



# **Integrated Performance Management: A Guide to Strategy Implementation**

## **Performance from a Finance Perspective: Shareholder Value and Beyond**

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## **Performance from a Finance Perspective: Shareholder Value and Beyond**

Kurt Verweire, Xavier Baeten, Lieven Somers and Lutgart Van den Berghe

Performance measurement and performance management are vivid topics among finance people. Finance people are mainly concerned how the outside world sees and values the long-term performance of an organization.<sup>1</sup> *Corporate performance* measures indicate how the successful organization can allocate its resources over different product markets. In specialized firms, the resources are devoted to a single product market (and in these cases, corporate and business unit performance are the same). In order to operationalize the concept of corporate performance in greater detail, we go back to the basic definition of the corporation: an organization is an association of productive assets which come together to obtain economic advantages. For an organization to continue to exist, the owners of these productive assets must be satisfied with their use. Then, corporate performance can be defined as a firm's level of achievement in creating value for *market constituents*.

Robert Simons (2000), a well-known Harvard professor, identifies three key constituents of value creation from a corporate performance perspective: (1) customers; (2) suppliers; and (3) owners and creditors. He sees these three groups of stakeholders transacting with the organization through different markets. Customers buy goods and services through *product markets*; suppliers sell products and services to an organization through *supply markets*; and owners and creditors buy and sell ownership claims - shares of stock in the company - or debt instruments through *financial markets*.

In this chapter, we investigate how the concept of performance is considered at financial markets. Whether the company is listed or not, managers must ensure that the financial returns created by the sustained profitability of their business are meeting the expectations of owners and potential owners. The quest for value creation from a financial market perspective has received most attention and dominates the Anglo-Saxon (and increasingly the global) world. The starting points for this chapter are the performance measurement and performance management frameworks, developed for this particular category of stakeholders, i.e., the *shareholders*.

First, we look at the traditional (financial) measures of corporate performance. We then focus on shareholder value and Value-Based Management. These performance measurement and management frameworks have been developed as a reaction against the traditional performance measurement frameworks. However, the new corporate performance measures, focusing on shareholder value, have been attacked as well. Nowadays, there is an increasing demand for *stakeholder value*. Therefore, we also pay attention to this concept and to the concept of stakeholder management. We will define these concepts and describe their implications for performance management in the last paragraph of this chapter.

### **Traditional Measures of Corporate (Financial) Performance**

Traditionally, corporate performance is defined in financial terms. Consequently, financial information is the most widely available information source on companies. This is mainly due to requirements imposed by regulators and supervisors to disclose certain financial information. The extent to which this financial information must be disclosed is dependent upon the public or private character of the company, its size, or whether the company is listed or not. The financial performance measures can be divided into two main types: (1) measures

based on accounting data; and (2) market-based measures derived from stock market values. In this section, we briefly describe these two types of measure. We refer to the more specialized literature for an extensive review of these various performance measures.

### Accounting-Based Performance Measures

The validity of accounting-based performance measures has been extensively examined. The focus has been on *profitability measures*, such as *Return on Investment (ROI)* and *Return on Sales (ROS)*. The interest in profitability as the ultimate performance measure is not that strange. Neoclassical economists and classical management theorists consider profit maximization as the legitimate objective of all private organizations. But, as we will see later in this chapter, this assumption has more recently come under attack from other economists and management theorists.

Apart from more philosophical reasons, Balaji Chakravathy (1986), a strategy professor at IMD, concluded that traditional profitability measures are inadequate for evaluating a firm's strategic importance. Despite the criticisms on these financial performance measures, they still play - and will continue to play - a central role in corporate life. Whatever their limitations, they are far too deeply linked to the legal and regulatory side of business to be completely replaced by new approaches (Hennell and Warner, 1998).

The most frequently used accounting-based measures are:

- Return on equity: earnings over shareholder's equity;
- Earnings per share: earnings over average shares in issue during the year;
- Pay-out ratio: defined as dividends over earnings;
- Cash flow: usually defined as earnings plus depreciations.

All these different financial measures paint a picture of the performance of the companies over the financial year, and over a longer period of time when compared with earlier accounts. Yet, herein lies one of the major criticisms of accounting-based performance measures: they merely reflect the firm's past performance, which is not always useful to monitor and guide future performance.

There are other drawbacks associated with accounting measures. One of the main drawbacks is that accounting measures can be misleading if they have been manipulated or massaged in such a way as to present a spurious reflection of the firm's performance. It is logical that the figures paint a façade of the company in the colours that the company wants (Brown and Laverick, 1994). Other critiques of accounting measures concern differences in accounting principles. With the General Accepted Accounting Principles (GAAP) varying significantly from country to country, it is possible for the same company, using the same figures, to declare a profit in one country and a loss in another. This is because of different treatments of goodwill, taxation, valuation of inventories, capitalization of costs, provisions, among others.

### Market-Based Performance Measures

Market-based performance measures are completely different from accounting-based performance measures. While accounting-based performance measures are thought to reflect a firm's past performance, market-based measures reflect the present value of future streams of income. They vary from day to day, and incorporate evolutions in accounting profits, as well as external factors.

