Management Quarterly

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A regular report on the practical application of current business techniques

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VALUE MANAGEMENT

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Management Quarterly

The aim of **Management Quarterly** is to provide Faculty members with a detailed review of a topical management theme, offering a range of articles which explore that theme and illustrate the practical application of management techniques.

This builds on the strategy of the first four years of the publication, when it followed some of the major threads of an MBA syllabus. Over this period, these articles have built up into a comprehensive overview of the knowledge needed to operate a successful business. The reader is enabled to understand current issues and debates in these areas, and distinguish core ideas from current fads.

Each part of **Management Quarterly** is self-standing, including useful references and details of further reading. Writers are selected from leading business schools, consultancies and professional institutions. Experts in each field explain and discuss the relevance, practicality and usefulness of key new concepts and ideas, thus enabling the senior executive to keep fully up to date.

This issue of **Management Quarterly** is edited by Carolyn White, who has worked for the EIU, FT, and on research programmes at Cranfield School of Management.

Comments and suggestions should be addressed to Chris Jackson BA FCA, Head of Faculty, telephone 020 7920 8486, e-mail chris.jackson@icaew.co.uk, or write to the Faculty at:

The Faculty of Finance and Management,
The Institute of Chartered Accountants in England and Wales,
Chartered Accountants' Hall,
PO Box 433,
Moorgate Place,
London EC2P 2BJ

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STRATEGY

MARKETING

The late Peter Doyle, who died of cancer on 30 March, was Professor of Marketing and Strategic Management at the University of Warwick Business School. The Faculty offers its deepest sympathy to his family. For a summary of his research and his many business and academic achievements, visit: www.wbs.ac.uk/news/special/doyle.cfm

HUMAN RESOURCES



FINANCE


IT

Putting VBM into practice

Over the past 50 years, value based management (VBM) has become the standard approach to running businesses across most of the developed world. More recently, the ease of cross-border investment, greater shareholder activism (especially among pension fund managers and proactive investors) and new regulations requiring fair and accurate reporting have all combined to increase the pressure on companies to improve returns to shareholders. Devising a VBM strategy and implementing it successfully, however, is far from easy. **Den Lackner** outlines the practical issues involved in journeying from theory to practice.

The objective of maximising shareholder returns has now become the primary criterion by which most large businesses judge their performance. Annual reports and market announcements regularly reinforce companies' commitments to shareholder value, profitable growth, and higher returns on capital, while the frequency of the term 'shareholder value' in major business publications has sky-rocketed over the past decade.

In companies which manage for value, all aspects of the business are fundamentally aligned to this primary objective, which forms the basis on which the whole business is run. However, true implementation of VBM across most organisations remains elusive. In many companies internal management processes, performance measurement and strategy development continue to work from different principles, and often at cross purposes.

Without a fundamental re-alignment between the company's objectives and the way it manages the business, a half-hearted VBM initiative risks either:

- simply becoming a theoretical, top-management agenda and target setting exercise, supported by a complicated valuation model built by consultants, but with no ownership in the organisation and no understanding by the line management;
- or, ending up as an accounting systems reshape, which produces a cumbersome and complicated set of reporting requirements which again, bear no relation to the way the business is run.

What is value based management ?

The basic principle underlying VBM is as old as the hills – the requirement to earn a positive return on capital. VBM therefore involves the continuous interplay between measurement and management.

> The basic principle underlying VBM is the requirement to earn a positive return on capital

From the management perspective, the means by which companies generate returns to shareholders are common to all businesses and include three characteristics:

- good products and services for which customers are willing to pay good money;
- a business model that works; and
- a strong management team to run and steer the business.

VBM provides top management with a framework for supporting decisions around strategy and structure. It also provides business operations with processes and tools for optimising basic components of their business model.

> VBM provides top management with a framework for supporting decisions

From the measurement perspective, all approaches to assessing equity value, at least those which involve a comprehensive management and measurement system, all share three basic components (see Figure 1, page 4):

- *single period metrics* – like economic profit or economic value added (EVA)[1], these measure how much value is generated after paying the two classes of capital providers, debt holders and shareholders;
- *a capital hurdle rate* – defining the required minimum return expected by capital providers; and

- *a total valuation framework* – which projects financial performance into the future to assess the total equity value of the company.

> Only an organisation which sustains a positive spread between what it buys and what its sells will create value

In contrast to pure accounting perspectives, VBM measures returns based on the spread between the profit which is generated and the full economic costs of capital associated with generating that profit (see Figure 2, below).

Whatever approach is used, there is a danger of focusing too much attention on refining the measurement of value creation delivered over single periods, and putting too little effort into creating a robust picture of future and sustainable value creation.

Understanding what drives value

If the definition of value is the ability to buy low and sell high over time, only an organisation which is able to sustain a positive spread between what it buys and what it sells will create value. This fundamental principle is less obvious than it appears because companies rarely know how much they are really paying to bring a product or service to market.

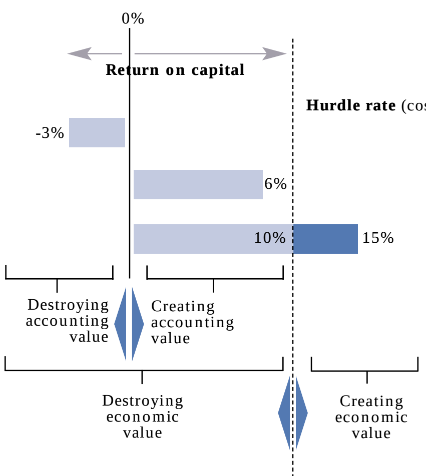
The first step in understanding what drives value in organisations therefore lies in understanding not just revenues, but also the fully loaded costs associated with each key segment. Here an activity based costing (ABC), or similar cost assessment exercise is an essential pre-requisite to understanding not just directly attributable costs of serving a particular customer segment or producing

Figure 1 The three basic components of measuring value

Single period metrics	Return ratio	**ROE** (return on equity)	**ROACE** (return on average capital employed)	**CFROI** (cash flow return on investment)	**ROA** (return on assests)	**ROE** (return on equity)
	Profit metric	Earnings	NOPAT (adjusted for capitalised R&D, etc)	EBITDA (adjusted for required capital	NOPAT	Earnings
	Value creation/ cash flow metric	**EP** (economic profit)	**EVA** (economic value added)	Cash flow/CVA (cash value added)	DCF (discounted cash flow)	ECF (equity cash flow or dividends)
Hurdle rate	Capital base	Shareholder equity	Average capital employed	Gross investment	Total capital (debt + equity)	Shareholder equity
	Hurdle rate	Cost of equity	WACC adjusted for tax	WACC adjusted for required capital replensihment	WACC	Cost of equity
Valuation framework	Valuation framework for determining equity value	Equity + PV (EP)	ACE + PV (EVA)	PV(CVA) - Debt	PV(DCF) - Debt	PV(ECF)

PV () = the present value of all future streams

Figure 2 VBM measures



Destroying or creating value?

Return on capital	Hurdle rate	Creating accounting value	Creating economic value
-3%	10%	-	-
0%	10%	0	-
3%	10%	+	-
6%	10%	+	-
10%	10%	+	0
15%	10%	+	+

a particular product, but also that segment's fair share of other costs essential to running the business, like rent, capital costs, management overheads or advertising.

A result of this exercise is a picture of the value creation (which can be variously measured through economic profit, EVA, or the spread between cost of capital and return on capital) of all lines of business. By including the cost of capital, operations and overheads in these calculations, VBM frameworks show what a company really pays for a given set of products or services (defined as a business line), and not just the direct costs of associated materials, sales and marketing activities.

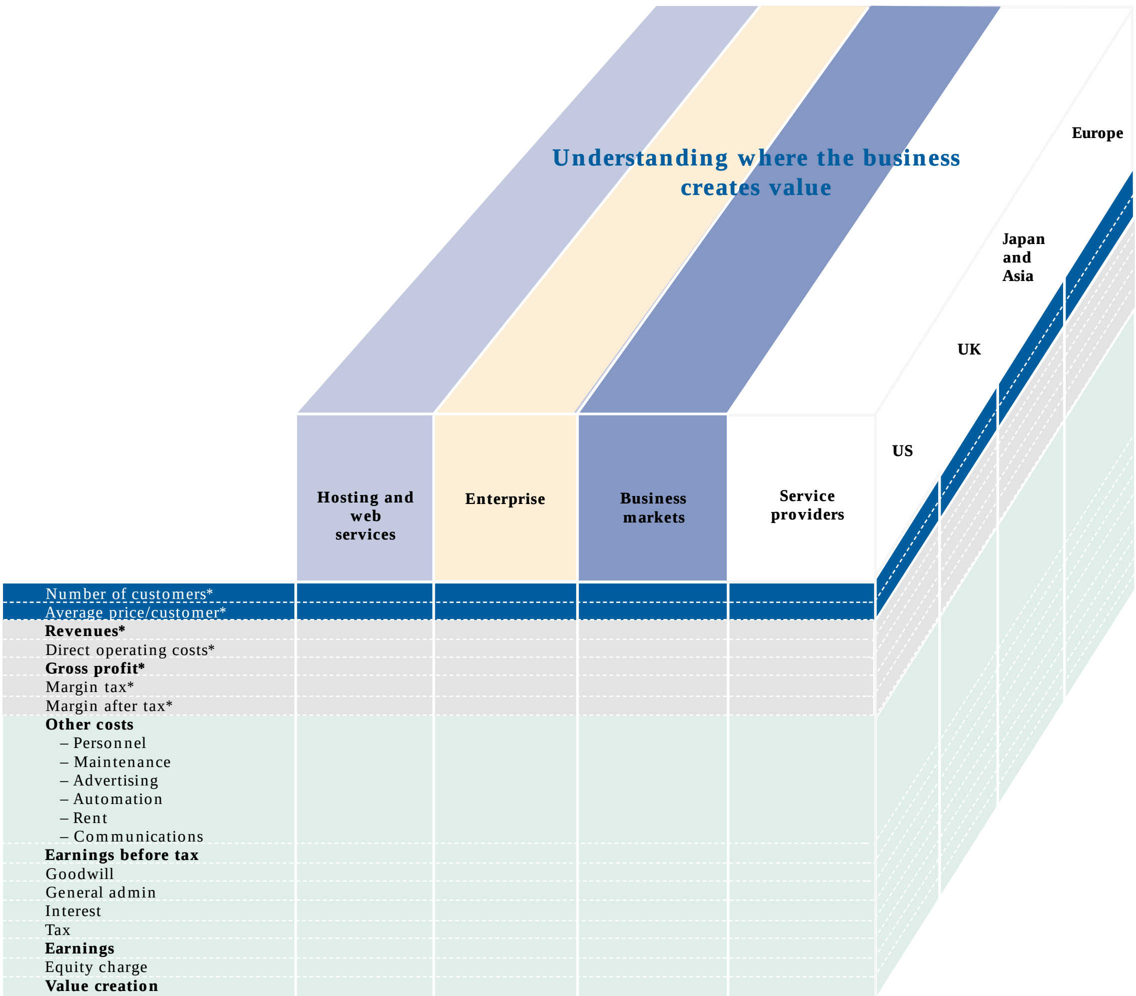
To do these calculations correctly, getting the segmentation of the business lines right from the beginning is crucial. VBM requires a segmentation of revenues to reflect the underlying business logic of customers, channels and geographies rather than traditional segmentations according to existing organisational and management structures (see Figure 3, below).

Segmentation is fundamentally a marketing concept, and a common pitfall is that accountants tasked with doing these calculations either do not really understand how to segment their markets correctly, or do not have the data to do it accurately.

Using the right segmentation and a fully loaded economic framework a VBM assessment enables an organisation to see for the first time the true economic costs of business lines and therefore their value creation. This

> Using VBM assessment enables an organisation to see the true economic costs of business lines

Figure 3 Segmenting costs and revenues correctly



* Most companies can only measure financial results between revenues and margin after tax per segment

assessment should have three components (see Figure 4, below):

- *a historic perspective* – which answers the question – how much value did each line of business create over the past 18 to 24 months?
- *a future perspective* – which answers the question – how much value will each business line create over the next three to five years? and finally
- *a steady state perspective* – which answers the question – what is the sustainable value creation of each business line into the foreseeable future?

The right value driver framework highlights to employers the inter-linkage between operating and financial performance

When assessing the future and steady state development of the business, we are fundamentally creating a picture of total future revenues and costs. To do this correctly, two complementary approaches are required:

- the first is an intuitive understanding of how the top-line revenues and costs are likely to develop based on the experience and knowledge of key business planners regarding competitors and customers; and
- the second is a 'best guess' as to how the business is likely to look in the foreseeable future. This can be based on sales funnels, expected personnel cost developments and other clear indicators of what is likely to happen.

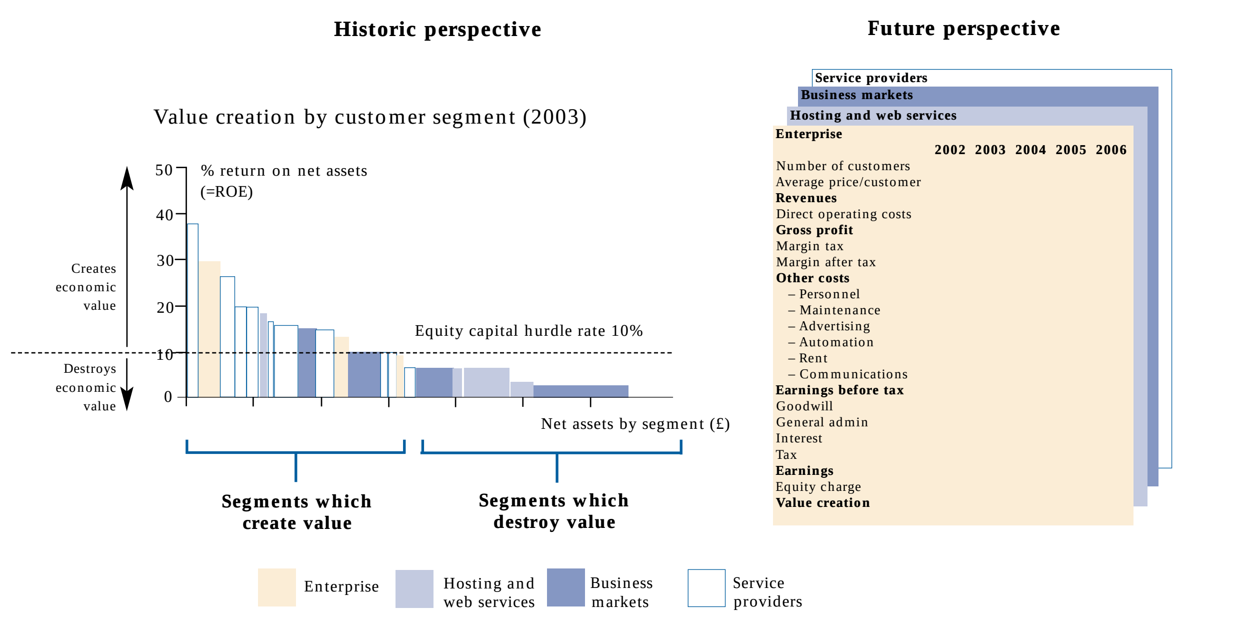
However, this is not enough. VBM also involves the discipline of placing all these drivers within a comprehensive framework which is linked explicitly to the streams of future value creation.

