value creation. He offered a series of models of marketing strategies that company managers could use in order to create value for shareholders.

Other researchers such as Ameels, Bruggeman and Scheipers define value-based management “as an integrated management control system that measures, encourages and supports the creation of net worth” (Ameels, Bruggeman and Scheipers, 2002).

The authors tried to identify the effects generated by the implementation of the VBM system at the level of enterprises in terms of fulfilling the main objectives. They underlined the fact that current practices of value based management depend mainly on data and information coming from the accounting and finance department and that accountants and auditors play a significant role. They considered that managers oriented towards the creation of value must comply with the financial and accounting rules and practices in order to succeed in fulfilling their goals. The main problem with the VBM system is that companies with highly hierarchized organizational structures have the tendency to exert pressures on the accounting and finance department in order to reach certain indicators that from an accounting perspective reflect the creation of value for shareholders.

Fig. 1. The model Briggs&Stratton: Value Based Management



Source: Adapted from Stern, J.M. (2001)

Researchers Ryan and Trahan have developed a new concept of the VBM system in terms of shareholder value creation. They considered that the motivation of employees and the control function exerted by managers play an important role in the process of value creation. Hence, they have come to the conclusion that there is a positive correlation between the employees' level of performance and the value created for shareholders.

There are many models of value creation and one of them is the model elaborated by Briggs & Stratton shown in **Fig. 1.** (J.M. Stern, 2001, p.55).

Companies must understand that in order to create the maximum of value wanted by shareholders, it is necessary for their management to interact with all parties involved so that expectations regarding value creation can be satisfied.

The Briggs & Stratton model in **Fig. 1.** presents the main value-creating paths. A first path is the one of employees as they can be involved in developing new products and services but they can also be involved in their professional development. The employees are responsible with the operational activity of the company. Their contribution is higher than the physical or intellectual effort. Both ideas, motivation and their very presence define the character of the business in the long run. From this point of view, employees form the intellectual capital and they are an extremely important asset for the good functioning of organizations. Nevertheless, in many companies, the intellectual capital is underrated from the point of view of value creation and in this respect human resources are valued very little. Hence, a first challenge for the company managers is to create favorable conditions for the development of their employees so that the latter's own interests can be reflected into the capacity to create value.

The model developed by Briggs & Stratton (**Fig. 1.)** presents also the path of customer value creation. From this perspective, companies must focus on the sale process and especially on the marketing activity.

Understanding consumers and their behavior is very important in the process of value creation. The buyers make decisions based on a multitude of factors that go beyond the notion of price and the products' characteristics. The concept of branding underlines very well these aspects. Hence, enterprises have learned that it is vital to inquire into the customers' opinion about the products and services offered and they have started to pay more and more attention to the process of communicating with customers. A company directed towards value creation will try to use any possibility of communication with its customers and will be attentive to the packing material used, quality of materials used but also to the messages transmitted via advertising.

Another path refers to developing and initiating new relations with suppliers and so the company needs to develop its logistic and technical potential. Suppliers are an important part in the value chain of an enterprise. The relation between suppliers and the enterprise must not be regarded as a simple exchange of resources. Suppliers can provide technological innovations through their materials while the company can come up with suggestions, propositions and knowledge by using the suppliers' products. In a company oriented towards value creation it is very important to choose those suppliers that offer certain social advantages and who comply with quality standards.

Also in this model, it is underlined the fact that in order to create value, a company must contribute as well to the development of the society where it is operating.

As it can be noticed, most of the authors have tried to create new VBM systems to produce value for shareholders. They have laid accent especially on the practical side and in this respect, they've created a series of instruments to facilitate the process. Most of the VBM systems are based on financial data and their comply with accounting rules and procedures.

From our point of view, there have been ignored a series of important aspects with respect to the creation of a value-based management system. Thus, we consider that managers oriented towards value creation must pay more attention to information on employees both in terms of motivating them but also in terms of rewarding them for their performances. Also, an important role in elaborating a company's strategy is the consideration of all information coming both from the inside and the outside of the company. Thus, a VBM system must not ignore the information on customers or suppliers, because they are key persons for the success of the business.

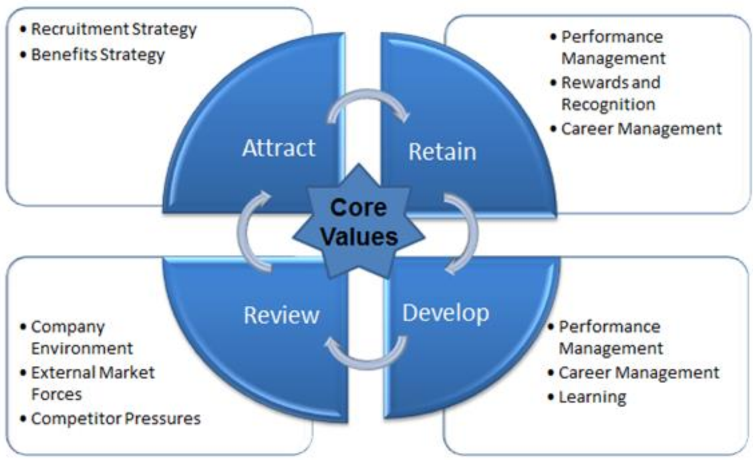
WE consider that in order to create value for shareholders, companies must aim especially at creating value for all parties involved. A company capable of satisfying its suppliers, customers, employees and the community, will be able to satisfy its shareholders too. Many times, companies which create shareholder value are limited to this aspect, inoring the other parties involved. This fact can affect the development of the company in the long run and even destroy the wealth of its shareholders.

