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ACCOUNTING AND ITS RELATIONSHIP TO SHAREHOLDER VALUE AND BUSINESS STRUCTURE

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Abstract

This paper develops the two themes as being important: the separation of ownership from control and the divisionalized form of business. The first is implicated in the emergence of capital markets and the value based management, the subject of this paper, in which several tools for measuring shareholder value are described. The link between shareholder value, strategy and accounting is then introduced.

The second theme is the shift towards a decentralized, multidivisional business structure and the measurement and management of divisional (i.e. business unit) performance that has influenced the development of management accounting. This paper introduces the structure of business organizations, with emphasis on the divisionalized structure and decentralized profit responsibility. The paper concludes with a critical perspective that questions the focus on shareholders alone and raises issues concerning accounting in the divisionalized organization.

1. INTRODUCE

Since the seventeenth century, companies have been formed by shareholders in order to consolidate resources and invest in opportunities. Shareholders had limited liability through which their personal liability in the event of business failure was limited to their investment in shares. Shareholders appointed directors to manage the business, who in turn employed managers. Shareholders have few direct rights in relation to the conduct of the business. The main powers are to elect the directors and appoint the auditors in an annual general meeting of shareholders. They are also entitled to an annual report containing details of the company's financial performance.

The market in which investors buy and sell the shares of companies is called the capital market, which is normally associated with the Stock Exchange Companies obtain funds raised from shareholders (equity) and borrowings from financiers (debt). Both of these constitute the capital employed in the business.

The cost of capital represents the cost incurred by the organization to fund all its investments, comprising the cost of equity and the cost of debt weighted by the mix of debt and equity. The cost of debt is interest which is the price charged by the lender. The cost of equity is partly dividend and partly capital growth because most shareholders expect both regular income from profits (the dividend) and an increase in the value of their shares over time in the capital market. Thus the different costs of each form of capital weighted by the proportions of different forms of debt and equity, constitute the weighted average cost of capital. The management of the business relationship with capital markets is called financial management or corporate finance.

Companies use their capital to invest in technologies, people and materials in order to make buy and sell products or services to customers. This is called the product market. The focus of shareholder wealth according to Rappaport (1998)[1], is to obtain funds at competitive rates from capital markets and invest those funds to exploit imperfections in product markets. Where this takes place shareholder wealth is increased through dividends and increases in the share price. The 1990s saw a growing concern with the role of accounting in improving shareholder wealth.

2. VALUE- BASED MANAGEMENT

Since the mid- 1980s, there has been more and more emphasis on increasing the value of the business to its shareholders. Traditionally, business performance has been measured through accounting ratios such as return on capital employed (ROCE), return on investment (ROI), earnings per share and so on. However, it has been argued that this are historical rather than current measures and they vary between companies as a result of different accounting treatments.

Rappaport (1998) described how companies with strong cash flows diversified in the mid-twentieth century, often into uneconomic business which led to the value gap- the difference between the market value of the shares and the value of the business if it had been managed to maximize shareholder value. The consequence was the take over movement and subsequent asset stripping of the 1980s, which provided a powerful incentive for managers to focus on creating value for shareholders. The takeover movement itself led to problems as high acquisition premiums (the excess paid over and above the calculated value of the business, i.e. the goodwill) were paid to the owners and financed by high levels of debt. During the 1990s institutional investors (pension funds, insurance companies, investment trusts etc) through their dominance of share ownership increased their pressure on management to improve the financial performance of companies.

Value - based management (VBM) emphasizes shareholder value on the assumption that this is the primary goal of every business. VBM approaches include total shareholder return, market value added, shareholder value added and economic value added. Recent research into the use of value-based management approaches by UK companies is covered by Cooper et. al. (2001).[2]

Total shareholder returns (TSR) compares the dividends received by shareholders and the increase in the share price with the original shareholder investment, expressing the TSR as a percentage of the initial investment.