A central concept here is *market capitalization*, which is defined as the total value of all shares in the stock market. If the market capitalization is higher than the shareholders' equity, the management has created value. This value added is called *market value added (MVA)*, and is the difference between the company's market capitalization and the shareholders' equity. Equity is made up of share capital plus retained profits. Consequently, MVA tells us how much net value has been created for the owners of the company, i.e. the shareholders (see [Figure 2.1](#)).

**Figure 2.1 Relationship between equity and market capitalization**



*Source: Hennell and Warner (1998: 39)*

Based on these different concepts, different market-based performance measures can be computed. The most common measures are:

- Price-to-book ratio: defined as the market capitalization over the shareholders' equity;
- Price-to-earnings ratio (P/E ratio): current share price over earnings per share;

- Dividend yield: dividend per share over current share price.

In general, high measures indicate well-performing firms. But this is not always the case. For example, a high P/E ratio can be a sign of the quality of the management, but might also reflect the poor quality of present performance. Furthermore, it is better to consider market-based performance measures in relation to the whole stock market, or against an industry average, or a subset of companies in a particular industry (peer groups).

### Accounting and Market-Based Performance Measures: A Preliminary Conclusion

This overview of both accounting-based and market-based performance measures has made clear that you need multiple performance measures to evaluate a firm's financial performance. It is also important to consider several years and, if possible, to benchmark with similar companies. We have collected some common key ratios for five major US companies and Suez. These figures are presented in [Table 2.1](#).

**Table 2.1 Common key ratios and statistics for major US companies and Suez (pricing and volume data as of 1 March 2002)**

	ROE (%)	EPS (\$)	Market capital (\$bn)	Price/Book	P/E	Dividend yield (%)
Microsoft Corp.	12.57	1.10	332.30	6.43	56.05	0.00
Wal-Mart Stores Inc.	20.12	1.49	279.9	7.97	42.15	0.45
General Electric Co.	27.27	1.41	391.8	7.31	28.04	1.83
The Coca-Cola Co.	39.00	1.60	120.4	10.86	30.22	1.65
Citigroup Inc.	20.52	2.75	235.6	3.08	16.63	1.40
Suez	15.76	1.80	29.0	2.36	15.73	0.00

Source: Money.cnn.com (2002)

### Towards Shareholder Value and Economic Value Added (EVA®) - The Emergence of Value-Based Management

The traditional financial performance measures have been subject to growing criticism. One of the major critiques has come from the accounting and financial corner. In the beginning of the 1980s, researchers detected that there was little correlation between historical accounting earnings and shareholder value, the latter becoming increasingly important in a global world dominated by the capital markets. Shareholder value is -as the word describes - the value created for the shareholder and is composed of two basic elements: (1) capital gains; and (2) dividends. This sum is often referred to as *total shareholder return* (TSR). The lack of correlation between shareholder value and accounting measures shows that profit is clearly not the only driver of stock market performance.

In order to cope with these criticisms, analysts, consultants and managers have been searching for performance measures that are more closely aligned with corporate strategies and long-term value creation. One of the solutions forwarded was the concept of *shareholder value*. The basic idea of shareholder value is simple: measure the value that firms create or destroy by subtracting a capital charge from the cash returns they generate on invested capital. The objective is to get decision-makers think about the *economic profit* that is generated when they evaluate new business opportunities. Economic profit means that a business generates returns similar to an investment in the stock market. Economic profit is different from accounting profit because the latter does not take into account the opportunity

cost of the capital employed.

### Some History

Theories of shareholder value are rooted in the history of corporate finance. According to Andrew Black and his colleagues (1998), the concept of shareholder value started to take on a life of its own as a result of the work done by Harry Markowitz and William Sharpe, and John Lintner and Jan Mossin on the *Capital Asset Pricing Model* (CAPM). This model gives a precise prediction of the relationship between the risk of an asset and its expected return. Generally stated, the higher the risk the greater the return should be. The key insight of the CAPM model - one that is central to the shareholder value view of the world - is that there is a risk-weighted discount factor which allows you to assess the value today of tomorrow's developments, profits and cash flows. This discount rate is derived from observations of capital markets and defines what the opportunity cost of equity to an investor in the market is. It states what the company has to earn in order to justify the use of the capital resources tied up in the business (Black et al., 1998).

These insights have been applied to the corporate world in the late 1970s and the early 1980s and gained prominence with Alfred Rappaport's *Creating Shareholder Value* (1986). Other publications followed and software products, which helped managers in achieving the goals of shareholder value, were created. Since then, the concept has gained more and more attention and, from the 1990s on, the idea that business existed only to increase shareholder wealth has dominated significant parts of the corporate world, especially in the USA and the UK. In fact, shareholder value became so popular among analysts that the mere announcement of its introduction could cause a share price to rise.<sup>2</sup>

In an article in the *Financial Times*, Anjan Thakor, Jeff DeGraff and Robert Quinn (2000) see two major reasons why CEOs are worshipping at the altar of shareholder value. The first one is corporate control pressures. During the 1980s and 1990s, corporate control contests in the US often resulted in the removal of CEOs whose companies failed to deliver adequate shareholder value. A second important reason is executive compensation. Large institutional investors are increasingly influencing corporate policies and are creating a heightened awareness of the role of compensation-based incentives in focusing executive efforts on creating shareholder value (Thakor et al., 2000).

