

**How important is customer satisfaction for long term shareholder value?**

by

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### **Abstract**

There has been much consideration of the drive for organisations to create value for shareholders, and much argument that the creation of value for shareholders is derived from the reduction of operational costs. The proponents of the techniques of shareholder value would deny this and argue that the creation of value for shareholders derives from improved decision making. Thus the discourse of shareholder value suggests that the use of such techniques leads to decision making which will optimise the performance of a company in both the short and the long term. Furthermore all companies which make use of shareholder value techniques recognise that the satisfying of the needs of key stakeholders – of which customers are always one – is an essential part of the creation of shareholder value. This paper takes this as a starting point and explores the difference between declared practice from the strategic decision makers and actual practice at an operational level.

The paper is based upon a case study using British Airways, but with supporting evidence from other companies. Through an exploration of operational practice the paper argues that often the creation of value for shareholders is operationalised through the reduction of costs within the organisation but that this is primarily derived from the externalisation of those costs to others. The discourse concerning the externalisation of costs normally focuses upon society and the environment but in this paper the focus is upon the externalisation of costs to customers. It is argued in this paper that such a focus upon customers reintegrates the accounting rationale for the creation of shareholder value with the strategic decision making function of the organisation, while questioning the fashion for outsourcing operational activity and focusing upon core competencies. The paper thereby argues that much of the current concern for the creation of shareholder value is based upon the satisfying of short term motives at the expense of the long term organisational future.

### **The performance management system**

An important feature of all approaches to performance management is the alignment of organisational objectives, measures of performance and strategic decision making towards the promotion of value creation at all levels of the business (Cornelius and Davies, 1997). The need for this alignment of the internal planning and control systems is not new and Emmanuel, Otley and Merchant (1990) suggest that:

“In order to measure organizational performance, it is first necessary to discover what the organization is attempting to achieve.” (p31)

It is recognised therefore that the link between the aims / objectives of an organisation and performance measures needs to be made clear. In addition Emmanuel et al (1990) suggest that the ‘multiple nature of objectives’ can generate the need for multiple performance measures. Furthermore, as objectives tend to be conflicting, the measures used can require trade-offs and composite measures. This in fact highlights one of the suggested advantages of a Value Based Management (VBM) approach as it provides a single overriding objective that should not require any such trade-offs. The making of significant decisions is an area that has already been aligned with the shareholder objective in finance theory. Brignall and Ballantine (1996) suggest that the Fisher-Hirshleifer model (Fisher, 1930; Hirshleifer, 1958)

has shown that shareholder wealth is maximised “by investing in all projects offering a positive Net Present Value (NPV).” Many organisations have shareholder value as an objective, and many (80% according to a 1997 UK survey, Arnold, 1998) also use NPV as a decision making criteria because it is consistent with shareholder value.

This suggests that it is the management of shareholder value which the overarching criterion for the management of performance by a firm but some changing trends in reporting have been identified by Beaver (1989) who highlights a rapid growth in reporting requirements and changes in existing requirements, with less emphasis on earnings and more on soft data and a greater emphasis on disclosure. He claims that there has been a shift from an economic view of income to an informational perspective with a recognition of social implications of an organisation's activities. Eccles (1991) concurs and states that there has been a shift from treating financial figures as the foundation of performance measurement to treating them as part of a broader range of measures. McDonald and Puxty (1979) on the other hand maintain that companies are no longer the instruments of shareholders alone but exist within society and so therefore have responsibilities to that society, and that there is therefore a shift towards the greater accountability of companies to all participants. Recognition of the rights of all stakeholders and the duty of a business to be accountable in this wider context therefore has been a relatively recent phenomenon and the economic view of accountability only to owners has only recently been subject to debate to any considerable extent.