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[1] . Rappaport, A. (1998). Creating Shareholder Value: A Guide for managers and Investors (revd.edn) New York, NY: Free Press

[2] . Cooper, S, Crowther, D, Davies, M and Davis, E. W (2001) Shareholder or Stakeholder value: The Development of Indicators for the Control and Measurement of Performance. London: Chartered Institute of Management Accountants

Market value added (MVA) is a difference between total market capitalization (number of shares issued times share price plus the market value of debt) and the total capital invested in the business by debt and equity providers. This is a measure of the value generated by managers for shareholders.

Rapport (1998) coned shareholder value added (SVA) to refer to the increase in shareholder value over time. He defines shareholder value as the economic value of an investment, which can be calculated by using the cost of capital to discount forecast future cash flows (which he called free cash flows) into present values. The business must generate profits in product markets that exceed the cost of capital in the capital market for value to be created (if not shareholder value is eroded).

Rappaport developed a shareholder value network. He identified seven drivers of shareholder value: sales growth rate, operating profit margin, income tax rate, working capital investment, fixed capital investment, cost of capital and forecast duration. Managers make three types of decisions that influence these value drivers and lead to shareholder value:

- Operating decisions – product mix, pricing, promotion, customer service etc, which are then reflected in the sales growth rate, operating profit margin and income tax rate.
- Investment decisions – in both inventory and capacity, which are then reflected in both working capital and fixed capital investment.
- Financing decisions - the mix of debt and equity and the choice of financial instrument determine the cost of capital which is assessed by capital markets in terms of business risk.

The value growth duration is the estimated number of years over which the return from investment is expected to exceed the cost of capital.

The seven Value drivers determine the cash flow from operations, the level of debt and the cost of capital, all of which determine shareholder value. A detrimental consequence of the emphasis on shareholder value is that it has led to a continental focus on short-term financial performance at the expense of longer-term strategy.

Economic Value Added (EVA) is a financial performance measure developed by consultants Stern Stewart&Co. It claims to capture the economic profit of a business that leads to shareholder value creation. In simple terms, EVA is net operating profit after deducting a charge to cover the opportunity cost of the capital invested in the business (when by taking one action you lose the opportunity to undertake any alternative) EVA's' economic profit' is the amount by which earnings exceed (or fall short of) the minimum rate of return that shareholders and financiers could get by investing in other securities with a comparable risk.

EVA accepts the assumption that the primary financial objective of any business is to maximize the wealth of its shareholders. The value of the business depends on the extent to which investors expect future profits to be grater or less than wealth, while returns below the cost of capital erode shareholder wealth.

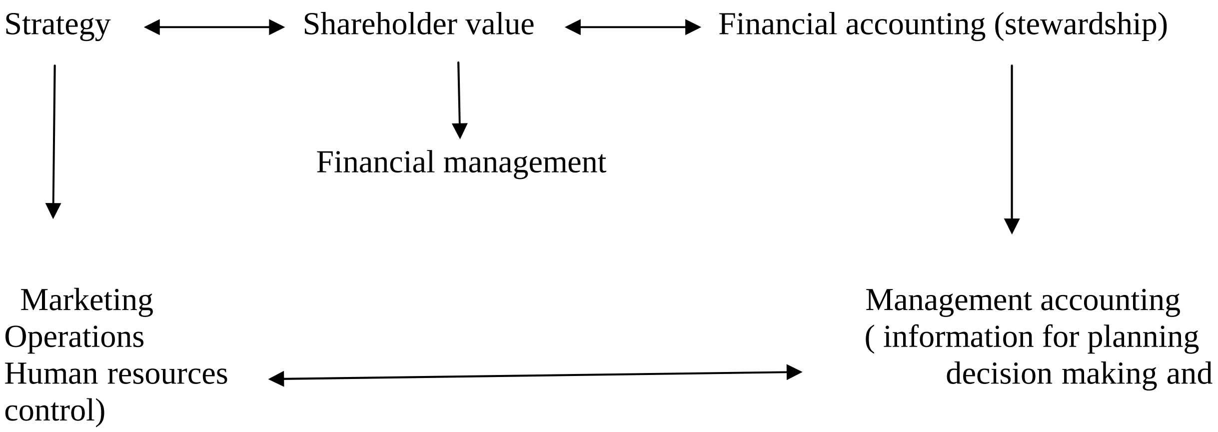
Stern Stewart argues that managers understand this measure because it is based on operating profits. By introducing a notional charge based on assets held by the business, managers (whether at a corporate or divisional level) manage those assets as well as the profit generated.