### What is New about Shareholder Value and EVA®?

As we already mentioned, the basic idea associated with shareholder value is that a company only adds value for its shareholders when equity returns exceed equity cost. There are different metrics available to calculate shareholder value. One of the most famous ones is *economic value added* (EVA®), a concept that is registered by Stern Stewart & Co., a consulting firm based in New York.

The basic idea of EVA traces back to the concept of *residual income*, which was first used by General Motors earlier this century. Residual income is a measure of how much additional profit remains for investment in the business or distribution to owners after allowing for normal (expected) returns on investment. It is defined as the accounting profit minus a charge for capital used to generate profit. A positive residual income should correlate with increases in the market value of the firm because positive residual income indicates that a business is accumulating net resources at a rate greater than is needed to satisfy the providers of capital

(Simons, 2000). As such, the residual income concept has shifted the paradigm from a focus on growth to a focus on good growth.

EVA builds further on the concept of residual income, as it tries to measure the difference between the sales made in a period and the real up-to-date cost of all resources consumed in that same period. Ideally, these resources should be valued in true economic terms, reflecting the current rather than historic costs. Stern Stewart has identified a possible 164 adjustments which can be applied to the profit or capital employed numbers before arriving at EVA. The differences in the approaches towards shareholder value are situated in which adjustments are made. However, all measures of shareholder value (whether it is EVA or another measure) have some elements in common. Hennell and Warner (1998) clearly describe what makes EVA (and other metrics of shareholder value) different from the traditional performance measures:

It is, however, in its treatment of the economic cost of using assets within the business that EVA is significantly different from the [traditional performance] measures. ... The key feature of EVA is that it brings balance sheet and therefore cash flow variables into the profit and loss account in a way which achieves the benefits of ROCE (Return on Capital Employed) without some of the problems. It does this by charging the company's cost of capital as a percentage of assets employed in the business as a final entry before the bottomline profit.

Another important feature of EVA is its emphasis on post-tax profit rather than profit at the operating level, encouraging managers to take a proactive approach to the management of this line of the profit and loss account. Not every company may wish to take this approach and we have seen companies adopt measures for their business units which are otherwise similar to EVA but at the pre-tax level. Their view is that it is better to encourage operating managers to leave tax issues to the specialists in the center. ...

The post-tax profit number is not as easy to extract as it may seem and this is one of the practical complexities of arriving at a true EVA number. The normal accounting definition of post-tax profit - the earnings number in the profit and loss account - is after the deduction of interest costs. As the above average on capital employed includes the cost of interest in the overall cost of capital calculation, an adjustment has to be made to avoid double counting. The actual interest cost is therefore added back and a new calculation of tax is made on the adjusted profit. The resulting number is often called NOPAT - net operating profit after tax. This adding back of interest may be an area of complexity but it illustrates a very important point. Interest on borrowing is not the only element of cost of capital, which has to be charged to arrive at a true definition of economic profit. There is also the required return for shareholders and any inclusion of a charge for capital must reflect both elements. Thus interest is added back only to be included as part of the composite cost of capital figure.

(Hennell and Warner, 1998: 49–50)

[Table 2.2](#) compares the traditional profit calculation with the EVA-based profit calculation.

### **Table 2.2 Comparison between traditional profit calculation and EVA®**

Traditional profit calculation	EVA-based profit calculation
Revenues	Revenues
- Operational costs	- Operational costs
= Earnings before interest and taxes (EBIT)	= Earnings before interest and taxes (EBIT)
- Interest	- Taxes
= Earnings before taxes	= Net operating profit after taxes (NOPAT)
- Taxes	- Capital charge
= Profit after taxes	= Economic value added (EVA)

Source: Jorissen and Bruggeman (1999)

### Shareholder Value and EVA: Pros and Cons

Shareholder value and EVA have increased in importance over the last years. In this paragraph, we focus on EVA since it is the best known of the shareholder value metrics (Brown et al., 2000).

Both academicians and practitioners point out numerous benefits of EVA. Because it is a single-period measure, it allows for an annual measurement of actual, not-estimated or forecasted, value created performance (Armitage and Fog, 1996). Others refer to the fact that it corresponds more closely to economic profit than accounting earnings do and, as an objective, is consistent with the pursuit of shareholder interest. Claims have also been made that EVA can drive behavioural change by providing the incentive for managers to promote shareholder wealth as the primary objective (Dodd and Chen, 1996).

Although some research indicates that EVA, indeed, is quite well correlated with stock price performance (Lehn and Makhija, 1996; O'Byrne, 1996; Bacidore et al., 1997), other research points out that EVA does not dominate earnings in association with stock market returns (Dodd and Chen, 1996; Biddle et al., 1997; Günther et al., 1999). The implied effectiveness of EVA as a performance measure based on the association between EVA and stock return is therefore at least ambiguous.

