CREATING VALUE

A PRACTICAL GUIDE FOR BOARDS AND DIRECTORS

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AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

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Print edition published in April 2016
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Text design Kirk Palmer Design
Printed by Ligare

National Library of Australia Cataloguing-in-Publication Data
Walters, D. (David), Rainbird, M. (Mark)
Creating Value
ISBN: 9781876604332 (paperback)
Subjects:
Directors of corporations--Handbooks, manuals, etc.
Boards of directors
Management.
Dewey Number: 658.422

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Preface

Constructing this text involved condensing four textbooks, multiple journal and conference articles and postgraduate teaching materials from many years. "Value" is a very wide term and creating value is a very broad-ranging subject.

We necessarily touch on a range of business subjects because understanding how value is created encompasses the whole company and must be cross-disciplinary. Trying to summarise complex and scholarly works from numerous authors and commentators in a few sentences is perilous. The hope is we do some minor justice to all.

This text is meant to be a practical guide – not in the sense of a detailed "how to" – which in any event is both the realm of management and not possible within the constraints of a single short book. Rather the purpose is to equip directors with what we call a broad *value literacy* so they can engage in the discussion and debate about creating value in the company on whose board they sit.

Large, complex companies may already have sophisticated frameworks for understanding how value in a business is created, measured and managed across a broad range of contexts. Indeed, the development of management theory in this area has been largely observational – looking at what works in practice and trying to draw general conclusions from that. Not surprisingly, that has mostly involved looking at large listed companies where the information is more readily available in the public domain.

In this book, we aim to integrate various lines of thinking and research in a form that is digestible for directors of smaller entities that may not command the resources for complex, value-focused processes and systems, but nevertheless have the same needs. To do this, we look at how performance can be created and managed from three basic perspectives: strategic value, operating value and social value. We also look at the basic tools and measurements that may be helpful to understand value and value creation. We then suggest how some of these ideas might be synthesised and simplified as a company's *value proposition*.

One of the major obstacles as we explore how to create value is the lack of a clear and agreed terminology. The same words are often used interchangeably for different concepts. The division of nations with a common language takes on another dimension with the US, UK and Australian dialogues on issues surrounding the various facets of value, sometimes at cross purposes.

The term *value chain* is, for example, often used interchangeably with *supply chain* even though the Harvard academic and well-known business theorist, Michael Porter, laid out a distinct set of concepts around value chains thirty years ago.[1]

This is one of the reasons we have tried to illustrate the theory with practical examples. It is hard not to do so, however, with some trepidation. In 1982, Peters and Waterman wrote one of the first popular and best-selling management texts, *In Search of Excellence*. While the principles they espoused are still interesting, some of their "excellent companies" have not stood the test of time, including Atari and Wang. The reality is that the business world is dynamic and what seems like an example of good practice may actually become redundant very quickly.

We also have provided extensive footnotes throughout the text. This is not only to acknowledge our wide ranging sources, but also hopefully will allow readers to pursue areas of interest.

Those sources include academic works, financial journalism and studies and surveys from management consulting sources. The latter have grown in depth and interest in recent years. They have resources and access to their client base that facilitates research that might otherwise have been done in Business Schools in the past. While the authors may well be developing and advocating their own services, that is probably little different from academics pursuing their own areas of interest in pursuit of research funding.

We have also used literary quotes and proverbs liberally – sometimes to illustrate a point, sometimes as a counterbalance. To some extent this is a self-indulgence, but also a reflection that much management theory is quite dense and that in practice analogies are useful ways of understanding complex arguments.

By providing context and the foundations for a broad value literacy, the hope is this will enhance a director's ability to put in place solutions appropriate for the company on whose board they sit.

1 M Porter 1985, *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Press, New York.

Part 1

Why directors should be worried about value

In **Part 1** we look at the responsibilities of directors for both corporate compliance and for corporate performance.

We explore why oversight of performance is inherently more difficult than compliance and perceptions that this has given rise to an “oversight gap” in corporate governance.

To address this, we suggest there is a need for a broad-based value literacy.

1.1 The challenge for directors in oversight of a company's performance

It was suggested in a 2014 study by the management consulting firm McKinsey that creating value in a company can be distilled down to a simple proposition:

> "The guiding principle of business value creation is a refreshingly simple construct: companies that grow and earn a return on capital that exceeds their cost of capital create value."[2]

Other studies, at least in the US context, have suggested that this "guiding principle" is actually not well understood in the corporate world, let alone followed.[3] Based on the similarities in business structures and practice between the two countries, the same result in the Australian context would hardly be surprising.