The measurement of performance is however crucial to the management of that performance, and Oakland (1989) states that to be useful a performance indicator must be measurable, relevant and important to the organisation's performance. Such indicators must also be meaningful to anyone seeking to evaluate performance and the cost of obtaining the information must not outweigh its value. Brewster (1994) makes the point that it is not a simple process to identify good performance indicators and that a comparative measure against the performance of other organisations can give misleading signals and can cause resources to be focused on the wrong things. The question of evaluating strategic performance is equally subject to debate and Chakravarthy (1986) suggests that traditional measures of performance based upon profitability are inadequate for evaluating strategic performance. He argues that, rather than using conventional financially based measures, use should be made of alternative measures, and he suggests composite measures. He also suggests that rather than the conventional perspective of market based evaluation of performance, alternative perspectives are needed which recognise the need to satisfy multiple stakeholders. Kimberley, Norling and Weiss (1983) also make this point and argue that traditional measures do not necessarily even measure some aspects of performance and can certainly lead to inadequate and misleading evaluations of performance.

### **The VBM approach to performance management**

Despite the fact that some writers (eg Tinker 1985) have argue for a changed basis for accounting to reflect the needs of the various stakeholders the discourse of performance management has retreated into a concern with shareholder value. Thus Rappaport (1986) recognises some of the problems with accounting but goes on to consider the concept of shareholder value and how this can be created and sustained. He develops a methodology of shareholder value based upon his previous work, where he argues (1992) that a shareholder value approach is the correct way of evaluating alternative company strategies. He states that

the ultimate test of a corporate plan is whether it creates value for the shareholders, and that this is the sole method of evaluating performance.

The return to a consideration of the importance of economic value and to the theory of the firm is based upon the assumption that maximising the value of a firm to its shareholders also maximises the value of that firm to society at large, and thereby provides benefits to other stakeholders. Within the discourse therefore the concept of shareholder value is frequently mentioned and there is acceptance of the need to account for shareholder value within the practitioner community. Indeed the annual reports of companies regularly expound the virtue of creating value for shareholders and it is frequently cited as a corporate objective. This objective can simply be defined as being achieved when the rate of return obtained within a business exceeds the cost of obtaining funds.

The concept of shareholder value as an objective appears to be widely accepted within the accounting community but its use as a quantified evaluation is less often found in practice. This, it can be argued, is because the managers of a firm are preoccupied with other objectives such as growth in size, turnover, market share or accounting returns, which are more easily measured. The achievement of objectives such as these is also often correlated with managerial rewards but less so with increasing shareholder value (Williamson 1963). Indeed Jensen and Meckling (1976) use agency theory to demonstrate how following managerial interests can lead to higher rewards for those managers at the expense of a reduction in the value of the company.

Problems arise from the use of accounting measures as a means of evaluating company performance. Stewart (1991) and Brealy and Myers (1991) separately consider how the use of earnings per share can be of doubtful value in achieving this end, both because of the different calculations used for the same accounting measure and because of the adoption of different accounting measures. Equally Fisher and McGowan (1983) show that ROI, ROA and ROE suffer from the same problem.

A recent development in the quest for a tool to measure shareholder value has been the concept of economic value added, which has been developed by Stewart (1991) as a better measure to assess corporate performance and the creation of shareholder value than conventional accounting measures. Indeed Stewart (1994: 73) states that:

" Economic value added is an estimate, however simple or precise, of a business's true economic profit."

Economic value added is claimed to have a number of important advantages over traditional accounting measures, the chief one being that economic performance is only determined after the making of a risk adjusted charge for the capital employed in the business. Critics however argue that while this may be theoretically sound, the need to make arbitrary adjustments to standard accounting numbers in order to put the technique into practice makes the technique of doubtful validity. The application of the technique and the adjustments needed were evaluated by Coates, Davies, Davis, Zafar and Zwirlein (1995) who suggest that simplified calculations produce satisfactorily reliable results.

Mechanisms for calculating economic value added are described by Stewart (1991), who elaborates the standard adjustments needed to transform accounting information into an

economic value added<sup>1</sup> calculation. A definition of economic value added can be given simply as operating profits after tax less a charge for capital used to generate these profits. The residual from this calculation is the measure of economic value added and if positive demonstrates that the company has earned a greater return on its capital employed than the opportunity cost of the capital employed, and has hence added value to the company from the viewpoint of shareholders. Opportunity cost is defined in this context simply as the market cost of capital, appropriately weighted between equity and debt capital. If negative the opposite is the case and value has been lost.