Moreover, EVA, being a single period measure, does not address the problem of the time period over which profits are to be maximized, nor does it deal with issues over short-termism. Furthermore, the EVA practice of 'decoupling' performance measures from GAAP while having significant incentive benefits also induces potential costs in the form of increased auditing requirements. Due to the fact that EVA is a monetary measure, Stewart (1999) proposes to standardize the metric on business unit level to reflect a common level of capital employed. Finally, because EVA assesses the capital charge on the firm's economic book value rather than on its market value, next to the fact that the adjusted capital represents only the values of the physical assets in place and not the strategy, some authors suggest using total market value of the firm's assets instead of the adjusted book value (Badicore et al., 1997).

A final drawback of EVA and shareholder value is their financial focus. Shareholder value measures fail to consider the industry and competitive context in which firms compete. They give no clear answers on how firms can create sustainable wealth from a more strategic perspective. As we will see later, other performance measures, such as the Balanced Scorecard, are more helpful in providing these answers. We will come back to this issue in [Chapter 3](#).

## Shareholder Value and Value-Based Management

The discussion of shareholder value has mainly focused on which metrics to use - and perhaps even more who can claim the copyright on them. Out of this discussion some new performance measurement (and management) frameworks emerged. These frameworks combine the performance measures discussed above with a specific management technique, which is labelled *Value-Based Management*. Value-Based Management is defined as 'a formal, systematic approach to managing companies to achieve the governing objective of maximizing wealth and shareholder value over time' (McTaggart et al., 1994: 367). How this is done is not agreed upon yet. Value-Based Management as a practice emerged from the experience and fieldwork of different professionals and consultants. Well-known Value-Based Management frameworks are Stern Stewart's EVA Financial Management System, Marakon's Managing for Value framework, McKinsey's Valuation framework, and PricewaterhouseCoopers' ValueBuilder.

The concept of Value-Based Management is very interesting from an Integrated Performance Management perspective. The main idea here is that adopting a Value-Based Management programme is more than simply altering the performance measures. It is not enough that a management accounting system is set up to capture business profitability by adjusting for a true cost of capital instead of measuring and reporting traditional return on income. Almost every consulting firm warns companies not to adopt only a performance measure change. Value-Based Management requires a fundamental change in the management processes adopted by an organization to interpret strategy, develop plans and budgets, measure performance and take decisions. Furthermore, all Value-Based Management frameworks stress the importance of an adequate and aligned reward and compensation system (Ameels et al., 2002). So far, consultants agree. However, there is less agreement on the format of the management system. It is beyond the scope of this book to give a detailed explanation of the differences between the main Value-Based Management frameworks of the four consulting firms. We will restrict ourselves to presenting the main steps in a Value-Based Management approach. Generally, Value-Based Management can be thought of as a three-stage process:

- Gain understanding of value creation in each business;
- Transform the company to align it with the ultimate goal of shareholder value maximization;
- Communicate, both internally and externally (Black et al., 1998).

*Value creation* is central in Value-Based Management. Shareholder value is created when a strategy is developed which generates future cash flows with positive present value that exceeds expectations. The whole organization needs to focus on the *value drivers* which ultimately generate the shareholder value of the organization. These value drivers are often defined in financial terms (e.g., revenue growth, profit margins, working capital, cost of equity, etc.). The management should set clear targets for each of these value drivers, which must then be cascaded down to the managers who exercise day-to-day control. As such, every aspect of the organization has to adopt an approach consistent with the overall goal of shareholder value maximization.

After the analysis phase, action must be undertaken to create and *preserve* shareholder wealth. 'Creating and sustaining value is not merely an analytical or planning exercise', says James Knight (1998: 3): 'To build long-term sustainable value in your organization you must transform its people, culture and processes to drive for shareholder wealth.' Clearly, this is the management component of the Value-Based Management process. Many consultants use

some well-known strategy frameworks (such as portfolio management and competitive advantage frameworks) to back this part of the process. Many add a specific section on how to reward and compensate managers. We elaborate in greater detail on these and other (often neglected) issues in the second part of this book.

*Communication* is the third step in a Value-Based Management approach. Some frameworks focus on the internal communication within the company. The purpose is to stress the importance of Value-Based Management to the whole company and to specify how everybody can contribute to this overarching goal. Communication efforts need to go outside the company as well. This is the *value realization* process.

The final step, value realization, is often neglected by corporations. Investors realize value through capital appreciation of their stock and dividend pay-outs. In most cases, the bulk of shareholder returns comes through capital appreciation. Since markets are only as efficient as the information available, investors will not benefit unless the market understands the value created by your company and the strategies in place to build and preserve that value. Companies that deliver credible and relevant information to the market in a timely fashion, and are recognized for effectively managing value expectations, are much more likely to maintain a market value that reflects their true value than businesses with poor communication programs.

(Black et al., 1998: 78)

Internal communication is a central element in the Integrated Performance Management literature, and the corporate governance literature tells us that a good and clear communication to the financial markets is crucial.

All in all, the philosophy that is promoted by Value-Based Management is fully in line with the philosophy behind Integrated Performance Management, as presented in [Chapter 1](#). Value-Based management favours a more integrated management approach and goes beyond just measuring performance, although the measurement aspect receives most of the attention. How the management part is given shape remains controversial and open for discussion. So far there is no generally accepted framework. Even the well-developed financial measures are being attacked. In the remainder of this chapter, we challenge one of the basic principles on shareholder value in greater detail, i.e., the maximization of shareholder value as the ultimate goal for a company.