At one level, this can be seen as simply a question of financial literacy; that is, being able to understand what "return on capital" actually means. For example, a survey in 2013 by the Australian Financial Reporting Council noted that "almost all respondents acknowledged in their commentary that there were concerns about the level of financial literacy of directors in Australia".[4] Perhaps not surprisingly, finance professionals generally had a lower view of the skills of directors they deal with than the directors did of themselves. The issues were more pronounced in smaller businesses.

Perhaps even more important than just understanding what a set of company accounts says, however, is what is actually done with that information. The answer may be very little.

For instance, in the UK in 2013, a study for the Chartered Institute of Management Accountants found that in the "backbone of the economy" – the small-to-medium enterprise (SME) sector – "… there is a tendency to make decisions without adequate, or indeed any, financial information or analysis".[5]

2 D Barton and M Weisman, *Making Boards Work*, McKinsey & Company, December 2014.
3 J Marco-Izquierdo, "CEO's Don't Care Enough About Capital Allocation", *Harvard Business Review*, 16 April 2015.
4 Australian Financial Reporting Council, *Results of FRC Survey on the Financial Literacy of Australian Directors*, 2013.
5 M Lucas, M Prowle and G Lowth, *Management Accounting Practices of (UK) Small-Medium-Sized Enterprises (SMEs)*, Chartered Institute of Management Accountants, 2013.

This suggests that in reality, the problem may be more fundamental than just understanding and using appropriate financial information. In what was described as a "shocking result", another US based study found that:

> "… a mere 34% of the 772 directors surveyed by McKinsey in 2013 agreed that the boards on which they served fully comprehended their companies' strategies. Only 22% said their boards were completely aware of how their firms created value, and just 16% claimed that their boards had a strong understanding of the dynamics of their firms' industries."[6]

In a practical sense, much of the actual day-to-day formulation of strategy and development of business models is a management issue. The problem from a director's perspective, however, is that to review and engage in the necessary debate and discourse on how this is occurring, they are often faced with a myriad of different, sometimes overlapping, sometimes ambiguous, sometimes contradictory concepts of what creating value actually means.

This all points to a broader issue and concern for directors – not just financial literacy, but a more general understanding of what drives business performance. This is what we call *value literacy*.

1.2 Why compliance is not the same as performance

A director of any Australian company should be well aware of their day-to-day legal duties and obligations. These include clear prohibitions on the improper use of their position and improper use of information, as well as obligations to act in good faith and exercise due care and diligence.[7]

This is not unique to Australia and it has been suggested that "most legal codes stress two core elements: loyalty (placing the company's interests ahead of one's own) and prudence (applying proper care, skill, and diligence to business decisions)".[8]

It is not a surprise then that a detailed framework of directors' duties and

6 D Barton and M Weisman, "Where Boards Fall Short", *Harvard Business Review*, January 2015.
7 http://www.companydirectors.com.au/Director-Resource-Centre/Director-QA/Roles-Duties-and-Responsibilities/General-Duties-of-Directors accessed 15/4/15.
8 Ibid.

obligations has built up over time. This focus on good governance is not just a corporate self-protection mechanism, but it is commonly argued "contributes to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency".[9]

Good governance, however, is not just legal compliance. While that is a key responsibility, so too is stewardship of the organisation's outcomes.[10] In the UK, this has been framed as a responsibility to ensure not only *conformance*, but *performance* as well.[11]

In many respects, the compliance or conformance obligations are much more straightforward. Over time, standards have evolved and regimes and mechanisms have developed to allow boards to monitor and ensure that these obligations are met. For example, dedicated board committees with independent non-executive directors are now generally accepted practice.

Performance is, however, far less prescriptive. It does not lend itself as easily to codes, standards and audits, particularly when it involves non-financial, non-quantitative concerns.

This potentially creates a gap in corporate life where it may simply be easier for directors to focus on compliance – where what they have to do is relatively clear – than on the more nebulous but challenging imperatives of value creation and capture. The Chartered Institute of Management Accountants in the UK have referred to this as "an oversight gap in relation to the performance dimension".[12]

1.3 Why oversight of performance is more difficult than compliance

The studies noted above suggest some common themes for this apparent gap in corporate life, including a lack of board time dedicated to these issues, a lack of focus on their importance, a lack of accepted frameworks, and the backgrounds and skill sets of the individual directors themselves. To some extent, these are all internal excuses that have a compliance flavour – "we just need to organise the board agenda better".

Really understanding the problem of overseeing performance requires

9 Australian Institute of Company Directors 2013, *Director's Signpost – Your Guide to Directorship*.
10 Ibid.
11 Chartered Institute of Management Accountants 2005, *CIMA Strategic Scorecard*.
12 Ibid.

acknowledging fundamental external influences that differentiate all companies – namely the fact that each business has a different market context, a different risk profile and may well have different time horizons.