Our initial assessment has answered the questions: how much is each business line worth to the shareholders and how much is the sum of all business lines worth as a total company? The next step involves answering the question: why? Understanding and reporting the value drivers of each business is essential to putting this knowledge to work in the development of a value maximising strategy. The right value driver framework also ensures a full understanding among line management and key customer-facing employees of the inter-linkage between operating and financial performance and helps embed a value-based performance culture in the organisation.

Linking operational, business and financial perspectives

If you take a profit and loss statement for a given business line and ask a manager to explain the story behind the results, the answer will invariably include quantifiable elements, like price development or volume fluctuations, salary levels and production process costs, etc, which, though not part of traditional P&L reporting, comprise the key determi-

Figure 4 The true economic costs of value creation



nants, or drivers, of the financial results behind the value creation. The development of an effective business performance and reporting framework needs to include this business perspective, and not be constrained by the items of the P&L alone. A good framework links three types of management information within an integrated whole:

- the financial (return on capital) perspective of the P&L and balance sheet;
- the business operational perspective of line management; and
- competitive and customer intelligence.

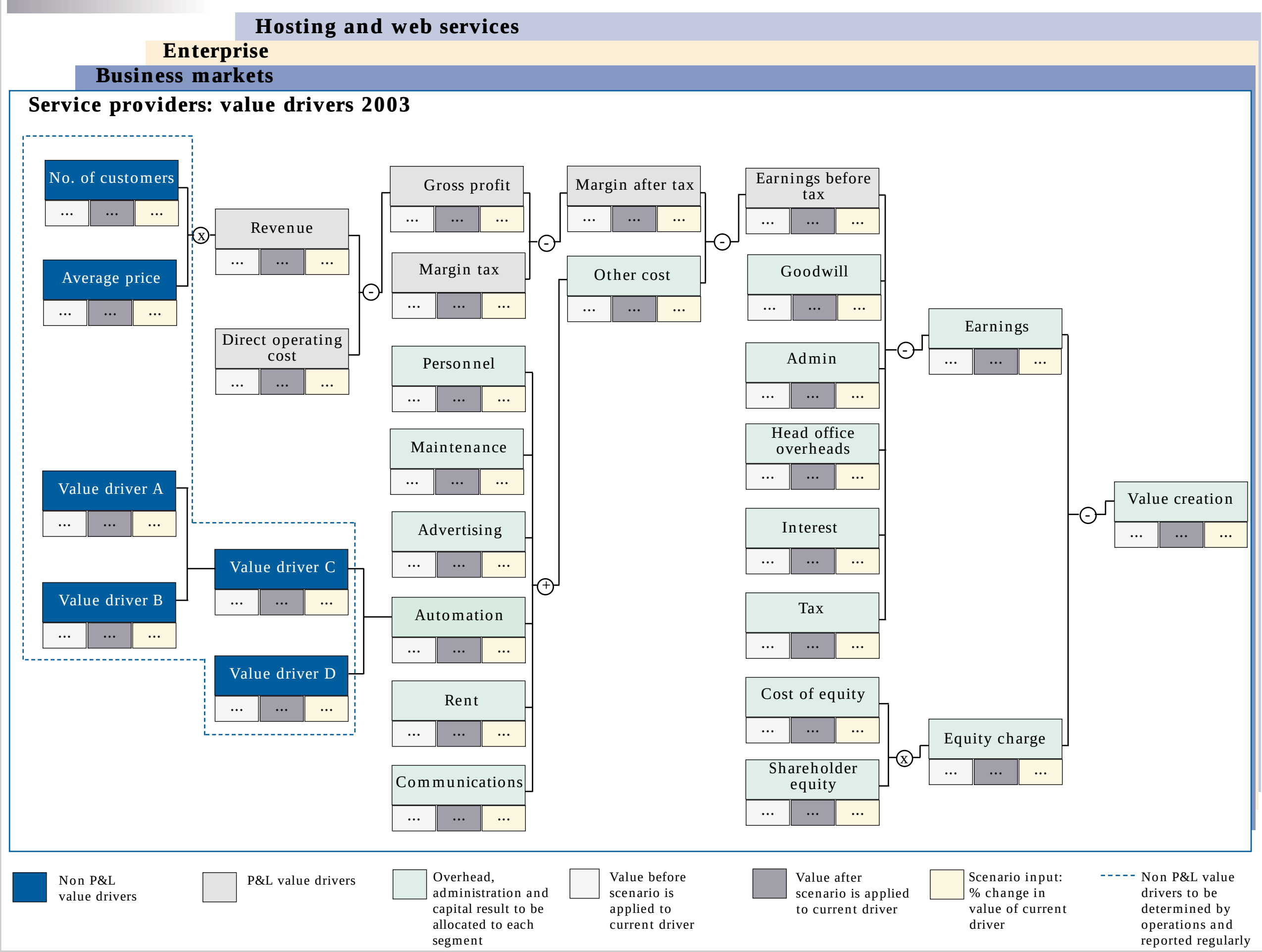
The extension of this business framework involves the development of operational and strategic value drivers. Though not constrained by the items of the P&L, it is nevertheless, often a good idea to create this framework around the structure of the P&L, so the impact of operating and competitive drivers can be clearly seen in the business's results (see Figure 5, below). This entails determining, agreeing and selecting usually seven to 10 key value drivers behind each major P&L item. Examples include both internal as well as external looking metrics:

- *revenue drivers* – orders received, conversion rate, number of customers, average price per customer, revenue mix, channel mix;
- *cost of sales drivers* – logistics costs, materials volumes, direct production workers required, average salary of direct production workers, purchasing volumes per supplier;
- *operating cost drivers* – IT, finance, property, corporate centre and management overheads; and
- *capital cost drivers* – cost of debt, cost of equity, working capital requirements, capital expenditure requirements.

Many of these drivers can, and should, be incorporated into this framework so that there is a direct mathematical relationship between the operational inputs and the P&L results. However, a number of strategic drivers, like levels of direct competition, customer pressures, regulatory developments etc, should

It is up to the business judgment of managers to assess the impact value drivers have on strategic decisions

Figure 5 Developing a value driver tree based on P&L items



simply be listed and taken into account when assessing future value creation potential rather than forced into a mathematical framework. It is then up to the business judgment of management to assess their impact on strategic decisions, rather than the role of the financial model builders to create an artificial relationship leading to a single value number at the other end of the model.

A key to success in this exercise is to tailor the value drivers to information that already exists, is reported and available regularly within the company, preferably monthly or quarterly. What should be avoided at all costs is a complete re-wiring of company information systems based on a perfect set of new reporting requirements.

Not only is this time consuming and costly, but it will postpone a company's ability to make informed, high value decisions indefinitely and put the entire VBM process in jeopardy.

As mentioned earlier, the key to VBM is its forward-looking aspect. Thus, once this framework is created, value drivers need to be projected into the future. This can only be done by key members of management or external advisors with expertise in the drivers of business results.

It is often a good idea to involve experts from different parts of the business

It is often a good idea to involve several experts from different parts of the business when assessing the drivers behind revenue/cost of sales, operating costs, capital costs, etc. For example, representatives from sales/ marketing, purchasing, as well as product managers and business development should be involved in providing a picture of the future development and value drivers behind revenues and costs of sales by business line. Finance as well as operations managers need to assess together the development of capital over time.

A forward looking picture of value creation can be formed

The robust road-map of value creation which is generated by this exercise will link the operating and financial performance of the company to a coherent picture of results to be achieved over the next three to five years. This forward looking picture of value creation can then be placed within a valuation framework, and the total equity value of the business assessed.

From a reporting perspective there is likely to be a threefold impact on the type of information management sees, and when:

- monthly business reporting can now include operational value drivers and not just P&L and balance sheet items;
- a forward-looking three to five year assessment of future value creation can be reported at least yearly, and in many cases quarterly; and
- all reporting can be integrally linked into a valuation framework that measures the expected equity value of the entire company.

Role of the board and CEO in implementing VBM

For VBM to succeed it is a truism to say that it needs to be championed by the people at the top. This means going far beyond annual report-type messages such as 'our company is managed for value; we judge our success using the criterion of value creation; this is the way we do business.' The Board and CEO have to not only proclaim VBM as the company's basic management framework, but to run the company in such a way as to maximise value.

In order to do this, line management must be equipped with the training, tools and a framework to manage for value within their own businesses. This means not only providing the resources and agreeing their level of autonomy, but also building a culture of high performance at all levels of the organisation.

In a company that manages for value the board and CEO have three key tasks:

- *to communicate the goal of value maximisation as the company's key decision criterion* – this involves not only announcements in annual reports and at analyst conferences, but a well planned and cascaded programme of cultural change within the company. This includes top and line management training sessions, value based reporting and incentivisation schemes as well as an accessible, shared and well-understood performance framework that links top level P&Ls and balance sheets to everyday decisions and processes;
- *to link management's agenda and accountability to value creation* – this means a disciplined approach to resource allocation and major investment decisions, ensuring existing streams of value creation are protected, and exiting from areas of the business which are likely to destroy value; and
- *to formulate and deliver a value maximising corporate strategy* – this entails (a) generating

and agreeing the right strategic alternatives for the business; (b) quantifying how much profit each particular strategy is likely to generate over time, and assessing their respective equity values; and (c) ensuring a well-planned and delivered implementation, with clear milestones, accountabilities and reporting of delivered results vs targets.

Without a value based performance framework even the most disciplined management process can, and often does, lead to value destroying decisions. Without a value-oriented management process, even the most timely and high quality business intelligence may prove ineffectual.

Getting the strategy right

Generating and agreeing the right strategic alternatives should focus not only on opportunities within the existing business, but should also incorporate intelligence and opportunities from existing and adjacent markets. For example:

- what are competitors' product, pricing and channel strategies?
- how profitable are adjacent markets in which we do not currently participate?
- what other products do our customers buy?
- how will developments in technology or production processes affect our underlying profitability?
- what is the market value of our non-core businesses vs their value to us?
- what are the cost bases of competitors vs our own? and
- what are the relative costs of our channels to market and what return do we earn in each?

Generation of strategic alternatives also needs to take into account feasibility, timing and ease of implementation.

Once an agreed and coherent set of alternatives has been produced, again the approach should be to evaluate each alternative course of action and pursue those which create the most value. This means understanding the business logic and economic profitability over the foreseeable horizon of each alternative and evaluating the value creation streams going forward. Hasty decisions without a robust profit plan and competitive intelligence often prove value destroying. On the other hand even the most elegant value based reporting and assessment system is useless without a management process focused around the value creation choice criterion.

Once the strategy is defined and chosen, implementation should be guided by a rigorous performance reporting and a tracking model which, on a monthly or, at least quarterly basis, tracks the delivery of both operational performance targets – measured, as we have seen, using a value driver framework – as well as the total financial delivery in terms of value creation.

What is equally important is that at regular intervals (usually quarterly), key management responsible for implementation provide new forecasts around expected delivery of both top-line financials and key value drivers, vs the initial targets.

This approach has a two-fold function. First, management can see periodically the expected value of the strategy now, six months into implementation, vs where we were at the outset. Second, it provides a clear and transparent tool for responsible management to see where they need to accelerate action and implementation, as well as where new opportunities for further value creation are emerging.

A strategy needs to be defined and chosen – guided and tracked for operational delivery and value creation

Applying VBM thinking to M&A – caveat emptor

One possible route to profitable growth is through acquisition. The past decade has witnessed an unprecedented level of value destruction from misguided acquisition and investment sprees, largely funded by debt, which have lead to catastrophic impacts on profitability and the balance sheet of many leading companies.

If the rule is to buy for a price less than the company is worth, why do companies so often get this wrong? Again, the key is found in getting the valuation of the acquisition right, and using a conservative assessment of the future sales funnel and cost base.

Another tip is always to engage an objective third party to perform the valuation, rather than rely solely on the investment bank. Investment bankers are incentivised to lend money at interest. Because loans, unlike equity, are secured by the company's assets, the shareholders are the big losers when the investment bankers' rosy valuation forecasts don't materialise.

A value based assessment of acquisitions has two basic components: stand-alone valuation and synergy assessment.

Value based assessment of acquisitions has two basic components – stand-alone valuation and synergy assessment

Stand-alone valuation
An assessment of what the target is worth ticking along in its current situation.The key here is not to rely overly on purely financial analysis but to link financial analysis with a robust understanding of the target's sustainable market position. What is the sales funnel over the next four quarters? How will this develop over time? What pressures do they face from customers and suppliers? What processes, assets or intellectual property does the company have that gives it a sustainable competitive advantage? How are the key cost items likely to develop over time?

Note that the stand-alone valuation will often vary significantly from the current market value, and will usually yield a lower value. The two most common reasons for this are:

- the market already views the company as an acquisition target, and incorporates an acquisition premium in the price; and
- the market has an overly optimistic view of the company's growth and profit potential.

Once the base case value is assessed, and this should usually include values under different market scenarios, the next step is to assess what benefits the target might bring to the existing business.

Synergy assessment
What additional value can the company bring to the acquirer, usually through a combination of rationalising shared costs and increasing revenues through combined distribution, product and customer bases.

Often synergies yield only a small fraction of the original assessment, and negative synergies in terms of wasted management time, and unexpected costs in the post merger integration phase balloon out of all proportion. Because synergies, especially on the cost side, are usually massively over-estimated, a general rule is to take the most pessimistic assessment of synergy potential, and divide by two.

Once both the target's base case and synergy potential have been evaluated, the sum of the two is the maximum price a company should be willing to pay. From a shareholder perspective, assuming the forecasts were correct, anything above this price is pure value destruction, whereas anything below this price is pure value creation.

The sum of the stand-alone valuation and synergy potential is the maximum price a company should be willing to pay

Summary

- Value based management will only succeed if it is closely tied to strategic operational decision-making.
- The first step in VBM is understanding the full costs of every line of business in the company, and ensuring lines of business are correctly defined to reflect market rather than organisational segmentations.
- The second step is fully understanding the value drivers in each line of business, and identifying, measuring and reporting them in a way that is helpful to line managers tasked with controlling them.
- Only when costs and value drivers are fully understood can results be projected into the future, and VBM used to evaluate alternative strategic options.
- VBM is an effective tool to guide M&A decision-making. MQ

Footnote and further reading

1. EVA is a trademark of Stern Stewart.

Three standard works on managing for value are:

- 'The value imperative – managing for superior shareholder returns'
  Kontes, PW, Mankins, M, and McTaggart, JM; London, 1994
- 'Creating shareholder value – a guide for managers and investors'
  Rappaport, A; New York, 1998
- 'Managing for value'
  Boetzel, S, and Schwilling, A; Capstone Publishing; New York, 2002

Acknowledgements

A personal note from the author

I would like to record my gratitude first to Bill Alberts, a gentleman, Renaissance man and the architect of VBM as it is truly practiced throughout the world today. Heartfelt thanks are also due to Ian Godden, a true business strategist and mentor, to Michael Steel and Neil Hampson for their Anglo-Saxon business acumen, to Stefan Boetzel and Andreas Schwilling for their practical wisdom in managing for value, and to Joost Geginat, Reinhard Geissbauer, Martin Wittig and Burkhard Schwenker who bring the principles of the cash flow statement, P&L and balance sheet to the great companies of Europe. Warm thanks are finally due to Ken Favaro, Herman Spruit, Dominic Dodd, Mike Baxter, Neal Kissel, Richard Steele and Matt Symonds, who together with Bill first initiated me into the theory and practice of VBM.

The case for a new driver

In today's hyper-competitive markets, satisfying customers' needs is the key to generating shareholder value. But marketing managers are poor at making their case to the board. They use metrics which are weakly related to value creation. Making marketing a genuine value driver requires a different approach; it requires marketing managers to integrate properly the financial implications of marketing investments. **Peter Doyle** explains how to do it.