EVA also has its critics. For example, the calculation of EVA allows up 164 adjustments to reported accounting profits in order to remove distortions caused by arbitrary accounting rules and estimates the risk-adjusted cost of capital both of which can be argued as subjective, although Stern Stewart argues that most organizations need only about a dozen of these. The increase in shareholder value is reflected in compensation strategies for managers whose goals, argues Stern Stewart, are aligned to increasing shareholder wealth through bonus and share option schemes that are paid over a period of time to ensure consistent future performance.

3. ACCOUNTING AND STRATEGY

The paper treats accounting as part of the broader business context of strategy, marketing, operations and human resources. The focus of accounting in business organizations is shareholder value- increasing the value of the business to its shareholders – through dividends from profits and/ or through capital growth. Strategy both influences and is influenced by shareholder value. Strategy is reflected in the functional business areas of marketing, operations and human resources, through the actions the business wants to take to achieve, maintain and improve competitive advantage. The relationship between these elements is shown in Figure 1.

Figure 1: Shareholder value, strategy and accounting



Financial management (which is outside the scope of this paper) is concerned with raising funds from shareholders or financiers to provide the capital the business needs to sell and produce goods and services. Financial accounting represents the stewardship function, that managers are accountable to those with a financial interest in the business and produce financial reports to satisfy that accountability. Management accounting provides the information for planning, decision making and control. Therefore, the main content of this paper is the interaction between the functional areas of marketing, operations and human resources – driven by strategy – and how accounting provides a set of tools and techniques to assist functional managers. Management accounting both influences and is influenced by the functional areas and by business strategy.

The importance of strategy for management accounting and the information it provides is that a strategic perspective involves taking a longer – term view about the business than is usually provided by traditional accounting reports. Management accounting comprises a set of tools and techniques to support planning, decision-making and control in business organizations. Accounting is – or at least should be integrated with business strategy. However, the same accounting tools and techniques can be used to help evaluate the performance of customers, suppliers and competitors in order to improve competitive advantage. This is called strategic management accounting.

Accounting should also extend beyond a narrow concern with financial measurement and encompass non-financial performance measurement, a subject of steadily increasing importance for those managers who are responsible for achieving performance targets, as well as for accountants.

Strategy is concerned with long term direction, achieving and maintaining competitive advantage, identifying the scope and boundaries of the organization and matching the activities of the organization to its environment. Strategy is also about building on resources and competences to create new opportunities and take advantage of those opportunities and manage change within the organization. There is also a link between strategy and operational decision in order to turn strategy formulation into strategy implementation (for a fuller description, see for example Johnson and Scholes 1997).[3]

An economic perspective is added by Grant (1998)[4] who saw the value created by firms distributed among customers, suppliers and equity risk-takers. In order to provide this value, business firms establish profit as the single dominant objective. The purpose of strategy is to pursue profit over the long term. Strategy is thus linked to performance by setting performance targets for the business as a a whole and for individual business units and then measuring performance against those targets. Is to the divisionalized organizational form that we now turn.

4. STRUCTURE OF BUSINESS ORGANIZATIONS

Organizations are typically considered to be of three types:
- The private sector, comprising business whose prime goal is profit,
- The public sector, which is government funded (through various kinds of taxation) providing services for the public, such as in health, education, law and order etc, and
- The third sector of not for profit organizations, providing a range of charitable or social services, funded by donations, lottery grants etc.