1.3.1 Different market situations

All companies share the same legal framework and are subject to the same general laws and regulations. What they do not share, however, are the same industries, the same resources and the same competitive environment. These all make a critical difference to performance.

At best then, frameworks for guiding performance can only be general and to some extent abstract. That is inherently more difficult to deal with than ensuring proper compliance processes have been followed.

1.3.2 Different risks and risk appetites

Creating value also implies risk which it is argued is “fundamental to business, however there is a line between taking responsible risks with the aim of increasing the company’s value and behaving without due care and diligence”.[13] This is enshrined to some degree in the defence offered to directors by the Business Judgment Rule in the Corporations Act.[14]

In recent times, there have been moves to systematise the understanding of risk though the development of the discipline of risk management with its own methodologies and standards – ISO 3100. However, since risk is essentially about the likelihood of future events, there must be a high degree of subjectivity. This makes navigating the line between risk and reward a far more difficult decision process than following prescriptive compliance based rules, with risk appetite quite rightly varying depending on a wide range of variables in the company’s situation.

1.3.3 Different time frames

Another consistent challenge in arriving at some general formulations around business performance is aligning thinking on the question of developing value over different time frames.

13 Australian Institute of Company Directors 2013, *Director’s Signpost – Your Guide to Directorship*.
14 Ibid.

A good example is an ongoing debate over "short-termism" in corporate life. At one extreme is what has been called the "fail-fast" philosophy that has supposedly become synonymous with start-up culture. A good example is Google X, the research arm of the internet giant, where the explicit objective is to evaluate and if necessary kill projects quickly, learning from the experience.[15] This may be a stark contrast to a private family company where aligning wealth generation and allocation across generations becomes problematic.

One institutional response to short-termism is evident in France where, from 2016, firms must commence granting double voting rights to shareholders who have held shares for more than two years, supposedly as a means of encouraging more loyalty between companies and their shareholders. Shareholders can, however, overturn this requirement themselves by a two-thirds vote, and it seems many companies are.[16]

Is short-termism inherently flawed? The answer is nuanced. As commentators have pointed out:

> "Long-termism and short-termism both have their virtues and vices – and these depend on context. Long-termism works well in stable industries that reward incremental innovation. But it is a recipe for failure in such businesses as social media, where firms are constantly forced to abandon their plans and 'pivot' to a new strategy, in markets that can change in the blink of an eye."[17]

1.4 A way forward – developing a value literacy

If there are inherent challenges for any board's understanding and oversight of managing value and value creation in the businesses for which they are responsible, what needs to be done?

The answer at one level is obvious. Directors have to devote their time to understanding something about the particular peculiarities of the business for which they are responsible. Rather than just wading through a jungle of detail,

15 S Hutcheon, "Google X Marks The Spot For Big Dreams Turning Into Reality", *Sydney Morning Herald*, 12–13 September 2015.
16 "Short-term or Short-changed", *The Economist*, 2 May 2015.
17 "The Tyranny of the Long Term", *The Economist*, 22 November 2014.

however, some frameworks and common understanding to help in that task would obviously be beneficial.

The problem is that, unlike compliance, there are no officially approved frameworks. Indeed, management theorists have thrown up so many competing frameworks over the last fifty years since it became a recognised subject in its own right, that there is an entire other jungle waiting to envelop the unwary.

The reality is that oversight of performance is an interpretative process bringing into play a broad range of ideas, disciplines and perspectives. This is not made any easier by overlapping and potentially confusing terminology.

While it probably sits poorly in an age of specialisation, a modern director needs to be closer to a Renaissance man in a business sense. This requires what we call a broad based value literacy to ensure there is an appropriate balance in corporate life between *conformance* and *performance*.

This is not to suggest that the role of the board and management should merge or even blur. Instead, there must be common ground so that there can be a constructive debate and effective oversight.

Developing this value literacy means traversing quite a wide field and looking at value creation from a number of perspectives. Our intention is to provide some of the basics of that literacy building on contemporary theory and practice. Some of these views are not yet orthodox and some are in their relative infancy, but in a business world where *disruption* is becoming a common theme a wide perspective is important.

Finally, central to the notion of the original Renaissance was that learning and enquiry were not fixed, but ongoing. So too is developing a robust value literacy.

Issues to Consider

1. Is the difference between "compliance" and "performance" understood and agreed as common ground around the board table and between the board and management?
2. Is the general performance framework that the company is operating under clearly articulated so for example there is common ground on what acceptable risks are and what time frames are important?
3. Are the board and management using the same language and terminology to describe and discuss performance issues?