

Contents

Part I Value-Based Management, Corporate Social Responsibility, and the Purpose of the Corporation

1 The Purpose of a Corporation	5
Adam Smith and the Invisible Hand	6
A Stakeholder Perspective	7
Value(s)-Based Management: A Middle Ground	8
Summary: Creating Firm Value—Think Value(s)-Based Management	10
Appendix 1A: John Mackey and Milton Friedman on the Goal of the Firm	13
2 The Elements of Value-Based Management	17
Wealth Creation Is Not Universal	18
The Proper Design of a V _s BM Program	20
Alternative Valuation Paradigms: Earnings versus Discounted Cash Flow	22
Connecting Business Strategies with the Creation of Firm Value	23
Summary	24

3 The Need to Measure What You Want to Manage	26
The Need for a Single Metric	27
Total Shareholder Return	29
Total Market Value	30
Accounting-Based Metrics	31
Think Economic Profits, Not Accounting Profits	32
Summary	37
Appendix 3A: Accounting versus Economic ROIC	39
Appendix 3B: More Problems with Accounting-Based Metrics	42

Part II The Finer Details of Value-Based Management and Corporate Social Responsibility

4 Free Cash-Flow Valuation: The Foundation of Value-Based Management	49
The Beginning for Value-Based Management: Free Cash Flows	50
What Is Free Cash Flow?	51
Calculating a Firm's Free Cash Flow	51
Calculating the Investors' Cash Flows	53
Free Cash Flow and Firm Valuation	55
Valuing the Firm: Framing the Analysis	56
Free Cash Flows, but for How Long?	56
Forecasting Free Cash Flows	57
Computing a Firm's Intrinsic Value	61
Determining the Discount Rate	63
The Value Drivers: Digging Deeper	65
Summary	68
5 Pick a Name, Any Name: Economic Profit, Residual Income, or Economic Value Added	69
The Fundamental Concept: Residual Income or Economic Profits	70
Residual Income and Free Cash Flow	71
An Illustration of Valuation	72
A Comparison of the Residual Income and Free Cash Flow Approaches	75
"Fine-Tuning" Residual Income with EVA	75
What Is EVA?	76
Measuring a Firm's EVA	77

Calculating NOPAT and Capital	79
From EVA to MVA	83
More Than a Financial Exercise	87
Summary	91
Appendix 5A: The Equivalence of the Residual Income and Discounted Dividends Valuation Approaches	93
Appendix 5B: An Illustration of the Computation of EVA	95
Appendix 5C: Performance Evaluation Using CFROI	101
6 Corporate Social Responsibility: Putting the S in Value(s)-Based Management	103
The Moral Argument for CSR	104
The Economic Argument for CSR	104
CSR within a VBM Framework: The Academic Evidence	106
Driving the Value Drivers	108
Red Mountain Retail Group: Creating Value through Relationships	108
Southwest Airlines: The Employee Comes First	110
Herman Miller, Inc.: Creating Wealth through Design and Innovation	111
Whole Foods Market, Inc.: Creating Wealth through Whole Foods, Whole People, and Whole Planet	112
Sony Blames Economic Value Added Mentality for Its Woes	113
Summary	116

Part III VBM Applications

7 Project Evaluation Using the New Metrics	121
Example Capital Investment Project	122
Traditional Measures of Project Value	122
Using EVA to Evaluate Project Value Creation	124
Fixing the Problem	124
Unequal Cash Flows and Positive NPV	127
Summary	127
Appendix 7A: The Equivalence of MVA and NPV	132
8 Incentive Compensation: What You Measure and Reward Is What Gets Done	133
All-Too-Common Mistakes	136
Creating a Culture of Ownership	139

Determining a Firm's Compensation Policy	142
What Should the Level of Compensation Be?	142
How Should Pay Be Linked to Performance?	143
Formula for Determining Incentive Pay	143
Single-Period Performance Measures and Managerial Incentives	146
Managerial Decision Horizon and the Use of EVA	146
Extending Managerial Horizons	150
How Should Employee Compensation Be Structured?	151
Fairness as an Additional Characteristic of a Firm's Compensation Policy	152
Summary	153
Appendix 8A: Whole Foods Market Executive Compensation Discussion and Analysis	155

Part IV Lessons We Have Learned

9 Lessons Learned	163
VBM Studies Based on Archival Data	164
VBM Studies Based on Survey Data	165
Factors Critical to the Success of VBM	166
More Recent Survey Evidence	168
Current CSR Research	171
Summary	172
 Epilogue: Where We Are Now	 175
 Notes	 181
 References	 187
 Index	 193