The accounting described in this paper is primarily concerned with for profit businesses although many of the concepts are equally applicable to the other two sectors. Business organizations can be further subdivided into a number of major types:
- Agriculture, or primary production,
- Manufacturing, or secondary production,
- Services, or tertiary production

Again, our concern is with all businesses other than agriculture as the means of production and the accounting requirements of that type of business are significantly different from the

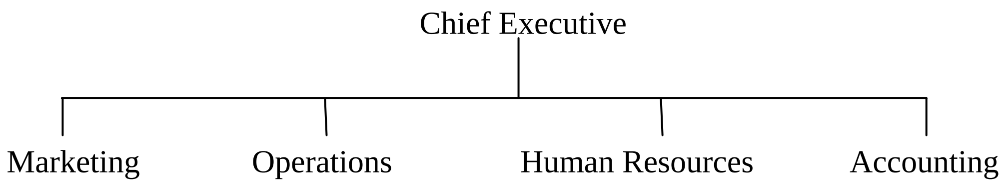
[3] Johnson, G. and Scholes, K (1997) Exploring Corporate Strategy, London: Prentice Hall
[4] Grant, R.M. (1998) Contemporary Strategy Analysis: Concepts, techniques, Applications, Oxford: Blackwell Publishers

latter two, which in any event dominate the economy. Manufacturing and service businesses are concerned with satisfying customer demand for products or services. Business produce products/services through a variety of organizational forms, but predominantly through either a functional structure or a divisionalized structure.

The functional structure locates decision making at the top of the corporate hierarchy, with functional responsibilities for marketing, operations, human resources, finance and so on allocated to departments, as shown in the typical organization chart in Figure 2.

In the functional structure, accounting provides a staff function to the line functions, simplified here as marketing, operations and human resources. Accounting knowledge tends to be centralized in the accounting department, which collects, produces, reports and analyses accounting information on behalf of its (internal) customer departments.

Figure 2: Functional organization chart



The divisional structure is based on a head office with corporate specialists supporting the chief executive, with divisions established for major elements of the business. These divisions may be based on geographic territories or different product/services, and each division will typically have responsibility for all the functional areas: marketing, operations, human resources and accounting.

The advantage of the divisional structure is that while planning is centrally coordinated, the implementation of plans, decision-making and control is devolved to local management who should have a better understanding of their local operations. The divisions are often referred to as strategic business units (SBUs) to describe their devolved responsibility for a segment of the business. The SBUs are, in accounting termed responsibility centres.

Responsibility centres through their managers are held responsible for achieving certain standards of performance. There are three types of responsibility centres:

- Cost centres which are responsible for controlling costs,
- Profit centres which are responsible for achieving profit targets and
- Investment centres which are responsible for achieving an adequate return on the capital invested in the division.

Management within divisions will carry out a significant function in analyzing and interpreting financial information as part of their local management responsibilities, typically supported by locally based accounting support staff. Accounting influences and is influenced by the structure adopted and the extent of managerial responsibility for business unit performance.

Emanuel et al. (1990)[5] described organizational structure as:
A potent form of control because, by arranging people in a hierarchy with defined patterns of authority and responsibility, a great deal of their behavior can be influenced or even pre-determined.

Child (1972)[6] defined organization structure as the formal allocation of work roles and the administrative mechanisms to control and integrate work activities, emphasizing that structure depends on the decision-makers evaluation of environmental impacts, the standard of required performance and the level of performance actually achieved. This stresses the role of decision-makers, defined as the power-holding group.

Galbraith and Nathanson (1976)[7] suggested that the choice of organizational form was the result of choices about five design variables: task, people, structure, reward systems and information and decision processes. These choices should be consistent with the firm's product-market strategy, i.e. there should be fit or congruence. Galbraith and Nathanson applied Chandler's (1962)[8] four growth strategies –expansion of volume, geographic dispersion, vertical integration and product diversification – to see how each affects the form of organizational structure, based on Chandler's thesis that structure follows strategy. They argued:

Variation in strategy should be matched with variation in processes and systems as well as in structure, in order for organizations to implement strategies successfully.