The marketing paradox

There is a paradox in how top management view marketing. On the one hand, marketing has become accepted as the central driver of shareholder value. Every world-class company now puts building long-term relationships with customers, based on satisfying their needs, at the forefront of strategy.

Three factors have increased the primacy of marketing. One is the emergence of excess production capacity in more and more industries from manufacturing sectors like textiles and steel, to services like banking and air transport. This has meant that marketing rather than production capabilities have emerged as the primary determinants of value added. Second, has been the deregulation of industry, the decline of trade barriers and the emergence of increasingly global competition. Today there is no place to hide if your company cannot satisfy customers.

Third, the information revolution has driven a renewed drive to get closer to customers. The internet, in particular, is shaping a new business model that allows suppliers to strip out distribution costs and develop one-to-one relationships with customers.

Yet while the central role of marketing in achieving competitiveness and creating shareholder value is undisputed, the role of marketing professionals appears increasingly questioned. A widely reported research study from consultants, McKinsey and Company, entitled '*Marketing's mid-life crisis*', concluded that marketing departments are "often a millstone around an organisation's neck". A study by Coopers & Lybrand concluded that the marketing department is "critically ill". Research by the Boston Consulting Group found that 90% of major companies claimed to have restructured their marketing departments. In recent months, both Marks & Spencer and Boots have taken the marketing directors' jobs off the main board. A recent survey of major companies by the Marketing Society echoed this marginalisation of marketing professionals. Only 12 out of 100 chief executives had previous experience in a marketing position.

Marketing capabilities have emerged as the primary determinants of value added... yet the role of marketing professionals appears increasingly questioned

Back to first principles

The basic problem with marketing management is that its objectives are unclear. Marketing managers have come up with a variety of metrics to evaluate campaigns and justify their performance. The most common criteria for measuring the effectiveness of marketing are increases in sales and market share. Unfortunately, any first year economics student can demonstrate that such growth may as easily decrease, as increase, profits. Sales growth increases profits only if the operating margin on the additional sales covers the higher costs and investment incurred to achieve the growth. Chasing profitless growth has been one of the most common sources of corporate failure.

Other criteria for justifying marketing strategies include brand awareness, consumer attitudes, repeat buying and ratings of customer satisfaction. Unfortunately, many of these have weak relationships to sales and almost none to profitability. Increasing advertising, for example, will generally raise brand awareness and in many situations will increase sales, but whether these incremental sales will be profitable is very hard to say. The same criticisms apply to all the conventional marketing metrics.

Lack of credibility in the board room has much to do with failure to quanitify marketing strategies' contribution

Marketing management's lack of credibility in the boardroom is much to do with its failure to quantify the contribution of marketing strategy to corporate performance. Claims that investment in a new campaign will increase sales or brand awareness do not rate highly for boards struggling to increase their share price in a hostile capital market. Other business functions such as operations, sales, finance, even human resources appear to make more measurable contributions to the bottom-line.

The starting point for reasserting the role of the marketing management begins with properly defining its objective. Major business firms now almost universally accept that the primary task of management is to maximise returns to shareholders.

Marketing can be at the centre of value-based management if managers embrace a new modern definition of marketing:

'Marketing is the management process that seeks to maximise returns to shareholders by developing relationships with valued customers and creating a competitive advantage'.

This definition clearly defines the objective of marketing and how its performance should be evaluated. The specific contribution of marketing in the business lies in the formulation of strategies to choose the right customers, build relationships of trust with them and to create a competitive advantage.

Determinants of shareholder value

Value-based management is based on the belief that management should evaluate strategies in the same way that outsiders do. Investors assess strategies on their ability to create shareholder value. The company's share price reflects investors' evaluations of whether the current strategy of management will create value in the future. To explore the implications for marketing we need to review how finance professionals estimate value and value creation.

Modern finance is based on four principles: the importance of cash flow, the time value of money, the opportunity cost of capital and the concept of net present value. Cash is the basis of value – it is what is left over for shareholders after all the bills have been paid. Cash has a *time value* because a pound today is

Table 1 Alpha company – shareholder value analysis (£million)

Year	*Base*	*1*	*2*	*3*	*4*	*5*
Sales	100.00	110.0	121.0	133.1	146.4	161.1
Operating margin	10.0	11.0	12.1	13.3	14.6	16.1
Tax (30%)	3.0	3.3	3.6	4.0	4.4	4.8
NOPAT	7.0	7.7	8.5	9.3	10.2	11.3
Net investment		4.0	4.4	4.8	5.3	5.9
Cash flow		3.7	4.1	4.5	4.9	5.4
Discount factor (r = 10%)		0.909	0.826	0.751	0.683	0.621
Present value of cash flow		3.4	3.4	3.4	3.4	3.4

Cumulative present value	16.8
PV of continuing value	70.0
Other investments	7.0
Value of debt	-25.0
Shareholder value	68.8
Initial shareholder value	52.0
Shareholder value added	16.8
Implied share price £	3.44
Initial share price £	2.60

worth more than a pound tomorrow. The *opportunity cost of capital* is the return investors could obtain if they invested elsewhere in companies of similar risk. The *net present value* concept calculates the value of an asset as the sum of the net cash flows discounted by the opportunity cost of capital. By maximising the net present value of a business managers are pursuing those strategies most likely to maximise the returns to shareholders.

To illustrate the calculations, consider the Alpha Company (see Table 1, opposite). Its current sales and net operating profit after tax (NOPAT) are shown in the first column.

Management has developed a new marketing strategy that it believes will grow sales by 10% annually. To arrive at net cash flow we have to deduct the investment in working capital and fixed assets that will be needed to support this growth. This is forecast to be 40% of incremental sales. Shareholder value is obtained by discounting this cash flow by the opportunity cost of capital, r, which is taken here to be 10%. The annual discount factor is $1/(1+r)^i$ where i = 1,2,… is the year.

The shareholder value calculation divides the estimation of the value created by a strategy into two components. The first is the present value of cash flows during the planning period. Generally, managers feel it reasonable to plan ahead in some detail for a period of around five years. Here they forecast a cumulative cash flow in the planning period with a present value of £16.8 million. The second component is the residual or terminal value, which is the present value of cash flow after the end of the planning period. The residual value is calculated by the standard perpetuity method, which is NOPAT/r.

This method effectively assumes that beyond the five-year planning period, competition will drive down profits to a level such that new investment just earns the company's cost of capital, so that there will be no additional shareholder value created. When the residual value is multiplied by the discount factor we arrive at its present value, £70 million. Adding any non-operating investments the firm owns and deducting the market value of any debt leads to the shareholder value of £68.8 million. If there were 20 million shares outstanding this would produce an expected share price of £3.44. If the current share price is below this figure, then analysts would recommend the shares for purchase. If the company had not introduced the new growth strategy and remained at its present level, the implied share price would have stayed at £2.60 (ie its residual value in the base year).

The significance of shareholder value analysis is that it provides a highly effective vehicle for demonstrating the contribution of marketing to the company's financial performance. To explore this further we need to show how marketing adds value.

SVA provides a highly effective vehicle for demonstrating marketing's contribution

Marketing assets

The task of marketing is to create shareholder value. Marketing expenditure adds value when it creates assets that generate future cash flows with a positive net present value. Marketing assets are what link marketing activities to value creation. Accountants define assets as economic resources, owned by an entity, whose cost at the time of acquisition can be objectively measured. Unfortunately, this definition generally leads accountants to only include tangible assets such as cash, stock, debtors, plant and equipment in their balance sheets. Yet, in modern companies, such tangible assets account for only a small proportion of the market value of companies. The 'market-to-book' ratio in Britain's largest companies averages three, which suggests that two-thirds of the market value of these companies lies in intangible assets.

Of course, not all such intangible assets derive from marketing activities, they may arise in the skills of the employees, the value of patents and licenses, or the possession of scarce resources. But in most companies, it is in the value of their customer relationships that long term cash flow is primarily based. Marketing assets can be divided into four types:

- *marketing knowledge* – superior marketing knowledge provides a core competency consisting of skills, systems and information that convey a competitive advantage to the firm in terms of identifying market opportunities and developing marketing strategies;
- *brand* – successful brand names convey powerful images to customers that make them more desirable than competitive products. Owners of strong brands possess assets that attract customers, often earn premium prices and can be enduring generators of cash;
- *customer loyalty* – if a company has built a satisfied loyal customer base it will be more profitable and should grow faster than other

There are four types of marketing asset – marketing knowledge, brand, customer loyalty and strategic relationships companies. Many studies have shown that loyal customers buy more of the company's products, are cheaper to serve, are less sensitive to price, and bring in new customers; and

- *strategic relationships* – a company's network of relationships with channel partners can provide incremental sales, access to new markets and allow the firm to leverage its competencies in additional areas.

The value of marketing assets lies in their contribution to generating future cash flow

Marketing assets are no different from the firm's tangible assets in that their value lies in their contribution to generating future cash flow. However, marketing assets are often more valuable to the firm for two reasons. First, they are harder to acquire than tangible assets. Normally they take years of investment and are closely integrated into the firm's culture, which makes them difficult to buy or reproduce. Second, the worth of marketing assets derives solely from the value customers attach to them. Since customers are the ultimate source of cash flow, marketing assets can be considered the primary source of customer preference and competitive advantage.

Marketing assets do not normally appear on the balance sheet because accountants believe that their value cannot be measured with sufficient accuracy. Commentators have speculated whether this matters. While accountants do not measure intangible assets, the discrepancy between market and book values shows that investors do. Most accountants recognise that balance sheets no longer give meaningful information about values, instead they record historical details of transactions. It has been suggested, on the other hand, that because marketing assets are not recorded their values are underestimated. Because they are treated as costs rather than investments that are depreciated, this then leads to insufficient spending on developing brands, retaining customers and creating channel partnerships.

It has been argued, that because marketing assets are not recorded their values are underestimated

Fortunately, shareholder value analysis (SVA) avoids such possibilities of bias. This values strategies and companies in the same way outside investors do. SVA is not based on accounting conventions, instead it is based on cash. While profits are subjective, cash is a fact. Investments and costs are treated identically as deductions from cash flow, at the time they are paid. Like investors, managers have to judge their strategies in terms of their impact on *future cash flow*. Expenditures to develop marketing assets make sense if the sum of the discounted cash flow they generate is positive.

Marketing assets determine shareholder value

Turning around failing companies has conventionally been seen as a financial problem. But the significance of SVA is that it shows value creation is much more to do with the firm's effectiveness in developing marketing assets.

The model illustrated in Table 1 (on page 12) shows that the amount of shareholder value created depends upon four factors:

- the level of future cash flow;
- the timing of cash flow;
- the risk attached to the business; and
- the residual value.

Marketing assets are the principal drivers of all four determinants of value.

Effects on the level of future cash flow

Table 1 shows that the level of cash flow is a function of sales growth, the after-tax operating profit margin and the net investment required to fund the growth of sales, ie

Cash flow = Sales growth x net operating margin - net investment

Faster *sales growth* drives up returns to shareholders as long as the additional sales deliver economic profit. While cost-cutting and downsizing can temporarily boost cash flow, only sales growth can deliver long-run growth in cash flow. Growing sales is the main task of marketing. Growth is accelerated where the firm has strong marketing assets: marketing knowledge, powerful brands, loyal customers and strategic partnerships with channel members.

To understand the role of growth in creating shareholder value, Table 2 (opposite) simulates the effects of different growth rates on the company illustrated in Table 1[1]. If the company remains static over the five year planning period, the value of the company does not change and the equity value of the business remains at £52 million. If sales grow at 10% annually and the operating margin remains constant, then the value of the company and its share price rises by 32%. At 20% annual growth, the value of the company rises by 78%.

Note that while faster growth greatly increases the value of the company, during the first five years the cash flow is reduced, as profits are

Table 2 Simulation of the impact of marketing on shareholder value (£million)

		Discounted cash flow	*Present value of residual*	*Shareholder value*	*Shareholder value added*	*Share price (£)*	*Change in value %*
No sales growth		26.5	43.5	52.0	0.0	2.60	0
Sales growth	**+10% pa**	16.8	70.0	68.8	16.8	3.44	32
Sales growth	**+20% pa**	2.2	108.2	92.3	40.3	4.62	78
Price increase	**+10%**	51.3	86.9	120.2	68.9	6.01	131
Operating costs cut	**–10%**	33.4	54.8	70.2	33.6	3.51	35
Investment rate cut	**–10%**	30.2	43.5	55.6	3.6	2.78	7
Accelerated cash flow		18.2	70.0	70.2	18.2	3.51	2*
Cost of capital cut	**–10%**	27.2	45.5	54.7	2.7	2.74	5
Extending growth period		20.5	70.0	72.5	20.5	3.63	5*

* Compared to 10% sales growth base case

reinvested to drive growth. Creating value is about sacrificing immediate cash flow to build a greater cash generating potential for the future.

The second determinant of the level of cash flow is the after-tax *operating margin*. This is a function of the size of the company's sales, its costs, and the average prices it is able to charge for its products and services. Profitable sales growth should improve the operating margin by spreading fixed costs. Strong marketing assets should also lead to higher prices and lower costs. This means the effect of growth could be greater than shown in Table 2.

There is much evidence that strong brands are associated with price premiums. Studies have found that brand leaders in the UK sell on average at prices 40% above regular brands. Strong brands also tend to possess higher advertising and promotional elasticities, implying that the costs of acquiring additional sales will be lower. There is also evidence that well-established brand names permit line and brand extensions that lower entry costs.

Table 2 shows the enormous effect price premiums can have on shareholder value. A 10% price premium more than doubles the projected share price and equity value of the company. It greatly boosts cash flow during the planning period as well as leaving a significantly higher terminal figure for profits. Putting it another way, if managers neglect to invest in marketing assets and suffer a loss of brand premium as a result, the share price can be expected to drop dramatically, as investors figure out the implications for future cash flow. There is no more dramatic proof of the power of brands than simulating on a spreadsheet the effects of brand premiums on shareholder value. The table also looks at the impact of marketing assets in lowering operating or fixed costs. If these costs amount to 50% of total costs, and they are reduced by 10% as a result of significant marketing assets, then shareholder value is increased by 35%.

The third determinant of the level of cash flow is *investment*. Recent years have seen a growing recognition of the importance of customer partnerships in augmenting cash flow by reducing working capital and fixed investment. Stimulated by new information technology, particularly the internet, marketing-orientated suppliers are forging closer links with key customers to eliminate the amount of stock and capital tied up in the supply chain. Customer partnerships are marketing assets built through carefully listening to customers and meeting their needs. They generate a return in enhanced cash flow through lowering investment requirements. For example, stock reductions of 15% to 20% are commonly reported by companies with effective channel partnerships. Table 2 simulates the effect of a 10% cut in investment requirements. This adds £3.6 million to shareholder value.

The effects of marketing assets on the level of cash flow have been looked at individually. The effects are of course cumulative. If price premiums and growth are combined the effects on the value of the company are additive. Such cumulative effects account for the

SVA shows that marketing assets are the principal drivers of all four determinants of value very high market-to-book value ratios earned by companies such as Microsoft, Nokia, Coca-Cola and Vodafone. Similarly, the failure to achieve growth or price premiums accounts for the poor returns to shareholders in such companies as ICI, Safeway and United Biscuits.

Brands, strategic relationships and co-marketing patnerships can speed market penetration and cash flow

Effects in accelerating cash flow

Because cash has a time value, cash flows are discounted. Shareholder value is increased if cash flows can be generated quicker. Table 2 shows the effect of accelerating the cash flow by one year. If the year 2 sales of Table 1 were achieved in year 1, year 3 sales in year 2, etc shareholder value would increase from £68.8 million to £70.2 million, even though final year sales and profits are unchanged. Again marketing assets are often designed to achieve such acceleration.