Associated with economic value added is the measure market value added<sup>2</sup> which is defined by Stewart (1991) as the market value of the company (ie stock price x shares outstanding) minus the economic book value of the capital employed. Stewart argues that this measure is superior to just using market value as a means of assessing the value creating performance of a company because market value can be increased simply by investing as much capital as possible, without consideration of the returns to be achieved from this investment. In theory market value added should reflect the present value of expected future value added and thereby provides a measure of the expectation of shareholder value created. In practice this relationship is not as simple as this because of the factors affecting the operation of the market. It is therefore argued by proponents of these kind of shareholder value analysis techniques that both measures need to be considered together in order to evaluate the value of the techniques of shareholder value analysis in assessing company performance. The two measures together are therefore taken as a representation of shareholder value.

Govinderajan & Gupta (1985) argue that long run criteria contribute to organisational effectiveness rather than short term criteria whereas Rappaport (1986, 1992) suggests that shareholder value analysis addresses both and maximises both. There is, nevertheless, a considerable body of evidence which suggests otherwise and that a concern with shareholder value added and returns to shareholders leads to a short term focus and lack of regard for the longer term (eg Coates et al 1995). Indeed some managerial actions taken to boost short term valuations, such as downsizing and outsourcing can be argued to actually reduce long term value (Crowther, Davies & Cooper 1998), particularly when the product and market development capability is externalised.

The market value added concept recognises that the market value of equity, and changes therein as a result of changed expectations by existing and potential investors, is an important part of the measurement of performance for investment purposes. It equally recognises however that the market value of equity does not by itself constitute a reliable measure of shareholder wealth creation. It does however seek to measure how much a firm has added to or subtracted from its shareholder investment and as such seeks to measure one factor which is of significance to this group of shareholders. It does of course fail to take into account the level of dividend return to shareholders, and in this respect can be considered as completely contrasting with more traditional measures such as EPS which is concerned entirely with profit attributable to ordinary shareholders. Dividend returns are of course a potentially significant source of wealth creation for shareholders, and for certain companies which adopt high dividend pay out policies the ignoring of such dividends would significantly distort their actual wealth creation potential.

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<sup>1</sup> The term Economic Value Added is copyrighted as the property of Stern Stewart & Co.

<sup>2</sup> The term Market Value Added is also copyrighted as the property of Stern Stewart & Co.

The proponents of shareholder value techniques would argue that the use of the techniques by an organisation will inevitably lead to better performance by that organisation, both for shareholders and for other stakeholders. Moreover they would argue that the use of the techniques would imply the use of different measures of performance management than the traditional accounting measures used in a traditional environment. It is therefore appropriate at this point to examine these differences.

According to Rappaport (1986) it is widely accepted that the primary objective of the firm is to maximise shareholder wealth. Indeed finance theory has long assumed that this is the case with, for example, Friedman (1970) suggesting that a firm should seek to maximise profits as to do anything else would be against the primary objective of the firm. More recently however there has been increased interest in a more explicit shareholder value oriented approach to managing a business; such an approach has become more generally known as Value-Based Management (VBM) or Shareholder Value Management. This increased interest has arisen not only within the academic discourse but also among practitioners and business managers; this interest has been confirmed through recent survey evidence (Coopers and Lybrand, 1996; Deloitte and Touche, 1996; KPMG, 1996; PA consulting, 1997; KPMG, 1998).

VBM has been defined by Copeland, Koller and Murrin (1996:96) as

'...an approach to management whereby the company's overall aspiration, analytical techniques and management processes are all aligned to help the company maximise its value by focusing on the key drivers of value.'

