

## About Value Based Management:

Value can be described as the quality (positive or negative), that renders something desirable or valuable.

The value of a product or service is the strength it wields in comparison with others in its class which yields a resultant effect of causing users/buyers/investors rate it above/below readily available substitutes. It can be considered to be of strength, mid ranged, or relatively weak which is dependent on individual perceptions (Price vs. Quality).

Essentially, for a good or service to be of value, it must be able to create utility (i.e. the satisfaction derived from consuming or using the good or service); there should be relative scarcity for it (i.e. the demand for it should be more than its supply); there should be a demand for it (i.e. consumers must be willing and able to purchase the good or service) and it should be transferable. There are various types of value, such as market value, tax assessed value, book value, insurance value, use value, par value, rental value and replacement value. However, for most business transactions, market value is crucial to investment and decision making.

Value based management is a management process aimed at achieving value creation within the organisation. The focus of management is to ensure all human and natural resources are directed towards achieving value adding activities or services. The bottom line is that if an activity doesn't add value to the organisation, it isn't worth performing. It is deemed a waste of resources that could have been otherwise allocated to better or more valuable use.

Money and the way it is being managed is a key determinant of strategic success. From a shareholder's perspective, what matters is the ability of management to run the business in such a way that it is capable of generating money and to allocate the resources available to the company in a manner that adds value to the business. This is because returns on investment to shareholders (in the form of dividend payout) and the ability of the business to reinvest in the future (which in turn would lead to future flow of dividend payments) is dependent upon the ability of the company to generate a healthy cash flow.

However, strategic success which is enabled by good financial management cannot be achieved through a set of rules which may apply to an organization and at all levels. Instead, the relationship between finance and strategic success is dependent on context.

Value based management can therefore be effected in the following context:

### **1. Managing for value:**

Whether the focus is to create value for shareholders or to ensure the best use of the funds available to the company, it is the responsibility of management to ensure its objective of value creation is effective at all levels within the organisation. This is because the long term success of this strategy is dependent on the extent to which management is able to deliver best value in the eyes of the stakeholders. Examples of this are the competitiveness of the business in the market place and the ability of the business to provide value to the shareholders in the form of dividend payout and increase in share price.

The ability of the business to remain competitive in the market place or to achieve competitiveness in the long term deciphers whether or not there will be returns to shareholders because competitiveness is driven by market forces. In other words, competitiveness and returns on shareholders funds are closely linked in some sense. Shareholder value is determined by the long-term cash generating capabilities of the business, which in turn, is determined by the ways in which a wide number of factors are managed. Value based management is important; therefore, managing for value needs to be understood to be achieved. Value based management can be achieved by managers through effective value creation in three main ways:

**(a) *Proper allocation of funds generated from business operations:*** The funds available to the company are central to its ability to create value. This is because it dictates the extent to which the company is able to operate profitably in the long term.

The long term profitability of a company is determined by:

(i) Sales Revenue- This is a function of the amount of sales output the company is able to produce multiplied by the price the company is able to charge for its goods or services.

(ii) Cost of production, Selling and Distribution- That is the fixed and variable cost elements of the business.

(iii) Overhead Costs- This are the costs incurred in the general day to day running of the business which cannot be allocated to a particular cost centre.

**(b) *Investment in Assets:*** The extent to which a company's resources (in terms of its assets and working capital) are stretched is also important. If the company is able to develop competences in supporting a higher level of business from the same asset base in comparison to its competitors, then it can create value for itself in the following ways:

(i) It can generate returns on capital invested in the business by maximising the use of its assets and disposal of redundant assets.

(ii) If management is able to optimise the elements of its working capital such as stock, debtors and creditors; it is able to increase shareholder wealth.

(c) **Managing Financing Costs:** This should be looked at in terms of the debt owed by the company (in terms of the interest payable) and the equity. All of this would affect the cost of capital and the financial risk the company is carrying.

## **2. Funding Strategic Developments:**

It is important that the nature of the funding is appropriate for the type of strategy being implemented. The company will need to look at the business and financial risks that are involved in the business, the different levels of strategic development and other relevant portfolio issues that may be applicable.

## **3. The Financial Expectations of the Stakeholders:**

This will vary from one stakeholder to another; their stance will also differ based on the different strategies to be adopted by the company. For instance the bankers would be interested in loan repayments, suppliers would be interested in what quantities to supply and the creditors days to be agreed, employees would look at job security, payment of salaries in terms of profits to be made by the company, the future prospects of the company and if there are career opportunities as a result of the strategy to be implemented. The community will be interested in job creation and other corporate social responsibilities of the company. Finally customers would think of the pricing strategy of the company and if its product and service offerings would add value to them. Managers should therefore bear this in mind when developing and implementing strategies.

Finally, the problem for most managers is that their financial responsibilities are usually confined to managing their budget; that is, managing the cash outflows of operations. More often than not they do this with little understanding of the other financial issues involved. There is therefore a real need for managers to be much more familiar with the impact of their day-to-day management decisions on a broader level to enable them fully grasp the financial position of their organisation in order to implement value based management.