In many cases Table 2 underestimates the effect of accelerated market penetration. Fast penetration can lead to first mover advantages. These include higher prices, greater customer loyalty, access to the best distribution channels and network effects that enable the innovator to become the specification standard. These feed back into both higher sales and higher operating margins. Many studies have shown that brands with strong images can expect customers to adopt their next generation products significantly earlier than those with weaker images. Companies now place much greater emphasis on 'pre-marketing' activities that focus on increasing awareness among opinion leaders even before the product launch to speed up the product life cycle and therefore accelerate cash flow.

Strong marketing assets enhance residual values and so have a marked effect on shareholder value

Brands are not the only marketing assets that can accelerate cash flows. Strategic relationships and co-marketing partnerships can also speed up market penetration. Alliances can enable the firm to open up overseas markets faster. A firm with good marketing networks can use these assets to more quickly capitalise on emerging market opportunities. Boots, for example, has an arrangement to place its pharmacies in Tesco supermarkets, enabling it to penetrate this new growth area faster. By demonstrating how such investments accelerate cash flow, marketers can quantify their efficacy in enhancing shareholder value.

Effect on business risk

The third factor determining the value of the business is the opportunity cost of capital used to discount future cash flows. This discount rate depends upon market interest rates plus the special risks attached to the specific business unit. The risk attached to a business is determined by the volatility and vulnerability of its cash flows compared to the market average. Investors expect a higher return to justify investment in risky businesses. Because investors discount risky cash flows with a higher cost of capital, their value is reduced.

Again there is evidence that an important function of marketing assets is to reduce the risk attached to future cash flows. Strong brands operate by building layers of value that make them less vulnerable to competition. This is a key reason why leading investors rate companies with strong brand portfolios at a premium in their industries. Many studies have also demonstrated the dramatic effects on the company's net present value of increasing customer loyalty. A major focus of marketing today is on increasing customer loyalty, shareholder value analysis provides a powerful mechanism for demonstrating the financial contribution of these activities. Table 2 illustrates this by showing, if the opportunity cost of capital is reduced from 10% to 9%, as a result of marketing activities which reduce the vulnerability of cash flows, then shareholder value is boosted by £2.7 million.

Effect on residual value

Shareholder value is made up of two components: the present value of cash flows during the planning period and the present value of the company at the end of the planning period. Not surprisingly, since a company potentially has an infinite life, the residual value normally greatly exceeds the value of the cash flows over the planning period. In the example of Table 1, the residual value accounts for over 70% of the corporate value. Indeed this is a typical figure across industry, in high growth industries the residual value is an even higher proportion of total value.

The problem is valuing the business at the end of the planning period. The most common approach is to use the perpetuity method, as in Table 1. This assumes that at the end of the planning period, the company earns a return on net investment equivalent only to the cost of capital, so that shareholder value remains constant. An alternative assumption is that the business can continue to earn returns that exceed the cost of capital. Another more pessimistic assumption is that after the planning period the cash flow turns negative as competition intensifies. The choice depends upon two factors: the sustainability of the firm's *competitive advantage* and the *real options* for growth it has created. Microsoft and Coca-Cola, for example, have very high residual values because investors perceive them having very long-term brand strengths that can be leveraged to future growth opportunities in new markets or product areas.

Strong marketing assets, such as new product development expertise, brands, customer loyalty and strategic partnerships should create competitive advantage and growth options that will often endure beyond the normal period for which a company plans. Because such assets are difficult to copy and create, and offer lasting advantages, they should enhance residual values and so have a marked effect on shareholder value. Table 2 illustrates this by showing the effect of extending the period over which the company earns positive net cash flow by one year, from five to six years. This adds £3.7 million to shareholder value (from £68.8 million to £72.5 million).

Demonstrating marketing's contribution

Shareholder value analysis allows marketing professionals to communicate the expected results of their marketing strategies in terms that make sense to top management. In particular, it allows them to quantify how investments in marketing assets may affect the share price. Measures such as sales, market share or consumer attitudes have little value as criteria for judging marketing strategies since they have no necessary correlation with how investors value the business.

Marketers need a simple decision rule to understand when additional sales will increase shareholder value. Sales are valuable if the operating margin on these sales exceed a *threshold margin*. The threshold margin is the minimum operating profit margin needed to maintain shareholder value. As can be seen from Table 1 it is a function of the added investment required to fund sales growth, the rate of tax the company pays, and its cost of capital. Specifically, it is defined as:

$$\text{Threshold margin} = \frac{\text{Investment rate x Cost of capital}}{(1 + \text{cost of capital})(1 - \text{tax rate})}$$

In the example of Table 1, the threshold margin is (40% x 10%)/(1.1 x 0.7) = 5.2%. Since the actual operating margin is constant at 10%, additional sales are earning returns well above the investors' cost of capital and shareholder value is being consistently created. The key point for marketers is that when a business is operating at *below* the threshold margin sales growth does not create value. But top management should appreciate that sales growth achieved at *above* the threshold margin does create value for shareholders.

This concept leads to another useful tool for marketers, the *threshold spread*. The threshold spread is the actual profit margin on additional sales less the threshold margin. In the example of Alpha Company this is 4.8% (10% - 5.2%). Its significance is that once the investment requirements and risk characteristics of a strategy have been established, shareholder value is determined by two factors: (1) sales growth and (2) the threshold spread.

Most marketers in developing strategy focus on the marketing value drivers. For example, the strategy might involve new creative ideas and new above- and below-the-line initiatives aimed at increasing customer loyalty, winning bigger shares of the customers' spend and gaining new customers. These marketing drivers then need to be translated into financial value drivers.

SVA allows marketing professionals to communicate the expected results of their strategies in terms that make sense to top management

For example, suppose Alpha management have to choose between the strategy proposed in Table 1 and an alternative one proposed by the new marketing director. This new strategy centred around a comprehensive relationship marketing programme. The marketing department believed this would add an additional 2% to annual sales, and to discount reductions amounting to 1% of sales (effectively this was the equivalent to 1% on the ex-factory price). They also believed higher customer retention would reduce the cost of sales by 1.5%. The additional cost of the marketing programme would be an up-front investment of £5 million in the first year and an on-cost of £2 million annually.

Table 3 (on page 18) evaluates the new strategy. While the new strategy reduces operating profits in the first year, and reduces cash flow for the first three years of the planning period, shareholder value is substantially increased. At £83.7 million, equity value is 22% higher than in the original plan due to the higher long-term profits created and which are reflected in the higher residual value of the business.

The example also illustrates the value of shareholder value for advocating aggressive marketing strategies. If management were orientated to maximising profits or earnings per share, they would reject the new marketing strategy. But a proper analysis decisively demonstrates that such a short-term orientation is in the

Table 3 Valuing a new marketing strategy for Alpha (£million)

Year	*Base*	*1*	*2*	*3*	*4*	*5*
Sales	100.00	113.3	127.1	142.7	160.1	179.6
Additional marketing		5.0	2.0	2.0	2.0	2.0
Operating margin	10.0	8.9	13.5	15.4	17.6	20.0
Tax (30%)	3.0	2.7	4.1	4.6	5.3	6.0
NOPAT	7.0	6.2	9.5	10.8	12.3	14.0
Net investment		5.3	5.5	6.2	7.0	7.8
Cash flow		0.9	4.0	4.6	5.3	6.2
Discount factor (r = 10%)		0.909	0.826	0.751	0.683	0.621
Present value of cash flow		0.8	3.3	3.5	3.6	3.8

Cumulative present value	15.0
PV of continuing value	86.8
Other investements	7.0
Value of debt	-25.0
Shareholder value	83.7
Shareholder value added	31.7
Implied share price under new strategy £	4.19
Share price under original strategy £	3.44

interest of neither shareholders nor the long-term competitiveness of the business.

Justifying advertising budgets

Many companies treat the advertising budget as a cushion; something that may be expanded in good times, but which is ruthlessly cut back when profit budgets are under threat. Top management appears to believe that advertising has no demonstrable impact on shareholder value. But proper analysis can show that this is a prime example of short-term thinking: while cutting advertising will normally increase immediate earnings, it has a deleterious impact on shareholder value. This is why cuts in advertising often lead to a fall in the share price even though short-term profits increase.

> Top management appears to believe advertising has no impact on SV... this is short-term thinking

The problems in justifying advertising budgets occur because sales are affected by many other factors in addition to advertising. All the studies of advertising agree that the effects of advertising on sales are small, certainly much smaller than the effects of price or promotion. The maximum advertising elasticities reported are around 0.2, meaning that a 10% increase in advertising would increase sales by 2%. Another problem making the effects of advertising even more difficult to calculate is its lagged effects. Sales today are not just affected by current advertising but by the customer's memories of past advertising. This means the short-run impact of advertising may underestimate its total impact on sales.

Demonstrating the effect of advertising on shareholder value depends on understanding the function of the advertising. There are two main approaches to explaining how advertising works: the persuasive hierarchy model and the low-involvement model. The former is sometimes called the aggressive theory of advertising, which sees it as first informing consumers about the product and then persuading them to try it. The ultimate test of whether such advertising has been effective is the resultant increase in sales. The shareholder value created by such an advertising campaign can be gauged by first estimating the advertising effect, generally though some form of econometric model, and then feeding the incremental sales attributed to advertising into the type of financial model illustrated in Table 1.

A more difficult case is justifying advertising for established brands in mature markets. While the persuasive hierarchy model of advertising might fit new products seeking to

Table 4 Effect of eliminating advertising on shareholder value (£million)

Year	*Base*	*1*	*2*	*3*	*4*	*5*
Sales (units)	100.00	90.0	85.5	83.4	82.3	82.3
Price	1.00	0.99	0.98	0.97	0.96	0.95
Revenue	100.0	89.1	83.8	80.9	79.0	78.1
Variable costs	66.7	60.0	57.0	55.6	54.9	54.8
Fixed costs	23.3	18.3	18.3	18.3	18.3	18.3
Operating profit	10.0	10.8	8.5	7.0	5.8	5.0
NOPAT	7.0	7.5	5.9	4.9	4.1	3.5
Net investment		-4.0	-1.8	-0.9	-0.4	0.0
Cash flow	7.0	11.5	7.7	5.7	4.5	3.5
Present value of cash flow	7.0	10.5	6.4	4.3	3.1	2.2

Cumulative present value	26.4
Present value of residual	21.6
Shareholder value	48.0
Original shareholder value	70.0

attract new customers, it hardly describes the role of advertising for brands like Coca-Cola, Persil or Flora margarine. Virtually everyone buying these brands has bought them before; they are familiar with them; and have already been persuaded to buy. The low-involvement model best describes the role of advertising here. This sees advertising as being essentially defensive: the object is to *maintain* the brand's market share and price premium, through reinforcing current buying behaviour. Advertising in these mature markets does not increase sales but it prevents them declining and preserves the brands as long-term generators of cash for the shareholders.

Table 4 (above) illustrates how shareholder analysis can be used to justify advertising, even though advertising does not create incremental sales. Initially the brand has stable sales at £100 million and a 10% operating margin. In an effort to increase profits and cash flow management decide to eliminate the £5 million advertising spend. A previous econometric analysis has estimated the advertising elasticity at 0.1, implying that eliminating advertising would only cut sales by 10%. Since two-thirds of costs were variable, management believed profits were bound to rise.

However, management ignored sales effects after the first year. In the second and subsequent years the brand increasingly loses saliency to consumers without the benefit of advertising to reinforce and update the brand's associations. The model of Table 4 assumes diminishing advertising effects: the first year the loss is 10%; the second year 5%; and so on. In addition, management failed to take into account the loss of volume on the brand premium. Faced with declining sales and margin the major retailers will demand bigger allowances. The effect was estimated to take 1% off the ex-factory price each year. In the first year profits were indeed up as a result of the £5 million saving on marketing. There was also a marked increase in cash flow in the first two years as lower sales resulted in declining working capital requirements. But from the second year, profits fall precipitously as declining margins and the drag of fixed costs take their toll.

If advertising had been maintained, the shareholder value of the brand would have been worth £70 million. Eliminating advertising produces a short-term jump in profits and cash flow, but a sharp decline in the long-run value of the business. The value of the business to shareholders drops by a third to £48 million.

Advertising in mature markets does not increase sales but it prevents them declining and preserves the brands as long-term cash generators

Valuing brands

The increasingly obvious gap between the balance sheet valuations of companies and their market values has led to a growing interest in valuing brands, which are seen as a major component in the difference. Brand valuations can be particularly useful in acquisitions both for the acquirer wanting to know what parts of the company may be worth, and for the defender wanting to justify its stewardship. Brand valuations are also used to calculate royalty rates in licensing deals. Tax authorities are now asking companies to charge their subsidiaries for the use of their bands and proper valuations assist negotiations. Finally, convinced of the importance of brands, many companies want regular valuations to track that their strategies reinforce the value of these assets.

The gap between balance sheet valuations market values has led to growing interest in valuing brands

Table 5 (below) illustrates the process of valuing a brand. The first step is to forecast brand sales, operating margins and cash flow over a reasonable period, such as five years. It is important that the forecasts are based solely on brand sales and not any unbranded products that may be produced in parallel.

Here brand sales are predicted to grow at 5% a year, the operating margin is 15%, the tax rate 30%, and net investment is estimated at 50% of incremental revenue. The second step is to calculate the percentage of the earnings that accrue from the use of the brand name. A brand name creates value by adding emotive associations, over and above the product, that lead to additional sales or higher prices. There are a variety of methods for estimating this increment, depending on the type of brand and its market. Where the brand operates by enhancing the margin, the most direct approach is to compare the operating margin on the brand with the estimated margin on similar unbranded products. This difference, ie ($OM_{branded}$ - $OM_{unbranded}$) should be attributable to the company's unique assets: its brands, patents, channel partnerships, and so on. In heavily branded markets, any residual earnings will be predominantly due to brands; in hi-tech markets other intangible assets may be more critical. In Table 5 the margin on unbranded products is estimated at 7%, implying earnings from intangibles account for 8% of sales (ie 15% - 7%). In this market, since there are no quality differences, it is assumed that the brand premium accounts for this residual. The brand cash flow associated with this premium is in any one year is then:

$$CF_{brand} = Sales(OM_{branded} - OM_{unbranded})(1 - \text{tax rate})$$

The final step is to estimate the brand discount rate. This will not be identical to the company's overall cost of capital since the brand's earnings may be more or less volatile than the average of the portfolio. The Interbrand Group, a pioneer of brand valuation methods, calculate the discount rate on the basis of a 'brand strength score', which measures the security that the brand name adds to the earnings stream. This rates such factors as the stability of the market, the brand's market share, its geographic spread, legal protection, etc. In the example, the discount rate is calculated at 12%.

Table 3 Valuing a new marketing strategy for Alpha (£million)

Year	*Base*	*1*	*2*	*3*	*4*	*5*
Sales	250.0	262.5	275.6	289.4	303.9	319.1
Operating margin	37.5	39.4	41.3	43.4	45.6	47.9
NOPAT	26.3	27.6	28.9	30.4	31.9	33.5
Net investment		6.3	6.6	6.9	7.2	7.6
Cash flow		21.3	22.4	23.5	24.7	25.9
Brand cash flow		14.7	15.4	16.2	17.0	17.9
Discount factor (r = 12%)		0.893	0.797	0.712	0.636	0.567
Discounted cash flow		13.1	12.3	11.5	10.8	10.1
				Cumulative present		57.9
		value				84.5
		PV of continuing value				142.4
		Brand value				

The brand value is calculated by applying the discount rate to the expected future brand cash flows. As with all shareholder analyses, sensitivity analysis is important to explore alternative scenarios using different price and growth assumptions and different brand investment policies. This allows an assessment of the robustness of the brand and the problems and opportunities it may face in future.