Thus this implies a different approach to management but concomitantly a differing use made of accounting information. VBM therefore goes further than merely using NPV for investment decisions as it also requires the application of appropriate measures of value to provide a 'shareholder value' perspective for all key internal planning and control systems: ie strategic decision-making, resource allocation, performance measurement and control and managerial compensation. An important, if not fundamental, feature of all VBM approaches is this alignment of objectives, measures, and rewards intended to promote shareholder value creation at all levels of the business.

In addition VBM theoretically involves a shift away from the use of traditional accounting measures such as earnings per share and net profit, which are argued, by the proponents of VBM, to offer an unreliable guide to 'shareholder value creation' (see for example, Rappaport, 1986; Stewart, 1991). In the place of such accounting numbers, a number of alternative measures have been proposed which are intended to provide a 'calculating machine consistent with the principles of economic income' (Bromwich, 1998). The applications of VBM techniques do however still require that managers seek to maximise the net present value of the company, through new investment in positive net present value opportunities and through improving the economic returns achieved on existing assets employed.

Whilst the alternative VBM approaches share these essential characteristics, it should be recognised that there are differences between them, which relate mainly to the specific measures employed. Firstly, different 'VBM recipes' employ different measures of 'shareholder value creation'. Thus McTaggart, Kontes & Manks (1994) and Stewart (1991) favour a residual income type approach (economic profit and EVA(r)<sup>2</sup> respectively), whilst

Rappaport (1986, 1992) advocates 'shareholder value added', and Madden (1999) promotes 'Cash Flow Return on Investment' (CFROI) as the preferred method of application. There has been much discussion of the merits of these different measures, particularly in terms of their relative accuracy and complexity (see for example, Cornelius and Davies, 1997), but in general it is their commonalities that are of interest and in this paper these techniques will be treated as homogenous.

Advocates of VBM techniques have advanced strong claims on its behalf, the chief of which is that its use will lead to the creation of shareholder value. McTaggart et al (1994: 51) for example argue that VBM will

'...greatly improve the quality of decision-making, by improving the quality of the alternatives that management has to consider as well as building a bias for choosing and implementing the best available alternatives.'

Stern Stewart (1995), meanwhile, claim that: 'The major benefit EVA firms can expect is a higher market value'. They also cite other significant benefits which will accrue from the use of the technique, stating that these are:

'a common language for planning and managing, more accountability for delivering value, a greater concern for managing assets, a greater willingness to rationalise and redirect resources, better bridges to link operations and strategy with financial results, more collaborative long-term planning.' (The EVA Company p.5)

As a further example, Copeland, Koller & Murrin (1996; 98) argue that:

'...the management processes...provide decision-makers at all levels of the organisation with the right information and incentives to make value creating decisions.'

These claims are extremely positive concerning the effects of VBM implementation within an organisation but it must be remembered that the literature in this area has largely originated from the leading shareholder value consultants (ie Rappaport, 1986; Stewart, 1991; McTaggart, Mankins and Kontes, 1994; Copeland, Koller and Murrin, 1996) who arguably stand to gain the most from the widespread adoption of their preferred techniques. If we now consider the use of VBM techniques in practice we see that little is known about how these concepts are in fact applied, and the problems practitioners experience in trying to implement a VBM approach. An International Survey of Shareholder Value Management issues, conducted by Coopers and Lybrand in 1996, for example, found that in the UK there is still great uncertainty on how to apply VBM principles throughout a company. Key issues identified included the perceived complexity of the techniques, the need for cultural change to coincide with adoption of the techniques, implementation difficulties and perceived problems with the application in both corporate headquarters and particular types of business such as research and development driven companies. More generally recent survey evidence (Coopers and Lybrand, 1996; Deloitte and Touche, 1996; KPMG, 1996; PA consulting, 1997; KPMG, 1999) indicates that whilst there is a growing interest in VBM / shareholder value and a recognition of its importance, it is neither widely used nor well understood. These surveys have found that contrary to 'VBM theory' few companies have successfully applied 'full VBM' and also that profit-based measures are often used alongside shareholder

value measures. The failure to apply 'full VBM' refers to companies in practice not applying VBM techniques consistently across all of the key internal planning and control systems: from decision making through to managerial compensation. These findings are supported by Cooper et al (2001) who find that all companies which claim to use the techniques of VBM also use traditional accounting measures while many companies which claim to use traditional accounting measures actually make use of some of the techniques of VBM. Thus many companies claim to be concerned with the creation of value for shareholders, without necessarily using the techniques claimed by their proponents to deliver this. In this respect there fore theory and practice differ.