### **Broadening the Financial Concept: From Shareholder Value to Stakeholder Value**

The purpose of each company is to create value. The question then arises: for whom? So far there is no consensus about the answer. Two, seemingly contradictory, perspectives have been taken: the shareholder perspective versus the stakeholder perspective.

It was Milton Friedman who stated that the only social responsibility of the firm was the maximization of profits. Profit is a surplus that is created by the firm's activities and is thus a signal that value is created (Henderson, 2001). The shareholder should then be the constituent for whom value is created. The strongest argument for this idea is based on the principle of private property. The shareholders are considered as the owners of the company and therefore have the right to control corporate resources so as to make sure that they are used in the shareholders' best interests.

This argument has been countered by several authors, who have introduced the stakeholder concept, arguing that the company is no longer the private property of one or a small group of owners, and hence should create value for all stakeholders (Figge and Schaltegger, 2000). Stakeholders can be defined as individuals or groups who have a direct or indirect stake in the company's activities. This means that the stakeholder approach is broader than the shareholder approach, the latter focusing only on one stakeholder. More and more managers are convinced that the corporation should be regarded as a coalition of interest groups with a stake. Charles Handy (1994a), for instance, is convinced that the immediate interests of shareholders have been given too much attention. He is convinced that their interests should be more balanced with the interests of other claimants. In their book, *The Performance Prism*, Neely, Adams and Kennerley (2002) have presented many examples that prove that there is a growing trend that executives across the world recognize and accept that the business empires they manage have a broader role to play in the twenty-first century than simply delivering value to their shareholders: 'For companies to be successful over time they must address multiple constituencies. If companies do not give each of them the right level of focus, both their corporate reputation and their market capitalization are likely to suffer' (Neely et al., 2002: 4–5). In the meantime, stakeholder management has been further developed, and a stakeholder view of the corporation has emerged (Post et al., 2002).

In what follows we will briefly present the most important stakeholder theories, and address the concept of stakeholder value. Finally, we present a framework for stakeholder-driven management.

### Stakeholder Theories

From a business perspective, there are several arguments why companies should adopt a broader perspective, focusing on stakeholders. Donaldson and Preston (1995) consider three stakeholder theories. We will briefly discuss two of them: the normative stakeholder theory and the instrumental stakeholder theory.<sup>3</sup> According to the *normative stakeholder theory*, which has a more philosophical background, a company should address its stakeholders because it is the only right thing to do. *The instrumental stakeholder theory* proposes that stakeholder-oriented companies perform better than companies that do not address their stakeholders. Potential reasons for this relationship are:

- Not establishing stakeholder relations could lead to a rise in stakeholder risk;
- Strong relationships with the business partners can stimulate innovation;
- Networks of relationships provide resources and knowledge for the development of new markets and opportunities;
- Relationships are the source of an excellent reputation, which in turn decreases the franchise risk and increases the *brand* value (Svendsen et al., 2000).

Thus, there are several theoretical arguments for why stakeholder management might affect performance. But what does academic research reveal in this respect? Post, Preston and Sachs (2002: 28) have examined the most important studies in the field and conclude that 'the empirical studies do not prove that corporations can "do well by doing good," but neither do they disprove that view, and there is no substantial evidence that corporations can "do well by doing harm".'

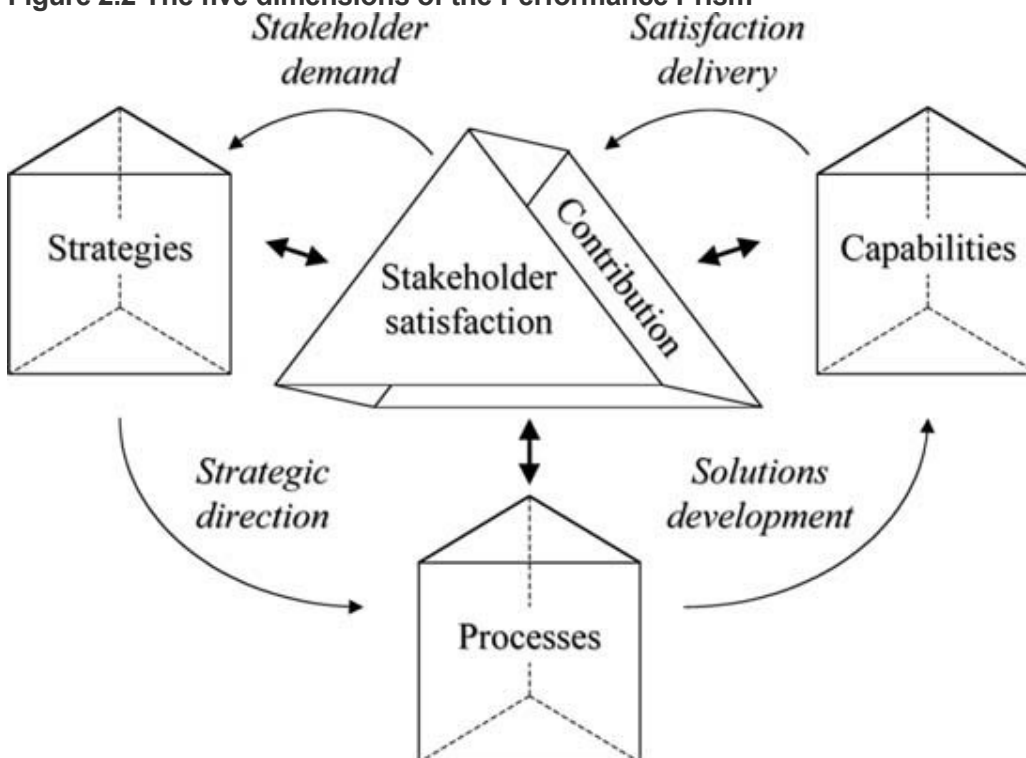
### Stakeholder Value versus Shareholder Value