Implications for marketing

Shareholder value has become the new standard because of an increasing realisation of the defects of conventional accounting. A focus on accounting profits encourages an excessively short-term view of business. It leads to an under investment in information-based assets – staff, brands, customer and supplier relationships. In today's information age, the accounting focus on tangible assets makes little sense now that intangible assets are the overwhelming source of value. Shareholder value analysis can avoid both these biases. But to achieve its potential, SVA needs marketing. Similarly, marketing needs SVA if it is to make a greater contribution to strategy.

Accountants will know, however, that like any technique SVA is no panacea, in particular it is only as good as the assumptions that are fed in as input. The key inputs are forecasts of sales growth, operating margins and investment requirements for at least five years ahead. These all depend upon good judgements about the evolution of the market and the firm's ability to sustain a competitive advantage. The cost of capital is also a critical variable and again depends upon assessments, particularly upon the degree of risk the unit or brand faces. Different judgements can lead to significant differences in estimates of the shareholder value created from a particular strategy.

Another key issue is the estimate of terminal or residual value. SVA splits the estimation of shareholder value into two components: the present value of cash flow during the planning period, and the residual value, which is the present value of the cash flow that occurs after the planning period. For growth businesses the overwhelming proportion of value arises in the terminal value. Unfortunately, it is difficult to be confident about this value. The reason for splitting the estimation into two components is that managers cannot forecast much beyond five years or so. So how can one decide the reasonableness of the terminal value, which is making an assumption about cash flows up to 20 or more years ahead? Different assumptions can give quite different estimates of shareholder value.

Marketing has not had the impact its importance jusifies – mainly due to its lack of definition of objectives

Finally, a concern has been that SVA underestimates the value of new ventures by overestimating the risks involved. In practice, the risks are not as high as they appear because managers can often proceed step-by-step, piloting on a small scale new projects before major investment have to be made. More recently, SVA has been extended with the development of real options analysis to fill this important gap.

Value-based marketing redifines the objective of marketing as creating value

While recognising these limitations, SVA is genuinely important for the development of marketing. Both as an intellectual discipline and a business function, marketing has not had the impact that its importance justifies. To a significant measure this has been due to the lack of definition of the objectives of marketing and to its failure to become integrated with the overall value-creating goal of the firm. Value-based marketing overcomes much of this deficiency by redefining the objective of marketing as creating value for shareholders and adopting the tools of SVA to evaluate proposed marketing strategies. MQ

The late Peter Doyle's most recent book, 'Value-based marketing', *is published by John Wiley, 2000.*

Footnote

1. These calculations can easily be checked by entering Table 1 in a spreadsheet such as Microsoft Excel, and simulating the changes discussed in the paper.

Do human resources really add value to a business?

The value created by the HR function is frequently questioned by line managers. This reflects how many human resources functions are perceived to be out of step with the needs of businesses. **Bernasia Halikowa, Mark Hoyal** and **Paul Osgood** consider how the 'people' people can be a critical part of the value creation process for any organisation.

Research suggests, time and again, that organisational change fails as often as it succeeds. Even where change projects do succeed, delivery of value is rarely as easy as it appeared at the outset. Why? Too often, emphasising the business and economic rationale of a project obscures the fact that value, in all of its forms, is actually created by the application of human talent.

Value in all its forms is created by human talent

But, amidst unprecedented uncertainty, deriving value from human talent is harder than ever. This has placed an increasing responsibility on HR function's to source the scarce human talent which can create the highest value for organisations. HR functions are also required to identify and sustain diverse talent pools which will maximise value creation in rapidly changing market environments.

So how are human resources professionals able to enhance the value creation process? Our experience suggests that:

- there is no single best way – a 'silver bullet' – of doing things as far as organisational success and productivity is concerned;
- the HR organisation, processes and technology need to be integrated and aligned with business strategy to maximise their impact as value creating opportunities;
- engaged employees create more value for the organisation; and
- there are many legitimate HR metrics which can measure the contribution that HR makes to value creation in a business.

The key to maximising talent is to align HR and business strategies

There is no single 'best way'

In recent years, there have been numerous new initiatives focused on creating more value out of a business – total quality, total customer satisfaction, customer chains, business process improvement, partnership etc. These various initiatives have often been accompanied by a hunt for new organisational forms – flatter hierarchies, project-based and virtual structures, network teams, 'no boundary' systems and so on. Organisations are continuously in search of an answer, a solution that will magically solve all the problems.

We have learned that there is no silver bullet. There is no one single 'best way' of doing things as far as organisational success and productivity is concerned. What works well for one organisation could lead to spectacular failure for another. The key to maximising value from HR is aligning HR strategy and programmes to an organisation's business strategy.

Integrating and aligning HR processes with business strategy

Business strategies and drivers should be analysed for their effect on HR and people practices. Different business drivers will suggest different approaches to HR strategy and organisational design. At the micro level, most companies have a business strategy with elements that are completely unique to their own circumstances. When studying business strategies, however, most observers agree that these thousands of discrete strategies can be classified into three or four categories. In his landmark book 'Competitive strategy'[1], Michael Porter used the term 'generic strategies' to refer to alternative strategic positions in an industry. He suggested that companies could compete in one of three ways:

Table 1 Implications of strategic style for HR management

Strategic style	Work environment	Employee competencies	Lead HR systems
Operational excellence	Stable, measurable cost-conscious, team-based continuous improvement.	Process control, teamwork analysis, financial/operational understanding and attention to detail.	Strategic sourcing, HR process improvement, compensation based on highly measurable results.
Product leadership	Experimental, learning focused technical, informal, fast-paced, resource rich, speed to market.	Life-long learning, information-sharing, creativity, breakthrough thinking.	Fluid organisation, emphasis on training and development, relatively undifferentiated rewards.
Customer intimacy	Values-driven, dynamic, informal, collegial, service-oriental.	Relationship-building, listening, initiative, collaboration, rapid problem-solving.	Selection for fit with values, consistent leadership, balanced emphasis between short-term and long-term rewards.

- *cost leadership* – being the low-cost producer;
- *differentiation* – having a unique product or service; or
- *focus* – concentrating special services or products on a specific market niche.

Porter contends that competitive advantage comes from setting up value-creating activities to deliver on a company's particular kind of strategy. This allows the company to erect barriers to entry.

In their best-selling book, 'The discipline of market leaders'[2], Michael Treacy and Fred Wiersema studied successful companies in different sectors and came to similar conclusions as Porter. They suggest that customers look for one of three sources of value or strategic styles from a company:

- *operational excellence* – low-cost, reliable and easy to use products or services;
- *product leadership* – leading edge products; or
- *customer intimacy* – highly customised solutions and services.

Applying Treacy and Wiersema's concepts of strategic styles to an organisation's people requirements we can see how these different strategic styles demand different competencies from employees and thus, different strategies from HR. In 'The talent solution'[3], Ed Gubman characterised these implications for HR, as shown in Table 1 (above).

Engage employees to create value

Measuring the connection between employee behaviours and business performance is often difficult. Traditional measures of employee satisfaction and commitment fail to link strongly with developments in business results and often leave the HR professional as a poor cousin when business metrics are used to monitor business performance.

One powerful HR measure which does enable the HR professional to link employee behaviours with business performance is a metric called employee engagement. Using a specialist employee survey tool, it is possible to measure the employee behaviours which impact on business performance and identify the key drivers of business performance improvement within a business. To date, we have learned that employee engagement:

- differs by company;
- is impacted by at least 16 different drivers in six broad categories;
- not every driver applies to every person;
- does impact financial results; and
- can be measured and managed effectively.

Customers look for one of three sources of value or strategic styles from a company

Employee engagement is a powerful HR value measure – it links employee behaviour with business performance

Figure 1 (below) highlights the employee engagement model, the six broad categories and main areas which can impact engagement.

To address the significance of the value created through employee engagement, US research showed that engaged employees[4]:

- produce $3,600 more profit per annum;
- create $18,600 more market value; and
- deliver $27,000 more sales per annum.

Measuring degrees of employee engagement provides data which enables actions to be taken at the point of business performance. So, for example, what employee engagement measures might do is help an HR professional to look at all the elements that make up the employment experience and identify which of those elements within the experience motivate employees to stay, and which motivate employees to go above and beyond the simple requirements of their job.

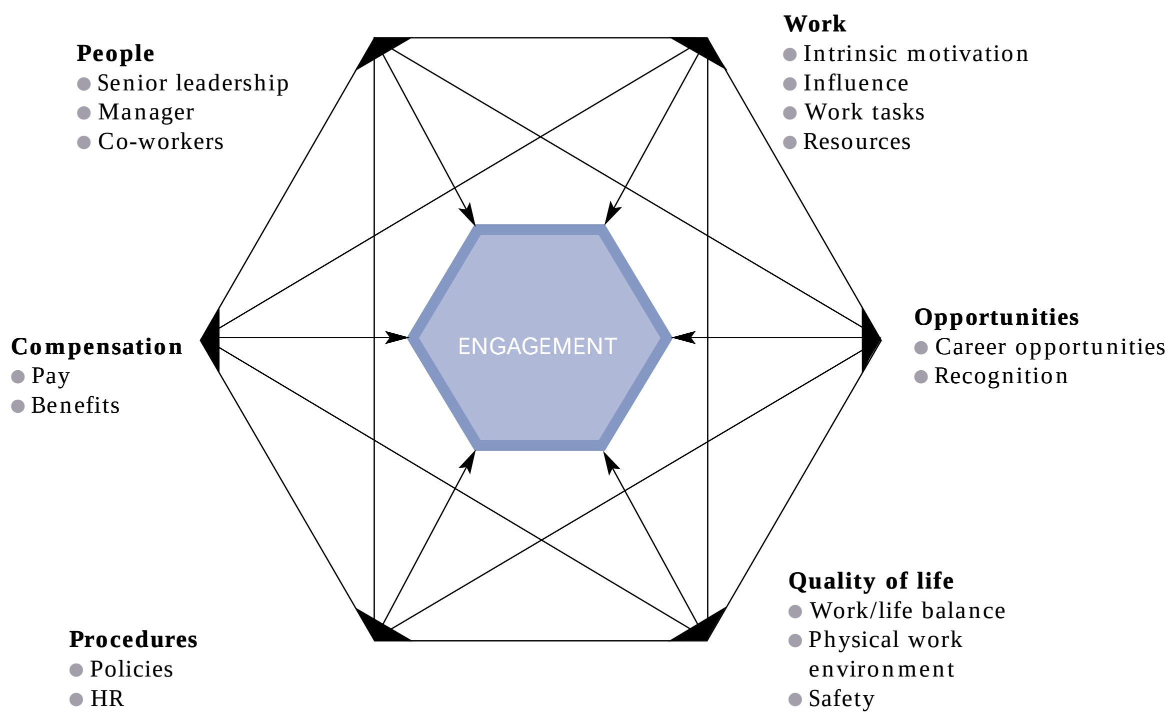
Employee engagement measures can also help HR professionals to look at which areas of activity have a greater influence on retention. Engagement measures can also help explain the difference between top performing units and units which perform less well, and thus determine how value can be improved across the business.

Measuring degrees of engagement in staff can help line managers to focus on the areas which will produce the greatest improvement in business performance. If engaged employees and non-engaged employees are compared, there are clear differences. Research has shown that engaged sales employees tend to stay longer with organisations, for instance, and tend to be responsible for larger amounts of sales, thus increasing profits per employee and revenues across a business.

Using HR metrics to measure value

A lack of early or sufficient consideration of measures such as employee engagement in business restructuring, denies access to a crucial insights which impact on value. A due diligence or risk assessment process, for example, that only has a financial orientation or where HR questions are asked only about

Figure 1 Employee engagement model



contracts of employment, misses out a whole range of human capital measures.

So, determining the real business drivers for an organisation is often the first and crucial link in defining the HR people and practices which have the greatest impact on value. In the last decade, on the back of increased use of IT solutions, more and more HR teams now have their own process controls and performance metrics. A recent research study[3] found that more than 80% of the companies contacted used some kind of HR measurement system. Of those with measures in place, 44% used balanced scorecards as their organising framework.

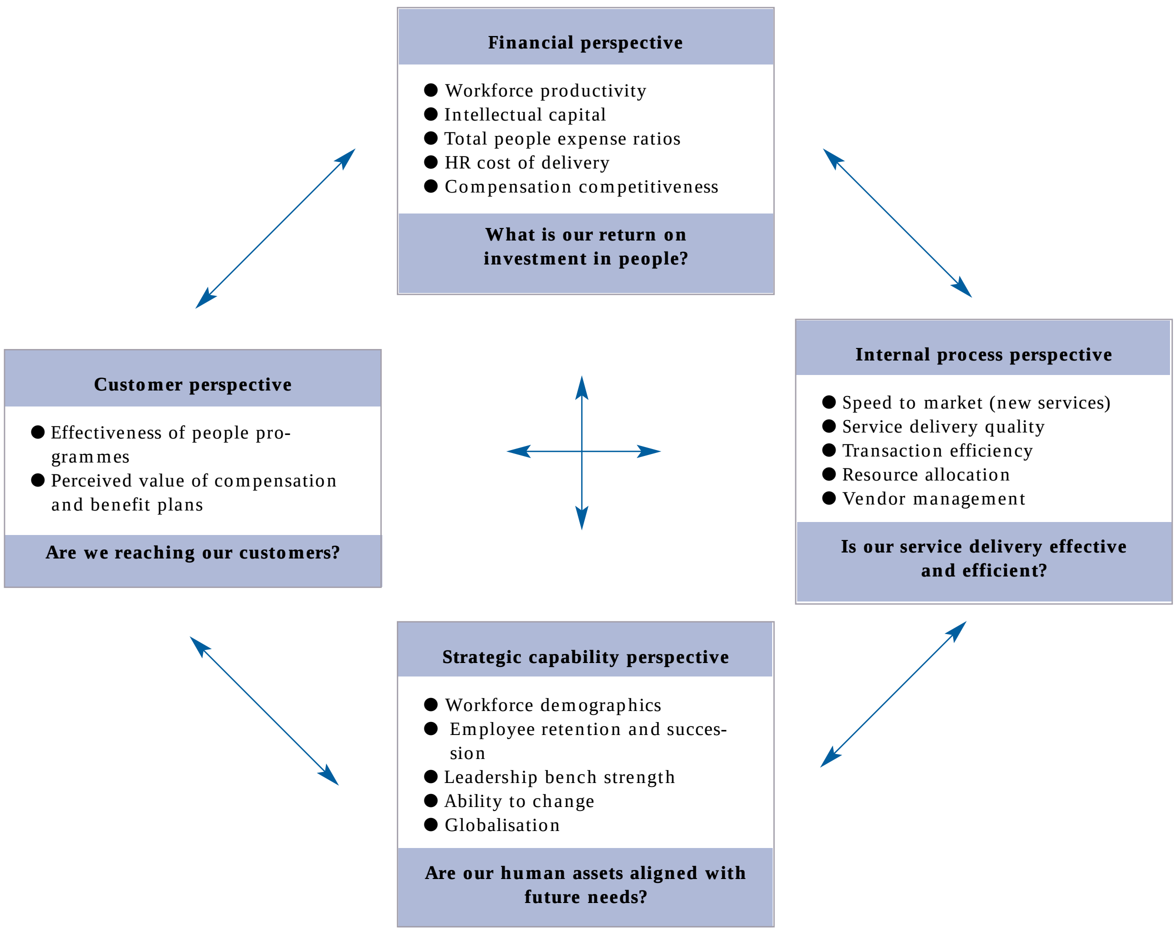
In their book 'The balanced scorecard'[6], Robert Kaplan and David Norton contend that customary financial measures are lagging indicators and can lead to short-term thinking designed to "get the numbers up". Instead, they suggest companies use a balanced portfolio of measures to measure their progress. Since its publication in the mid-1990s, many companies have adapted this approach. In our work with HR departments we have found that the balanced scorecard approach is well suited to HR departments that are keen to take the first step in showing the value they add to a business. HR balanced scorecards take many forms and must ultimately support the business strategy but a generic balanced scorecard for HR might look something like the example in Figure 2 (below).