3. A new vision on the VBM system

In our opinion, in order to create an effective VBM system, first of all, it is necessary to change the mentality of the company managers. The latter should not focus on the methodology, that is, on the identification of instruments for the measuring of performances, but they should aim at changing or influencing the organizational culture of the company so that value can be created for all parties involved and not only for shareholders. A manager applying the VBM system uses the process of value creation as an instrument for measuring performances but also as an instrument for making decisions.

If the VBM system is implemented correctly, then managers from all hierarchical levels can be informed adequately and they will be stimulated to make the best decisions on the value creation process. Hence, the manager of a department will receive information that will help him measure and compare the value generated by different strategies and eventually he will be stimulated to choose the strategy that generates the highest value. Moreover, decisions made by managers must be in accordance with the company's short, medium and long-term objectives regarding value creation.

Fig. 2. Value creation process



Source: Adapted from http://www.stixis.com/data/about/careers.php

As it can be observed in **Fig. 2.,** the process of value creation must start from a series of basic values. This process can be defined through for paths:

- the first path is **"Attract".** This involves identifying a strategy and take into consideration the advantages and disadvantages generated by this strategy;
- the second path is **"Retain".** It refers to practicing a performance management, recognizing and rewarding merits as well as developing the premises for a successful career in management;
- the third path is "**Develop"**. The system must develop the principles of the management oriented towards performance using innovation as the main driving force;
- the forth path is "**Review"**. It involves knowing the external environment of the enterprise, identifying factors that can affect the enterprise but also taking into consideration actions taken by the competition.

The VBM needs first of all, a change in the attitude of the enterprise's decision-makers. For a VBM manager, maximizing the value of the enterprise is the most important goal and the decisions he makes must lead to the accomplishment of this goal. These managers must also identify those variables that lead to the creation of value. They need to see if the enterprise's resources are distributed according to the strategic plan and intervene through corrective decisions when the situation asks for it in order not to compromise the whole strategy.

A very important role in the process of value creation for the enterprise is played also by the processes and systems of management that involve employees and managers in fulfilling the pre-set goals. From this point of view, it is very important that the process of communication should be in close connection with the process of value creation so that employees will know clearly their assigned tasks and managers can receive useful information on the fulfillment of their tasks.

The VBM involves firstly establishing as main objective the creation of value for the enterprise. As we could see in the first part of this paper, the classical indicators for measuring performances, like earnings or earnings growth, are not the most appropriate ones to measure the newly created value by the enterprise.

We consider that before we establish which are the most appropriate indicators for measuring value creation it is important to mention that an enterprise should take into account other aspects that lead to the creation of value. For instance, there is a series of non-financial objectives that can affect positively or negatively the process of value creation. These non-financial objectives refer, for instance, to customer satisfaction, employee satisfaction or even processes such as product innovation. The most prestigious companies are not limited only to value creation but their purpose is to attain several non-financial goals because hence a higher value can be created even if it is not always measured in financial and accounting terms.

Another important aspect is to adjust the VBM goals in accordance with both the hierarchical level of managers and the field of activity. For instance, the goal of the finance department's manager regarding the creation of value should be expressed in financial and accounting terms while the goal of the sale department's manager regarding value creation should be expressed in terms such as the market share, after-sales services, quality etc. On the other hand, the goal of a head of division should be translated into terms such as fabrication cycle, unitary cost, fixed costs, variable costs etc. The goal on the value creation shall be expressed differently, that is, also depending on the field of activity. For instance, within the human resources department, the goal on the creation of value shall be expressed in terms such as productivity, qualification level, employee satisfaction level etc., while the research and development department shall use terms such as innovation, number of newly created products, quality etc.

One of the most important aspects for the creation of a healthy VBM system is to identify and in particular to understand correctly the elements that generate value for an enterprise. They are called key value drivers. An enterprise cannot create value out of nothing but it must act on the things that lead to the creation of value such as cost of capital, customer satisfaction, employee satisfaction etc. Hence, we can define the concept of "value driver" as a variable on which the enterprise can act in order to create value. The managers must identify those value drivers with the highest impact on the process of value creation as well as coordinate the employees who can contribute to the realization of the value drivers. The identification process of the value drivers is not simple at all because managers need to think in other terms than the financial ones.

4. Conclusions

As it results from the above, we can see that a reconsideration of the VBM system is necessary in that the managers need to change their mentality with respect to the process of shareholder value creation. They should not focus on the methodology, that is, to identify the instruments for measuring performance, but they should aim at how they could change or influence the organizational culture of the enterprise and employees so that value can be created for all parties involved.

On the other hand, managers oriented towards the creation of value must focus and direct the enterprise's all resources to those activities capable of generating value for both shareholders as well as for the other parties involved.

Also, it is very important for the company to take into account other aspects that lead to the creation of value such as non-financial objectives that can affect positively or negatively the process of value creation. At the same time, the goals within the VBM system must be adjusted depending on the hierarchical level of the managers but also in accordance with the field of activity.

A management system based on the creation of value should take into consideration all information coming both from the inside as well as from the outside of the company. At the same time, it is necessary to involve all employees in that all those contributing to the creation of value within the enterprise, must be stimulated and rewarded.

An last but not least, the success of a VBM system resides also in its key value drivers. Hence, managers must identify those variables that they can influence in order to generate surplus value.

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