It is clear that there is still a vast debate concerning the question for whom value should be created. This is not the only question that evokes a lot of discussion. Another equally important question is: 'What is stakeholder value? And how can we measure it?' Unlike shareholder value, stakeholder value is not a univocal concept, and there are many operationalizations for it.

John Elkington presented in *Cannibals with Forks* (1997) the concept of the *Triple Bottom Line*. The Triple Bottom Line is a more integrated performance measure, giving equal weight to the economic, social and ecological dimensions of corporate performance. It is true that these three dimensions should be managed properly, but it is our belief that it is not efficient to manage these dimensions (and the associated stakeholders) as if they were equally important. Therefore, it is very important to identify the expectations of different types of stakeholder. They are not all equally important, and it would be naive to suppose that all stakeholders should and will benefit all the time (Freeman and McVea, 2001). This is one of the first steps in the stakeholder management process. We will come back to this process in the next paragraph. Another drawback of this measure is that it does not help managers to understand and respond to what stakeholders want and expect. Svendsen et al. (2000) call for new stakeholder value measures that incorporate the quality of the relationships with different stakeholders. They consider this as a key, but still underdeveloped, territory in the field of stakeholder management.

Recently, Andy Neely, Chris Adams and Mike Kennerley (2002) have developed the *Performance Prism*, a more comprehensive and comprehensible measurement framework, built around five major interrelated perspectives on performance that pose specific vital questions (see [Figure 2.2](#)):

Figure 2.2 The five dimensions of the Performance Prism



Source: Kennerley and Neely (2002: 153)

- Stakeholder satisfaction: who are our key stakeholders and what do they want and need?
- Stakeholder contribution: what do we want and need from our stakeholders on a reciprocal basis?
- Strategies: what strategies do we need to put in place to satisfy the wants and needs of our stakeholders while satisfying our own requirements too?
- Processes: what processes do we need to put in place to enable us to execute our strategies?
- Capabilities: what capabilities do we need to put in place to allow us to operate our processes? (Neely et al., 2002: 160).

Neely and his colleagues define strategy and strategic objectives in terms of stakeholders. The central question becomes: How can our stakeholders help us to realize our strategy, and thus to achieve our organizational objectives? In their book *The Performance Prism* (2002), they present some relevant ideas and new performance measures to manage the following stakeholder categories:

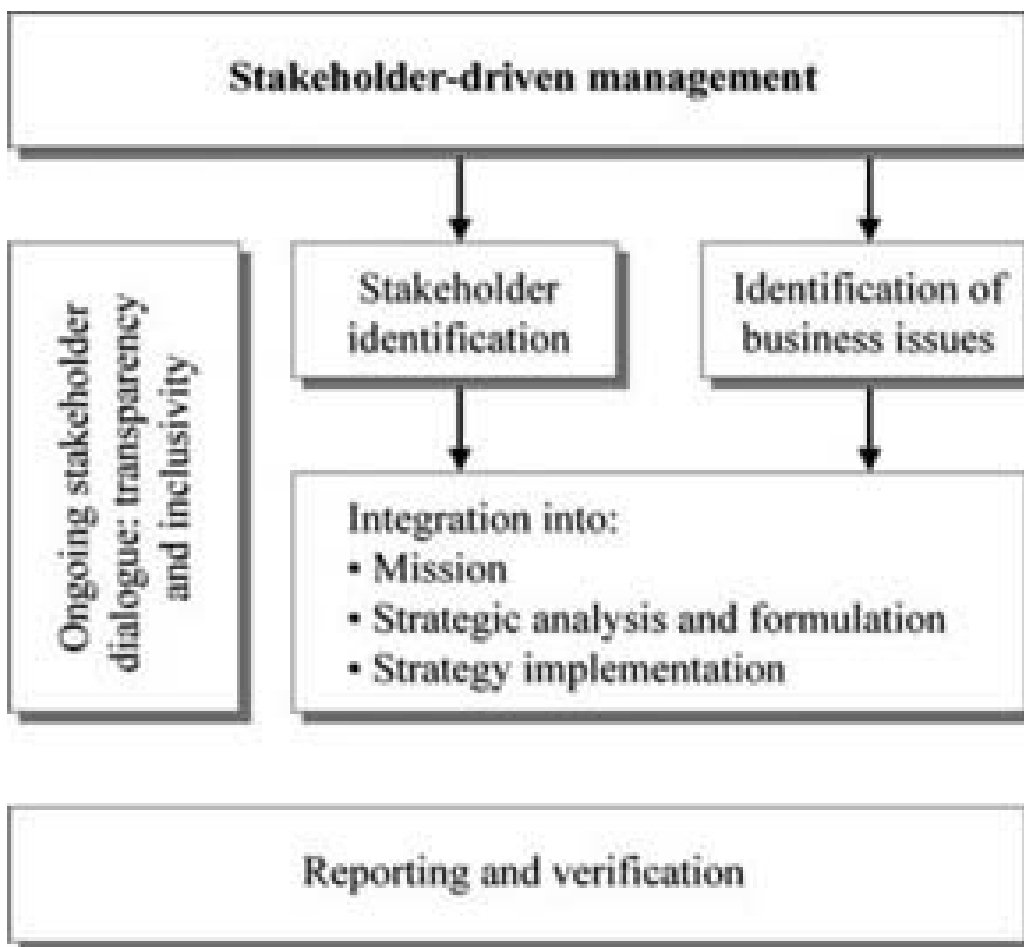
- Investors (including shareholders, bankers and other capital providers);
- Customers and intermediaries;
- Employees (including labour unions);
- Suppliers and alliance partners;
- Regulators, pressure groups, communities and the media.