As you see, this balanced approach to HR measurement answers how HR is adding value from four different perspectives:

- what is our return on our investment in people?
- is our service delivery effective and efficient?

HR departments are using HR balanced scorecards to show how they are adding value

Figure 2 Measuring HR's contribution to the business



- are our human assets aligned with future needs? and
- are we serving the needs of our customers?

Among those companies in our study that are already using HR measurement, their primary purposes in doing so are to:

- build a common language among HR professionals for communicating HR strategy and results;
- be proactive in identifying workforce trends and offering solutions; and
- strengthen relationships with the lines of business.

Companies adopting HR value measures realise substantial financial performance advantages

Of the 20% of companies without measures in place, access to data and human resource management systems (HRMS) were described as the 'next hurdle'. The box below, 'HR performance measures', shows more detail on the kinds of measures many companies now use to assess the value provided by HR.

As a result, HR's contribution to business success is no longer a soft and fuzzy concept where the cost effectiveness and payback is unclear. Stories about the axing of the HR training and development budget as a quick cost-cutting measure by finance are a symptom of HR's past inability or willingness to demonstrate the link of cost and added value.

The combination of a robust HR measurement system and HRMS framework allows today's HR leaders to make decisions that are grounded in fact and to evaluate the outcome of business investment. It also offers a means to translate ideas about business strategy into behaviours and actions that support the company's future direction by creating culture and implementing talent management practices.

Research conducted by Fulmer, Gehart and Scott[7] argues that companies which adopt HR measures of value realise substantial financial performance advantages over companies with less employee-focused employment strategies. They go on to suggest that companies considering adoption of the types of HRM strategies and measurement processes used by the firms they studied may not have much downside risk, and if their competitors are using these practices, they may even find themselves at a disadvantage.

In another study, Frank Russell, the financial services company, compared the results of the 51 publicly listed companies in the 2003 edition of the '100 best companies to work for in the UK'[8], with the FTSE All-Share Index. Their study showed that the 'best companies' group substantially outperformed other companies in the index (see Table 2, opposite).

HR performance measures

HR delivery measures

- *In HR service centres* – call volume, response time, processing accuracy, first-call resolution, abandonment rate and customer satisfaction.

- *Overall HR effectiveness* – HR cost per employee, HR as a percentage of total operating cost, HR staff ratio and staffing cycle time.

- *HR delivery effectiveness* – measuring overall process of effectiveness instead of focusing on functional activities.

HR talent measures

In addition to tracking employee turnover and using an employee opinion survey, several companies in the study presented innovative approaches to measuring an organisation's effectiveness in managing talent on a global basis. For example:

- leading indicators for potential talent shortages – ie competency gaps, regretted turnover for high potentials and the ratio of external to internal hires;
- staffing measures of both efficiency (cost per hire, time to fill) and the type of hire (new graduate, client facing);
- the percentage of employees who are 'internationally mobile' to evaluate success in building a global leadership culture; and
- employee engagement results to evaluate the overall commitment of the workforce and make cross-border comparisons.

Conclusions

The search for value creation by HR functions has always been legitimate but in the past has tended to incorporate suspicious elements of self-fulfilling prophecy when compared to the value measures presented by many other disciplines within businesses. In our view, the HR function has often tried in vain to convince others of the value inherent in delivering HR support by reference to esoteric HR-centric models. We believe that it is now possible to unlock the value of the 'people quotient' with clear and unambiguous value drivers and measures which connect directly with broader business metrics.

The HR function has a key role to play in

Table 2 Comparison of 100 best companies to work for with the FTSE All-Share index

	Best companies to work for	FTSE All-Share Index
5 year compound annual return	12.1%	-5.8%
3 year compound annual return	3.6%	-15.0%
1 year return	-21.1%	-28.8%

helping organisations to understand their sources of value (strategic style) and in blending the work environment, employee competencies and the lead HR systems which support the organisation. The analysis and professional skills required to identify and develop value in this area are very much a part of the development of the role of HR as strategic partner to a business.

Measures such as employee engagement deliver a much closer picture of the link between the people in a business and the overall business performance. An HR function which is able to prioritise its investments in financial, human and infrastructure resources and link these investments to improved business performance is placing itself at the heart of value creation.

HR performance metrics are measuring value creation within businesses. More sophisticated HR functions are using these metrics inside and outside of the function to broaden the scope of business management so HR leaders are now using robust data to measure the impact of investments.

For HR professionals, the challenge is not so much how quickly they can embrace and deploy these value drivers, but more whether they can retain ownership of them before other disciplines claim them for their own. MQ

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Getting the equation right

The finance function has been the subject of radical restructuring in recent years. However, following a number of high-profile corporate disasters, people are questioning whether the finance function has become an executive lapdog rather than a company watchdog. While the immediate pressure is to cut costs, the finance function also faces the wider task of proving it can add value without diluting its key functions. **Marcus Boyle** and **Peter Moller** review current trends and provide practical ideas for getting the value equation right.

Is it possible for the finance function to cut costs further, add value and maintain its position as company watchdog?

The finance function has undergone dramatic change in recent years – with increased automation, fewer employees and added responsibilities. For the most part, finance directors (FDs) have been successful in reducing costs: the cost of the average finance function as a percentage of total company sales has halved to just over 1%, according to Deloitte & Touche research (2002). Given the current economic climate, the pressure on costs looks likely to continue, and in the first half of this article we focus on trends in this area and ideas for implementation.

Alongside cost pressures, however, is a larger issue – the question of whether the shift towards 'business partnering' has negatively affected the independence and integrity of FDs. Restructuring the finance function has created a shift in the role of chief finance officer (CFO) – from a process-driven role to more of a 'chief value officer' role, focusing on adding value, supporting changing business models and managing risks.

The question now on everyone's lips is how to add value to the business while fulfilling finance's essential role in governing what is 'true and fair'. Is it possible for the finance function to cut costs further, add value and maintain its position as company watchdog? We believe the answer is 'yes' – and we discuss how in the second half of this article.

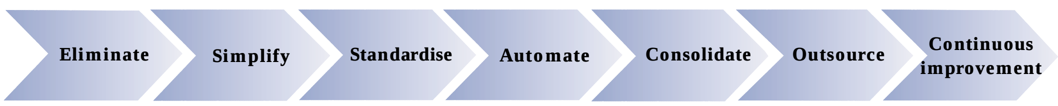
Cost-cutting trends

Many organisations jump into cost-cutting transformation projects without doing the groundwork first. Too often, time and money is wasted on standardising or automating processes that would be best eliminated. Another pitfall is severely underestimating the 'people' element. When implementing major finance transformations, the most common difficulties are getting the business to buy-in to the need for change and underestimating how difficult employees will find the transition. These problems can be avoided through good planning and change management. In our experience there is a logical order to follow for transformation efforts to be effective, as shown in Figure 1 (below).

Step by step, this process works as follows:

- *eliminate* – by documenting a process from end-to-end, you will quickly identify where

Figure 1 Seven steps to transform the finance function



duplication of processes exists and how it can be eliminated;

- *simplify* – a number of processes are likely to be over-engineered to meet all business requirements. Review the processes and remove any complexities that do not deliver requisite business benefits;
- *standardise* – where possible try to adopt a single process and a single technology;
- *automate* – having standardised your processes, key elements can be automated to further reduce the cost of transaction processing;
- *consolidate* – left to their own devices, individual business units will have tailored finance processes to meet their every need. Now is the time to rein them in and consolidate finance processing across business units into shared service centres;
- *outsource* – time to consider outsourcing transaction processing, as it is not a core competency. Those that have achieved shared services at an optimal cost base will have an excellent benchmark for price negotiations with outsourcers; and
- *continuous improvement* – the business will be constantly changing and it is essential for the finance function to remain responsive to the business' needs. A continuous improvement framework should be put in place that gives employees incentives to improve their working methods and performance.

Organisations who have followed these ground rules have been successful in reducing costs in the following areas:

- automation of end-to-end processes;
- introduction of self-service to employees;
- leveraging of supplier relationships; and
- implementation of shared services.

Automation of end-to-end processes
Automation offers opportunities to further reduce costs, but should only be performed after a process has been simplified and standardised. The cost of accounts payable, for example, can be reduced significantly by automating the matching of a purchase order to an invoice and goods received note, using what is called 'two touch processing' (see Figure 2 below).

Automation of the end-to-end processes offers opportunties to further reduce costs

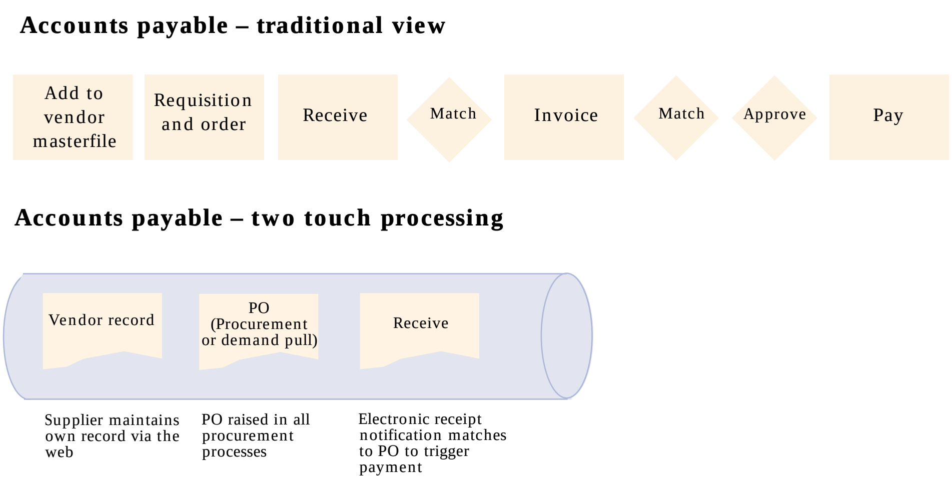
In Figure 2, the purchase order is automatically generated when an employee goes on-line to order from an electronic catalogue that lists approved goods from approved suppliers.

The system sends the purchase order to the supplier electronically. Upon receipt of the goods, the employee generates an electronic receipt that triggers the payment by BACS or other technology with no further intervention from accounts payable.

Introducing web-enabled 'self-service' to employees
Self-service enables employees to generate information or requests on-line, thus reducing the need for further transaction processing to be performed by finance.

Web-enabled employee self-service reduces the transaction processes performed by finance

Figure 2 Traditional vs automated accounts payable process



Recent trends have seen a sharp increase in self-service in:

- travel and expense claims;
- time recording;
- requisitioning; and
- HR related areas, eg flexible benefits options, skills maintenance, training assessments, development needs.

Web-enabled procurement systems go beyond automation, reducing costs through compliance and negotiation

Self-service can result in significant savings. For example, an FD in the leisure industry reduced the number of full-time equivalents (FTEs) processing expense claims from 12 to one by adding the web-enabled expenses module to the applications suite he was purchasing. When developing a business case for shared services, he discovered that there were 12 people spread across different locations whose sole jobs were to process travel and expense claims.

By introducing self-service to all employees in the organisation, the finance function was able to move to a governance role rather than processing the transactions. Its only role was to match receipts; once this was done, electronic payment was automatically triggered (see Figure 3, below).

Leveraging supplier relationships
Web-enabled procurement systems go beyond automation to reduce costs through compliance and negotiation. These systems help businesses to control indirect spending and to leverage their supplier relationships by demanding better terms and/or prices. Depending on a company's spend, the savings can be sizeable.

One company recently implemented an e-procurement system across its entire UK business, based on a business case that forecast procurement cost savings of £8 million or 8.3%. These savings came from consolidating suppliers and increased compliance.

Other benefits of a web-enabled procurement system include:

- *greater control* – on-line approval hierarchies ensure that the purchases are approved by the correct people;
- *better analysis of spend* – all purchasing is properly coded based on the predefined

Figure 3 Simplified processes for web-enabled expenses

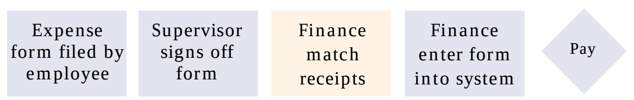
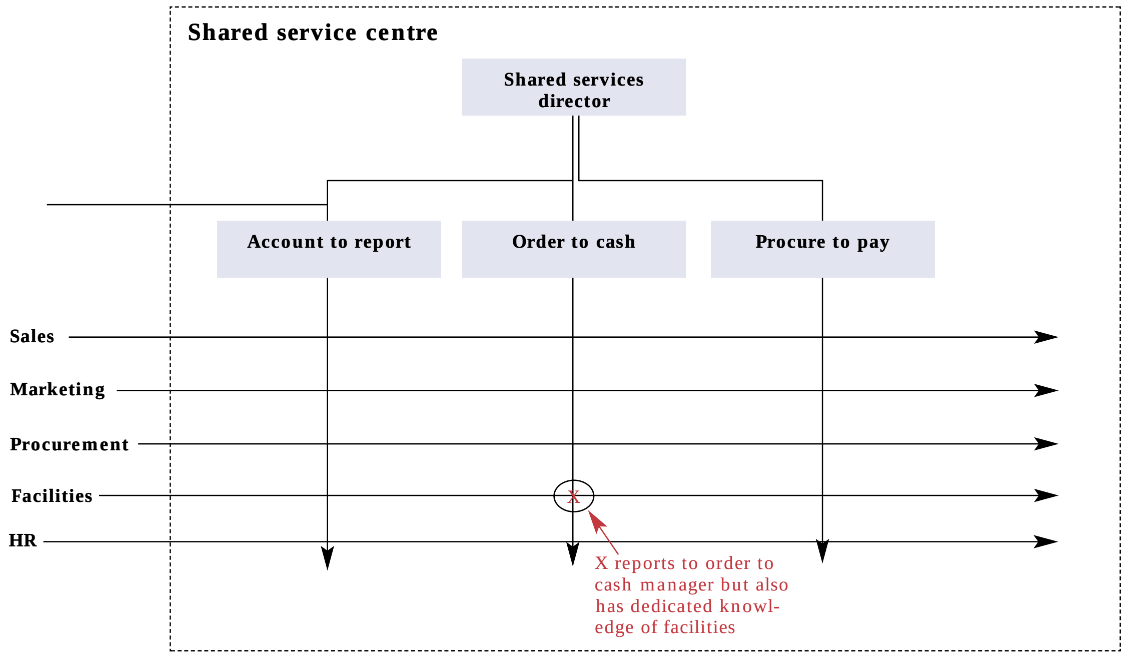


Figure 4 Matrix model for finance function's structure



mapping to the chart of accounts, thus reducing the level of human error; and
- *reduced transaction-processing costs* – invoices are not slowed down by coding and approval processes.