### **Recognising other stakeholders**

The theoretical discourse of managing according to the creation of shareholder value gives primacy to the shareholder and assumes that all other stakeholders will benefit from the creation of that value without any of the proponents being specific as to how they will benefit or to what extent. Practitioners however recognise that these other stakeholders are important to the long term success of their business and Cooper, Crowther, Davies & Davis (2001) show that all firms which manage according to shareholder value creation recognise the importance of other stakeholders and seek to manage their performance in recognition of the most important of these stakeholders. For every company customers and employees are recognised as being significant stakeholders. Thus all firms which purport to manage according to shareholder value creation in actual fact use some kind of balanced scorecard which seeks to take into account the other major stakeholders in their management of performance. In this respect also theory and practice diverge as shareholders are not necessarily awarded primacy, at least according to the strategic management of the organisation.

Although all companies purport to recognise the importance of various stakeholders to their management of performance this is often only at the level of strategy, and it is often not carried forward into operational practice. This is despite the claims made by the senior managers of the company (see Cooper et al 2001), which raises a dichotomous question about operational activities within a company. Is a concern with stakeholders merely rhetorical or is there a problem within a company in translating this concern into operational practice? It is the purpose of this paper to explore this question and provide some insights into operational practice. This paper therefore takes the strategic management recognition of the importance of various stakeholders as a starting point and explores the difference between declared practice from the strategic decision makers and actual practice at an operational level. The paper is based upon a case study of the airline industry, using British Airways, but with supporting evidence from other companies. The airline industry is replete with problems in its operation and many of these are concerned with congestion, competition and investment, which have been well documented. Other problems are concerned with the carrying of passengers and associated health risks, with arguably cost reduction being a factor in this. Airlines have a great deal of freedom in the way they approach their business and are unique in that the contract to carry a passenger to a particular location at a particular point in time, enacted through the purchase of a ticket by the passenger, can be negated with impunity by the airline. These are all well documented and much attention has been focused upon the benefits of strategic alliances.

It is recognised that managing an airline is a complex and costly process and that the containment of costs is at least as crucial to the successful operating of an airline as is the logistics of moving passengers with a degree of reliability. There are many ways in which these costs are contained but excluded from the discourse is a consideration upon shareholder value of the way in which passenger luggage is handled. This therefore is the focus of this paper. The logistical necessities of moving passenger luggage require that this is handled by a variety of people acting as agents of the airline in order for it to be loaded at the airport onto the correct plane and unloaded upon arrival; this is further complicated when it needs to be moved in transit from one flight to another. Mistakes happen and in the words of a British Airways employee '*Unfortunately, where there is a mixture of manual and mechanical labour, things can go wrong from time to time*' but '*...under our Conditions of Carriage we are not liable for any consequential losses*'.

### **The world's favourite airline?**

It is obviously inconvenient for a passenger to arrive at a destination without luggage but the cost reduction imperative of airlines means that it is less costly for a plane to depart without all the luggage of the passengers than to suffer delay, even when this necessitates the subsequent use of couriers to reunite a passenger with that luggage. Thus airlines are quite blatant and unrepentant about such practices as the imperative of cost minimisation – disguised as scheduling constraints – prevails. The inconvenience of this practice is one of the unfortunate costs which a passenger must bear in order to be transported to another location but it is quite clearly a cost which has been externalised from the airline to the customer which is thereby removed from the accounting practices which record value created for shareholders.