### A Framework for Stakeholder-Driven Management

In the previous paragraphs, we defined stakeholder value and described why it is important to incorporate an increasing number of stakeholders in the strategy process. We define *stakeholder-driven management* as a goalsetting process, not limiting the organization's purpose to the sole creation of shareholder value, but broadening it to creating societal value for all those who have a direct or an indirect interest (stake) in the company's functioning. It should be made clear that it can by no means be the intention to manage the stakeholders (i.e., trying to convince stakeholders without taking their needs into account) or to have the company managed by its stakeholders.

Stakeholder value can only be realized if a company has a clear understanding of what stakeholders want and how they can contribute to the company's objectives. Therefore they need an open stakeholder dialogue to identify stakeholders and issues and to integrate this into the company's strategy, its management style and daily operations. A much more open and collaborative relationship between the company and its stakeholders is a key success factor. We are convinced that stakeholder dialogue is one of the most essential elements for creating stakeholder value. The framework, presented in [Figure 2.3](#), gives an overview of the main steps of a stakeholder-driven management approach.

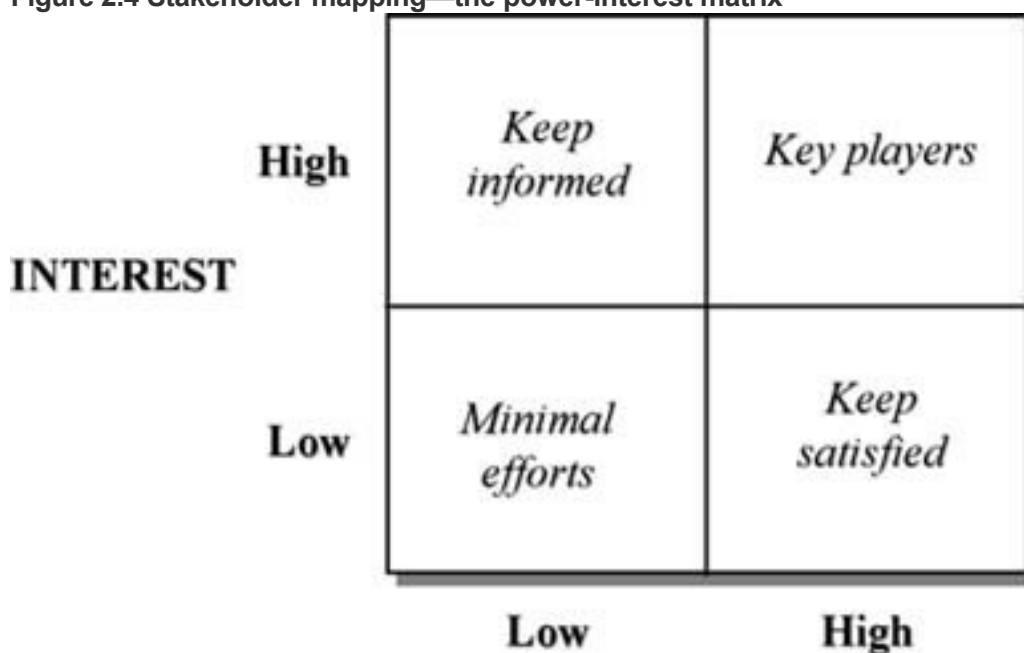
### Figure 2.3 The business framework for stakeholder-driven management (and CSR)



The stakeholder management process consists of a defined number of recurrent steps. The first step is the *identification and mapping* of the stakeholders. Stakeholders are abundant. They are not limited to shareholders, customers and employees. For example, suppliers, authorities, local communities can also play a significant role in formulating and implementing the firm's strategy. It will also become clear that the stakeholders will differ depending upon the level of analysis. A multinational organization will consider national governments as a very important stakeholder. When we look at the business unit level of that multinational company, more local stakeholders will become relevant. Therefore, before engaging in the process of stakeholder management, the level of analysis, or scope, should be defined.