Consolidating processes via shared services

Today, the bulk of cost for the finance function remains in transaction processing. Shared service centres (SSCs) consolidate transaction-processing activities shared by multiple parts of a business. They typically reduce costs by 25% to 40% while improving service levels through the use of standardised technology, processes and service level agreements.

Mid-sized companies may find the idea of establishing an SSC a bit daunting or assume it is only for multinationals. In fact, increasing the span of control and standardising is always a good idea as it will reduce costs. While companies generally need about 30 FTEs before an SSC will pass the cost/benefit test, this is by no means a hard and fast rule. Two key questions are:

- will the costs of the physical building for the SSC, any required redundancies and hiring and training new people outweigh the overall reduction in finance costs (bearing in mind that relocation can significantly reduce salary costs)? and
- can the company implement a common software and business process solution that enables them to realise the benefits of automation and standardisation?

Restructuring can be combined with a shared service approach to help free the finance function to provide more value to the rest of the business. With the introduction of shared services a new model for the finance function becomes possible (see Figure 4, opposite). This new structure is based on a matrix combining processes (account to report, order to cash, etc) and functions within the company (sales, marketing, etc). It is intended to be collaborative and participative. Using this structure, for example, marketing employees with questions about their cost centre report would liaise directly with a member of the SSC dedicated to supporting marketing.

A new role for the finance function?

By delegating day-to-day transaction processing to an SSC, the remaining finance staff are freed to focus on offering services such as:

- analysis of revenue by business unit;
- project accounting;
- support in understanding costs allocated to business units;
- external analysis;
- business cases for new initiatives;
- support to the business with performance measurement;
- activity based management – eg to better understand product and customer profitability; and
- a more collaborative approach to planning and budgeting.

SSCs consolidate transaction processing activities shared by multiple parts of a business – freeing up finance to focus on offering other services

Balanced scorecards for the finance function

Balanced scorecards are a popular and powerful management tool, based on the idea that an organisation should be evaluated not only by traditional financial measures, but also by other measures of interest to stakeholders, such as:

- value-driven financial measures;
- customer satisfaction;
- internal processes; and
- ability to learn and grow.

Balanced scorecards can be used to measure the finance function's success in fulfilling its new role: they can help demonstrate how the finance function adds to the value of a business and supports its strategic objectives. The following sections shows some specific measures for doing this.

Balanced scorecards can be used to measure how well the finance function is performing

Value-driven financial measures

These measures serve as a focus for establishing and tracking the drivers of value for the finance function, such as the financial results and outcomes from profit improvement, cost reduction and risk management initiatives. Sample financial measures are shown in Figure 5, overleaf.

Customer satisfaction measures

These focus on the level of service and support the finance function provides to internal operations, suppliers and customers, including relationships forged through more value added services and SSCs.

Customer satisfaction measures will determine whether the finance function:

- is delivering the right mix, quality and levels of transaction processing, risk management and decision support;
- is viewed positively by business partners such as other internal operations, customers and suppliers; and
- has the appropriate partnering relationships and experience with other internal operations, suppliers and external customers.

> Internal process measures focus on the critical processes finance must excel at

Some sample customer satisfaction measures could include:

- percentage of finance analyst time spent partnering with operations management;
- percentage of finance analysts experienced in both finance and operations;
- percentage of finance employee time spent with suppliers to improve processes and information flow;
- percentage of finance employee time spent with external customers to make sales process more efficient;
- percentage of transactions processed with errors – eg payroll, accounts payable, billing, accounts receivable, general ledger, etc;
- internal operations satisfaction (perception surveys);
- external customer satisfaction (perception surveys); and
- supplier satisfaction (perception surveys).

Internal process measures

These measures focus on the critical processes that the finance function must excel at in order to assess and report on value accurately. Internal process measures should demonstrate how any process changes affect the customer satisfaction and financial measures of the balanced scorecard.

Increasingly popular techniques used to evaluate finance processes include activity-based approaches (eg activity-based costing and activity-based management) and finance function benchmarking. These techniques are frequently used in measuring the effectiveness of finance services and support functions such as transaction processing and producing accounts, budgets and reports. Some sample internal process measures could include:

- cost of transaction processing as a percentage of revenue per transaction, eg accounts payable, accounts receivable, billing, payroll, etc;

Figure 5 Financial measures for the balanced scorecard

Traditional measures	Value-driven measures
● Total cost of finance as a % revenue	● Level of integration of strategic, tactical and financial planning process – eg fully integrated, integrated at corporate level only, integrated through financial systems, not integrated
● Total finance headcount as a % of total organisation headcount	● Frequency of rolling forecasts
● Total finance span of control (staff to management ratio)	● % of finance analyst time spent on planning and analysis vs getting data or doing historical reporting
● % of transactions processed centrally	● Average cycle times for key business planning process (in days) – strategic plan, annual plan, forecasting
● % of shared services versus corporate accounting for transaction processing	● % of manager time allocated to decision support
● Cost of technology as a % of total finance cost	
● Cost of transaction processing cost as a % of revenue	
● Finance headcount as % of total organisation headcount by main activity – finance function management, decision support, risk management, transaction processing	
● Cost of non-transaction processing as a % of revenue – eg finance function management, decision support, risk management	

- number of transactions processed by transaction-processing employees, eg invoices, remittances, expense reports, payroll cheques, etc;
- cost of finance as a percentage of revenue by cost component, eg labour, outsourcing, technology, other; and
- average days to close the books and report.

Learning and growth measures
These track an organisation's ability to adapt in the face of change, which is fundamental to achieving excellence in finance, customer satisfaction and internal processes. They also stress the importance of taking a holistic view of the finance function's infrastructure, systems, capabilities and culture by emphasising the development of finance staff skills and competencies. The core measures should focus on employee retention, employee productivity and employee satisfaction.

Some sample learning and growth measures could include:

- finance staff turnover;
- finance staff absenteeism;
- revenue per finance employee;
- percentage of qualified finance employees;
- number of training hours per finance employee; and
- staff satisfaction (perception surveys).

Figure 6 (below) provides an example of a finance balanced scorecard extract. It describes how the measures for each section of the scorecard should ultimately and rigorously tie in to the financial results and outcomes of the finance function.

The need for balance

Despite the attractions of offering all these extra services, this new vision of the finance function must be balanced with the need to continue acting as an independent arbitrator of 'true and fair' company reporting. Chief executive officers (CEOs) and the board must be able to rely on FDs to provide accurate information to support decision-making, and it is important that chief value officers who can extract and provide this data act as facilitators – not manipulators – of the facts. They should not seek to blindly support pre-determined strategies; instead they should alert CEOs to the true state of the business, so informed decisions can be made.

These concerns are being addressed at the highest levels, not just in the UK but also in the US and worldwide. In the UK, a tough new package of boardroom measures will have a far-reaching impact, not least on the CFO. The Financial Reporting Council will be implementing recommendations from the Higgs report regarding the role and effectiveness of non-executive directors via changes to the Combined Code. It will also be implementing recommendations from the Smith report, which focuses on strengthening the role of the audit committee. It includes particular emphasis on:

> Despite the attractions of offering extra services the finance function must balance this with its role as independent arbitrator of 'true and fair'

Figure 6 Extract of a sample balanced scorecard (finance function)

Value creation

↑

Financial perspective (Financial results plus value driven measures)
Aim: reduce cost of transaction processing
Example measure: transaction processing cost as a % of revenue

↑

Customer perspective
Aim: increase internal operation satisfaction through minimising problems
Example measure: % of transactions processed with errors

↑

Internal process perspective
Aim: simplify and improve transaction processing
Example measure: number of transactions processed per transaction processing employees – eg invoices, remittances, payables, expenses etc

↑

Learning and growth perspective
Aim: increase transaction processing staff satisfaction levels
Example measure: staff satisfaction levels (perception survey)

- monitoring the integrity of the company's financial statements, including preliminary announcements, interim reports and other material in the annual report;
- reviewing the company's internal financial control system and risk management system;
- monitoring and reviewing the effectiveness of the internal audit function; and
- ongoing and timely training to members on principles of and developments in financial reporting and related company law.

In addition, the ICAEW has issued interim good practice guidance to help directors prepare the annual report's Operating & Financial Review (OFR). This establishes the following key principles:

Finance's emerging ability to measure and report on value should be encouraged

- the OFR is the responsibility of the full board of directors;
- the OFR should be relevant to and meet the recommendations of existing pronouncements on content; and
- the OFR should be an integral part of the corporate reporting process.

These corporate governance measures, which are scheduled to come into effect for accounting periods beginning on or after 1 July 2003, place finance in the spotlight more than ever. Providing a fair financial reflection of the business has never been more important.

A health warning

Developments post-Enron have led many to question whether a 'business partnering' role for the finance function is a step in the right direction or a step too far. In our opinion, business partnering continues to be the right direction but care must continue to be exercised in its application. The key role of the finance function is to provide information – to extract and analyse financial data in a way that is fair and meaningful to management.

However, its emerging ability to measure and report on value (rather than traditional financial measures only) is a trend that should only be encouraged – provided it doesn't get distorted into supporting the executive agenda of the moment.

CFOs face tough challenges in asserting their 'watchdog' role and in cutting costs in this tough economic climate. As shareholders and stakeholders will be watching anxiously for signs that the finance function is subject to excessive executive pressure, getting the balance right will be essential for the health of the company. MQ

New ways to extract value from systems

Getting value from investments in information technology (IT) is notoriously difficult. Disillusion with 'silver bullet' IT solutions such as enterprise resource planning (ERP) systems, customer relationship management (CRM) systems, and many dubious internet adventures, have left managers cynical about the value of new IT proposals. But IT is now not only essential to the day-to-day operation of every business, but also the bedrock of new growth and development in many companies. **Dr Joe Peppard** describes a new, more realistic method of assessing the potential of IT investments and increasing the likelihood of benefits being delivered, in which business executives share responsibility for success or failure alongside their much-maligned IT colleagues.

In most organisations, IT has a poor reputation. There are many reasons for this but the one that tops them all is that IT is seen as consistently failing to deliver 'value for money'. A recent Korn Ferry/*Financial Times* international IT survey[1], for example, reported that more than a fifth of all US chief information officers (CIOs) consider that their existing IT investments have failed to generate a genuinely good return for their organisation, and a further quarter were only mildly convinced that they had. These figures probably understate the situation, and if business executives had been surveyed the figures would have been substantially lower. As a result of this scepticism it is increasingly difficult to get approval for IT proposals, a situation which may fatally undermine the competitiveness of an organisation.

Why are IT projects failing to deliver value? Partly it's a result of poor management practice. A survey of the top 200 companies in the UK, conducted by Cranfield School of Management, revealed that 47% openly admit to overstating expected benefits in order to get IT projects through the investment appraisal process[2]. More worrying is that the survey also highlighted that the traditional IT investment appraisal process is simply regarded as a ritual to be overcome before any project can begin, rather than a useful process in its own right.

No wonder few companies engage in post implementation reviews: it is already known that many of the benefits identified in the investment proposal are unlikely to be achieved anyway. And the criteria used by most organisations to assess the success of an IT project? Generally, they are whether the new IT system is delivered on time, within budget and whether it works technically, ie meets the specification. Although these criteria sound sensible, and are not irrelevant, the real problem is that no account is being taken of whether the new IT system is being exploited by the business and ultimately delivering the expected value. There is a naive assumption underpinning investments in IT that 'once we get it in, value will begin to flow'.

When IT projects fail to deliver, poor management practice is partly to blame

Because of this widespread misunderstanding, and consequent levels of disappointment, most companies today are slashing their IT budgets, or choosing to outsource the function in attempt to get better value – although much research shows that outsourcing often fails to generate the cost savings expected[3]. This paper argues that, even in an economic downturn, simply focusing on reducing spend is the wrong approach. As IT becomes more intricately linked with corporate strategies, organisations must move away from a simplistic cost focus to approaches which concentrate on creating value from IT.

Companies need to focus on creating value from IT and realising the benefits to business

Unlocking the value of IT investments

So, how can IT generate value? After evaluating numerous IT investments across many industries, our research indicates that value can be created in many ways, for example, through:

- increasing process effectiveness;
- better and faster product designs;
- increasing employee effectiveness;
- better asset utilisation;
- generating new revenue streams;
- increased connectiveness; and
- improved customer service.

IT has no inherent value. The value must be unlocked by business managers

Yet, one fact is without contention: IT has no inherent value in itself. Just having the technology does not automatically confer any benefits or create value, all it does is incur cost; the value must be unlocked, and it is only business managers who can do this. The value only comes from business changes enabled by the technology. This is a point of view endorsed by a 2001 McKinsey study of IT and productivity[4], which noted that: "contrary to conventional wisdom, widespread application of IT was not the most important cause of the post 1995 productivity acceleration". The authors went on to say that where IT did play a role, it was to support or drive business changes.

Companies need to organise to realise the potential benefits from IT

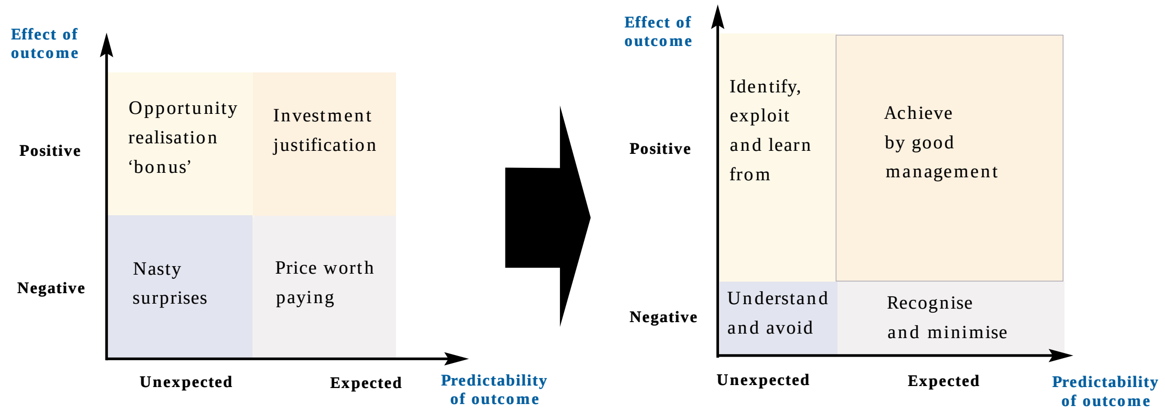
Our research indicates that IT value management needs to be proactive, and that successful IT investments are managed on the basis of detailed plans focused on releasing value, which run in parallel with more traditional IT implementation and roll out plans. But, before you can put together any such plan, it is important to have a realistic understanding of the value inherent in the investment you are considering. Figure 1 (below) suggests a framework for assessing this; the framework maps the effect of the outcome of an IT investment on the organisation (either positive or negative) against the predictability of the outcome occurring.

Obviously, management attention should be focused on ensuring that IT projects not only deliver maximum benefits, but also that this delivery is highly predictable, and therefore that the size of the top right quadrant is as large as possible, relative to the other quadrants. We have called the process for doing this 'benefits management'. Benefits management can be defined as the '*process of organising and managing such that the potential benefits arising from the use of IT are actually realised*'.

Whilst the objective is to increase the area covered by the top right quadrant in Figure 1, and reduce the area covered by the other three (especially the bottom two), benefits management is not only about only managing for the positive expected outcomes; it is also about managing the other three quadrants. It must be remembered that all IT projects have outcomes, but not all outcomes can be considered as benefits. For example, reducing order-cycle time may be an outcome of a new order processing application, but this is only a benefit if this results in increasing customer satisfaction and retention levels, better utilisation of customer service staff, and perhaps attracting new business. The challenge for management is to ensure that outcomes translate into business benefits.