Galbraith and Nathanson further built on Chandler's research, adding that diversification leads to multidivisional forms, with competition as an important variable.

5. A CRITICAL PERSPECTIVE

The shareholder value movement has subsumed much consideration of the wider accountability of business to other stakeholders. Shareholders' interests dominate business and accountants occupy a privileged position as those who establish the rules and report business performance. This can be seen as a historical development.

Stakeholder theory looks beyond shareholders to those groups who influence, or are influenced by, the organization. Shareholders are not representative of society and stakes are held in the organization by employees, customers, suppliers, government and the community. Stakeholder theory is concerned with how the power of stakeholders with their competing interests is managed by the organization in terms of its broader accountability.

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[5] Emmanuel, C., Otley, D and Merchant, K. (1990) Accounting for management Control (2nd edn) London: Chapman Hall
[6] Child, J (1972) Organizational structure, environment and performance: The role of strategic choice, Sociology, 6, 1-22
[7] Galbraith, J.R and Nathanson, D.A. (1976). Strategy Implementation: The Role of Structure and process. St paul, MN: West Publishing Company
[8] Chandler. A.D.J. (1962) Strategy and Structure: Chapters in the History of the American Industrial Enterprise, Cambridge, M.A: Harvard University Press

Dermer (1998)[9] suggested a broader view organizations as non goal- oriented, non-instrumental social systems enmeshed in broader socio political contexts.

Dermer contrasted the presumption of managerial authority and unitary purpose with a pluralistic governance model comprising four elements: leadership (management) citizenship (stakeholders), institutions (formal and informal patterns of relating) and ideologies (patterns of belief).

Given that accountability is the duty to provide an explanation – an account – of the actions for which an organization is responsible, this implies a social accounting and a right to information by various stakeholder groups in a democracy.

Strategy is also open to criticism. Mintzberg (1994)[10] was critical of strategic planning because it is a a calculating style of management resulting in strategies that are extrapolated from the past or copied from others. Rather, Mintzberg saw some strategy as deliberate but other strategy as an emergent process, which should lead to learning. He argued:
Strategic planning often spoils strategic thinking, causing managers to confuse real vision with the manipulation of numbers.

A critical stance can also be applied to be divisionalized form of organization. Roberts and Scappens (1985)[11] argued that in a divisionalized company there is distance between the division and the head office, such that the context within which accounting information is gathered will typically be quite different from the context in which it is interpreted. This may result in manipulating the appearance of accounting reports. Roberts and Scapens concluded:
The image of an organization which is given through accounts will be from a particular point of view, at a particular point in time and will be selective in its focus. Events, actions etc. which are significant for the organization may be out of focus, or not in the picture at all… the image conveyed by the accounts may be misrepresent the actual flow of events and practices that it is intended to record.

CONCLUSION

The separation of management from control, the creation of decentralized business units and the pursuit of shareholder value imply a particular goal-oriented, economic and rational theory of management behavior and organizational action. This paper has provided the context in which the changing role of the accountant has taken shape. First, we considered the importance of capital markets and how they dictate the drive for shareholder value-based management. Second, we described how strategy that is the result of shareholder value approach has led to the divisionalized form of organization that dictates much of the way in which management accounting is organized. Finally, we have added a critical perspective that challenges shareholder value with a stakeholder view and raises concerns about strategy and divisionalization.

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[9] Dermer, J. (1988) Control and organizational order. Accounting, Organizations and Society, 13(1), 25-36
[10] Mintzberg, H. (1994) The fall and rise of strategic planning, Harward Business Review, Jan-Feb, 107-14
[11] Roberts, J and Scapens, R (1985). Accounting systems and systems of accountability- Understanding accounting practices in their organizational contexts. Accounting Organizations and Society, 10(4), 443-56

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