Every stakeholder has his or her own interests and issues to be addressed. However, not all issues are equally urgent or important. A company must set priorities on which issues to solve. It is therefore necessary to segment the generic stakeholder groups into different subgroups. Stakeholder mapping is a tool that helps companies looking for common denominators among stakeholders to categorize them and to approach them in similar ways. The stakeholder identification model of Mitchell, Agle and Wood (1997) uses three variables - urgency, legitimacy and power - to group stakeholders into nine different categories. Johnson and Scholes (1999) identified the power/interest matrix to map the different types of stakeholder (see [Figure 2.4](#)). It is important to detect gaps between the current status and future stakeholder expectations and to study the actual quality of the relationships with these different stakeholders. Some variables that can help to do this are communication flows, personal relationships, problems that have occurred in the past, etc. The next step consists of making an inventory of *business issues*, i.e., environmental issues, changing values and needs, etc. It is extremely interesting to link these issues to the relevant stakeholders.

Figure 2.4 Stakeholder mapping—the power-interest matrix



Source: Johnson and Scholes (1999: 216)

*Stakeholder dialogue* is the second step in the stakeholder management process and is the most crucial one. The purpose of the stakeholder dialogue is to find a balance between the expectations of the company and its stakeholders. A stakeholder dialogue requires efforts from both sides and is not free of engagement. Expectations will rise and it is very important to be aware of the expectations of the stakeholders before engaging in dialogue. These expectations have to be in line with the expectations of the company. Another important aspect of the stakeholder dialogue is the knowledge level of both parties. When a company wants to dialogue with its stakeholders and it expects input from the stakeholders on a particular issue, the company must be sure that stakeholders are sufficiently informed and understand the issues at hand. Otherwise, stakeholders might lose their trust in the dialogue process, which might even lead to adverse effects!

Once the expectations of both parties are known, the adequate dialogue technique must be selected. It is obvious that, depending on the purpose and the number of stakeholders involved, different techniques should be used. Examples of dialogue techniques are: focus groups, surveys, group meetings, information sessions, etc.

The information obtained during the stakeholder dialogue will be used in the strategy formation process. As we said before, stakeholders have interests and want those interests to be served. In other words, they expect a certain degree of progress. To express this progress, performance indicators will have to be identified, calculated and reported. *Identifying these performance indicators* is the third step in the stakeholder management process.

*Reporting and verification* is the final step in the stakeholder management cycle. It is the end of a cycle and, at the same time, provides the input for the next cycle. It is a very important step because the company indicates to the stakeholders that it has taken actions, as agreed upon in the stakeholder dialogue. Credibility is a critical issue. It is a challenge to build

credibility into stakeholder management reports. One way to do this is to have the report externally verified by a trusted independent organization. Another method for building credibility is to follow a reporting standard such as the *Global Reporting Initiative* (GRI), although these guidelines also suggest an external verification.<sup>4</sup> Several companies publish a stakeholder report without passing the previous steps of the stakeholder management cycle. Those reports are easily dismissed by stakeholders as public relations efforts.

Many companies have started the process of stakeholder management. Case studies show that it is far from easy to establish solid relationships. Stakeholder management is a gradual and a continuous approach. The aim of the process cannot be reached by having a single dialogue or by publishing a report.

We acknowledge that other stakeholder models exist that were not discussed in this publication. Most of them focus on identifying relevant performance measures for an extended group of stakeholders. But more is needed to redefine the corporation, and to convince people that stakeholder management can be the driving force of organizational wealth.

## Conclusion

This overview has shown that the concept of corporate performance is multidimensional in nature. Within corporate performance, the focus has always been on the financial side, but this encompasses a broad range of elements. For a long time, accounting measures and market-based measures have been the most important measures to evaluate a company's overall performance. Now the concept of shareholder value is dominating large parts of the corporate world. This concept has evoked a new set of management tools, commonly referred to as Value-Based Management. Value-Based Management incorporates some aspects of Integrated Performance Management, but is restricted to developing strategies, rewards and the appropriate communication.

Furthermore, in Value-Based Management the focus is too much on the shareholder. Other stakeholders are important in the strategy formulation and implementation process. Here we introduced the concept of stakeholder-driven management. It was defined as a goal-setting process, not limiting the organization's purpose to the sole creation of shareholder value, but broadening it to creating societal value for all those who have a direct or an indirect interest (stake) in the functioning of the company.

## Notes

1 In this book, we use the terms 'organization', 'corporation', 'firm' and 'company' as synonyms.

2 Famous examples in this respect were Coca-Cola and Quaker. Their moves to performance systems based on shareholder value had a direct and positive impact on their share price: they went up merely on the announcement of such a move (Hennell and Warner, 1998: 4).

3 The third one is the descriptive stakeholder theory, which describes how companies consider their stakeholders. This theory is less relevant in explaining why companies should address their stakeholders.

4 The Global Reporting Initiative (GRI) was established in 1997 with the mission of designing globally applicable guidelines for preparing enterprise-level sustainability reports. GRI is one

of the better-known reporting standards for Triple Bottom Line performance.

- shareholders
- measures of performance
- stakeholders
- stakeholder theory
- profit
- cost of capital
- capitalization

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