Figure 2 (opposite) attempts to capture the process of benefits realisation. This figure illus-

Figure 1 Setting the overall objectives of benefits management – possible outcomes of IS/IT investments



trates that the changes leading to benefits unfold over time, and that this process of change takes place within a particular organisational context. It is the interaction of IT functionality and business changes which delivers particular outcomes[5]. These outcomes, assuming that they are positive, ultimately deliver business benefits which help in satisfying the overall investment objective.

Despite the simplicity of the benefits management concept, to deliver benefits, fundamental organisational and managerial mindset shifts are required. Figure 3 (below) shows some of the more profound shifts that we have identified in our research. It is either the inability or reluctance of management to make these transitions that can be the key barrier to releasing the value of IT.

From the list in Figure 3, the first item is the most important – the crucial requirement that the focus of attention within IT projects shifts away from delivering technology to delivering business benefits. After all, this is why the investment is being made – a fact that is often lost on management teams. With this as the new focus, the overall management of the project can then be centred around benefits tracking, as opposed to low level project task monitoring, a feature of traditional project management approaches.

As a consequence of this, the IT implementation plan becomes a more general change management plan, requiring that business managers no longer assume neutral roles but get actively involved in controlling the project. In fact, all stakeholders should become involved in the delivery of the project rather than be the passive observers. Essential to stakeholder involvement is a fundamental shift in thinking away from merely providing training to use the technology, towards education in the exploitation of technology and how to use the information it generates to support decision taking[6].

Finally, rather than undertaking a post-implementation technology project audit, which often degenerates into a 'witch-hunt' if a project has failed, the focus should shift towards reviewing the project to assess whether expected benefits have been achieved, drawing out lessons and experience from the project in order to incorporate these in future projects while also seeking to leverage further benefits. Understanding the opportunities provided by IT is often experiential; it may be only after having used the new system for a time that managers and users see new possibilities.

The project should be assessed to see if benefits have been achieved

Figure 2 Linking the investment objective with the content of IT and business changes

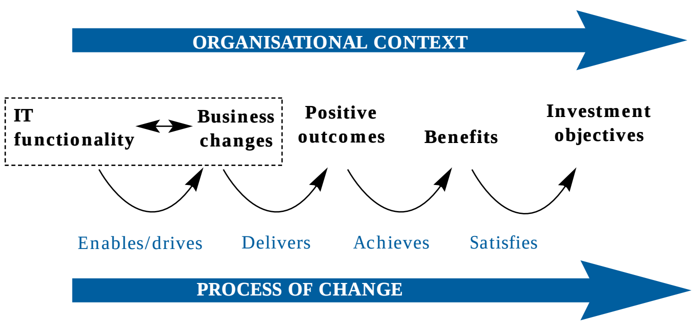


Figure 3 Shifting mindsets to unlock business value

From	To
Technology delivery	Benefits delivery
Expenditure proposal – loose linkage to business needs	Business case – integration with business drivers
IT implementation plan	Change management plan
Business manager as victim	Business manager involved in control
Large set of unfocused functionality	IT investment which is sufficient for the job
Stakeholders 'subjected to'	Stakeholders 'involved in'
Low level project task monitoring	Benefits tracking
Trained in using technology	Educated in exploitation of technology
Do a technology project and audit	Review for learning and to leverage more benefit

The benefits management process assesses the feasibility and likelihood of success

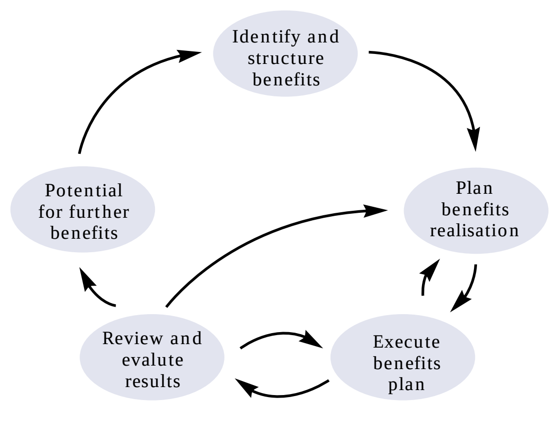
The benefits dependency network (BDN) identifies business changes that need to occur

The benefits management process

Through our research with some of Europe's leading corporations we have developed a benefits management process[7], which is illustrated in Figure 4 (below). It is an iterative process, but following the diagram clockwise, it can be summarised as follows:

- *identifying and structuring benefits* – the process begins by understanding the business drivers for the project; identifying all the possible benefits, and expressing these in business terms; quantifying and valuing these benefits in terms of scale and money, and determining the distribution of the benefits (where and who);
- *planning benefits realisation* – following on from this, decisions are made regarding how the benefits are going to be achieved, ie the business changes required (including the identification of who will be assigned responsibility for ensuring that these changes actually happen), and when the changes will be made. Establishing metrics for performance measurement and ongoing monitoring is also important at this stage;
- *executing the benefits realisation plan* – this is the making it happen phase, in essence executing the change management programmes. Monitoring progress against the activities of the benefits realisation plan is just as important as for the IT implementation and development plans; and
- *evaluating and reviewing results* – the philosophy of benefits management is that the benefits are tracked during the lifetime of the system. It entails formal reviews of what was and was not achieved in order to maximise the benefits of the project. The project is also evaluated not only to establish learning for future project but also to identify the potential for further benefits, which in turn can generate another iteration of the whole process.

Figure 4 The benefits management process



At Cranfield we have developed a comprehensive approach and tool set that takes organisations around the benefits management process shown in Figure 4. The approach as it relates to the first two stages of this process are shown in Figure 5 (below). These, in essence, are a series of questions to be considered in order to construct a robust business case for the investment, and a viable change management plan to deliver the benefits. Only when this assessment has been completed, and the feasibility of achieving the target benefits thoroughly tested, should a case requesting funding for the IT investment be developed. More importantly, after this process, the investment proposal will be supported by a comprehensive benefits delivery plan which greatly increases the likelihood of the benefits being realised once the project begins.

The benefits dependency network

Addressing the questions posed in Figure 5 usually requires the use of analytical tools, some of which are already in existence, such as stakeholder analysis and impact analysis, but which have been tailored to the requirements of the approach. Other, new tools and techniques were developed during the course of the research. One such tool is the benefits dependency network (BDN), which has proved to be a powerful device in getting the philosophy of benefits management across to executive management teams, as well as highlighting the central role they play in the process of releasing value.

The BDN tool provides a framework for linking the overall investment objective with the requisite benefits through describing the business changes which are necessary to deliver those benefits, and then linking them to the required IT functionality to both drive and enable these changes to be made. Figure 6 (opposite, bottom) illustrates a partial BDN for a CRM project, developed during our work with a large European manufacturer; the actual network was considerably more complex. This process can enable management to identify not only where interdependencies exist, but also to identify and assign responsibilities for managing issues.

Figure 5 Constructing the benefits delivery plan

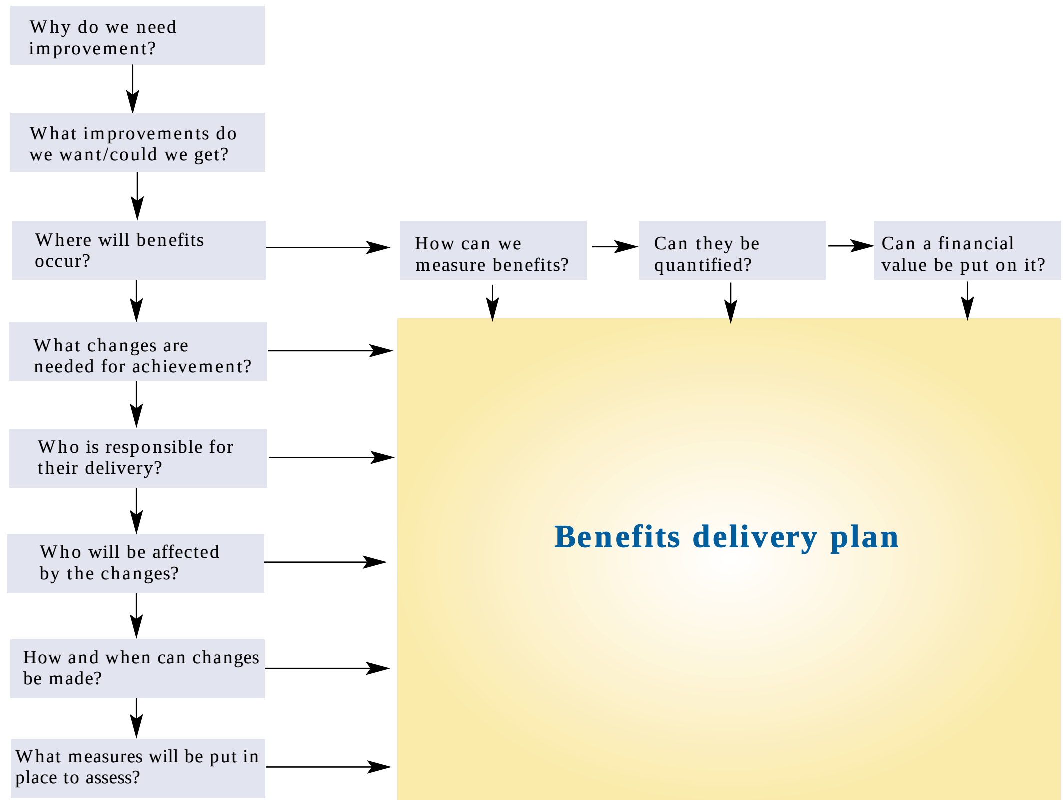
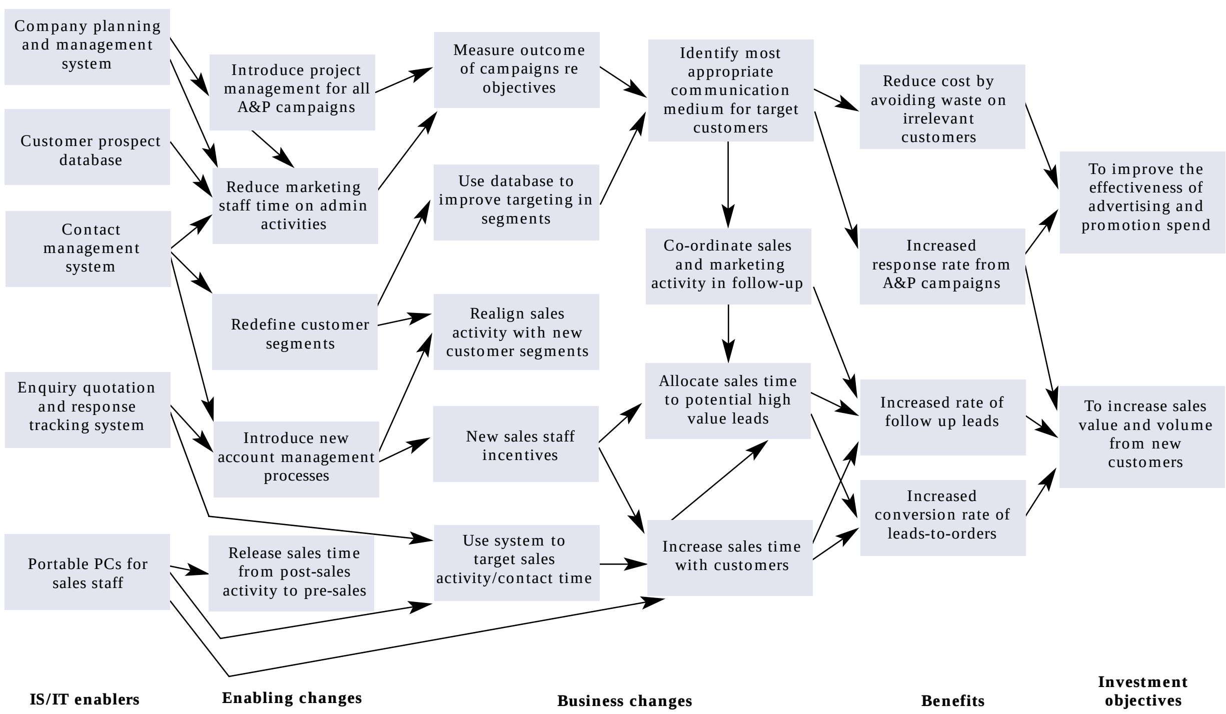


Figure 6 An example of a (partial) benefits-dependency network for a CRM investment



The changes highlighted by a BDN can be categorised as either business changes or enabling changes. These can be distinguished as follows:

BDN contrasts with approaches which focus on implementing technical components rather than business benefits

- business changes are those changes to working practices, processes, and/or relationships that will cause the benefits to be delivered (or begin to be delivered). They cannot normally be made until the new system is available for use and the necessary enabling changes have been made; eg allocating more sales time to potentially high value leads identified by the new system, requires the system and perhaps other enablers to be in place; and
- enabling changes are those changes which are pre-requisites for making the business changes and/or are essential to bring the new system into effective operation. These often involve defining and agreeing new working practices, redesigning processes, changes to job roles and responsibilities, new incentive or performance management schemes, training in new business skills (as well as the more obvious training and education in the new system), etc. They can often be made, or have to be made, before the new system is introduced, for example, agreeing a new sales account management and incentive scheme to ensure rewards reflect the attention to high value customer needs.

Benefits management seeks to provide a framework for maximising returns from IT expenditure

Once the initial BDN has been constructed, responsibilities for each of the changes can then be assigned and time-scales for their achievement can be established. Assigning ownership for making the changes will help focus management attention. Expecting the changes to occur automatically is leaving too much to chance, but this is exactly what happens in most IT projects. In our work, we have found that management teams often struggle to construct the BDN, even after a project has started, yet it is these very changes that will ultimately deliver the benefits.

In addition, determining metrics to assess progress in making the changes over the duration of the project can prove very worthwhile and these can also be linked to staff compensation. One global pharmaceutical company we worked with developed a BDN for the implementation of its shared services centre across 13 European countries. All of the change activities identified in the BDN for the new enterprise resource planning (ERP) system were cascaded down to the level of the individual employee and built into their six monthly performance objectives.

Some organisations have used the BDN to help in scoping individual work packages on a large-scale IT project. Through identifying all the necessary changes to deliver a particular benefit or set of benefits, one particular insurance company created a number of sub-projects, which were then implemented on a phased basis. Each sub-project focused on achieving particular 'benefit streams' and provided focus to what was a complex project. This is in contrast to the fragmented approach that organisations often adopt with IT projects, where phased implementation is based on technical components not business benefits.

Conclusion

We would be the first to admit that releasing value from IT is not rocket science but rather common sense. Yet, how many organisations do actively manage for benefits? Our research suggests that less than 10% of the largest UK companies actually have a formal benefits management process; we would suggest a similar figure in the US and mainland Europe.

Today organisations such as pharmaceutical companies GlaxoSmithKline and AstraZeneca, financial institutions Alliance & Leceister and NatWest Bank, and telecommunications organisation BT are using a benefits management process to release value from their investments in IT. Their experience and lessons are being incorporated into the process as we improve our understanding of how benefits and value through IT are created.

In summary, benefits management seeks to provide a framework for maximising the return from IT expenditure. It is not simply a cost/benefit technique nor is it an expenditure proposal methodology. Benefits management is a life-cycle approach to delivering beneficial return on an organisation's IT projects. It provides a framework and a toolset for mapping the flow of achievable benefits as a result of investment. MQ

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