Of greater concern however is the mechanism which has evolved for dealing with the luggage which is mislaid in transit. Briefly the situation is that the dealing with problems in this respect has been removed from the direct control of the airline company itself and is dealt with by a series of agents. One company deals with the details of mislaid luggage and assume responsibility for locating it; another company provides call centre facilities for a helpline, while yet another company provides the courier service which delivers the luggage to the passenger when it is finally relocated. It is presumably structured in this way because of the cost minimisation imperative but one consequence is that it is very difficult to ascertain which company one is dealing with – or in the case of the call centre – even where the company is located. Thus any chain of responsibility is effectively obfuscated and when a problem arises the various parts of the chain are able to deny responsibility and attempt to pass that responsibility onto another party. As most people who are involved are not employees of the airline then it is not surprising that they feel no particular loyalty to the airline. Indeed with the different steps in the chain the customer changes and, while the airline's customer is clearly the passenger, for the other companies involved the customer is less certain – some recognition is made that the passenger is at least a significant stakeholder but not necessarily the customer; it is the airline who settles the bills.

Mislaid luggage is a relatively frequent occurrence associated with air travel and procedures have been developed to handle the situation. To a great extent these are common to all airlines in all locations – perhaps inevitable as the same agents act on behalf of a number of different airlines, with the agents employed being determined by location of the airport rather than any other factor. The systems adopted by British Airlines differs slightly from

that of other airlines although all claim to make use of 'a worldwide computer baggage tracing system': others enter details directly into this system and can inform passengers there and then of what has happened. British Airways state: *'Your luggage details are entered into a tracing system, however this is usually done when you have completed the form and left the airport.'* A set procedure purports to exist for contacting passengers to arrange delivery of the mislaid luggage. According to a BA representative: *'...as it is a very busy office, we do not contact passengers. It is our Courier Company who will attempt to call the passenger to inform of the bags arrival.'* Alternatively: *'It is not normal policy for our staff to contact you regarding your delayed luggage, it is only when it has been picked up by our Courier Company and is ready for delivery that they should call you to inform you that it is on its way.'*

One of the problems with outsourcing the various stages of the luggage handling however is that staff training cannot be uniformly ensured and verbal communication of the procedure differs considerably between staff at different stages in the process, and even between different people in the same stage. This is one of the consequences of this approach to cost minimisation. Another consequence is that the cost is effectively transferred to the customer who must initiate action to instigate the location of the mislaid luggage. Cost minimisation through outsourcing also has the consequence that the staff involved are highly pressured and cannot give the necessary time to dealing with any particular query; indeed the problems associated with call centres in particular have been well documented in this respect.

## Conclusions

All companies claim to recognise the customers are an important stakeholder but for airlines they seem unable to deliver satisfactory service to these customers. It is argued that customer satisfaction is sacrificed to the drive to create shareholder value. Moreover it is argued that this value is created not through the operational activities of the airline companies but rather through the externalisation of costs, which are passed on to customers. Examples of similar practice are evidenced elsewhere (eg Crowther 2002a) and it seems that companies adopt a philosophy that any individual customer does not matter. It has been argued however (Crowther 2000, 2002a) that the advent of the internet has effected a change in the power relations that exist between companies and their customers. Indeed one of the features of the freedom of access to the Internet has been a proliferation of websites dedicated to protest about particular companies and their activities. These sites have been labelled as rogue sites (Chipchase 1999) and in many ways tend to be parodies of the official company site about which they are protesting. Many such sites exist for airlines and a particularly good example is the anti British Airways site, British Scareways (<http://www.aviation-uk.com>) which provides links to many other similar sites. On these sites complaints concerning the handling of lost luggage abound.

Through an exploration of operational practice this paper argues that often the creation of value for shareholders is operationalised through the reduction of costs within the organisation but that this is primarily derived from the externalisation of those costs to others. The discourse concerning the externalisation of costs normally focuses upon society and the environment but in this paper the focus is upon the externalisation of costs to customers. It is argued in this paper that such a focus upon customers reintegrates the accounting rationale for the creation of shareholder value with the strategic decision making function of the organisation, while questioning the fashion for outsourcing operational

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