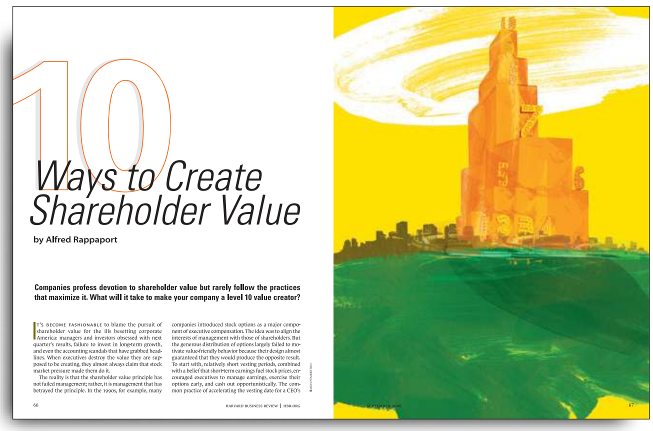
# Letters to the Editor

## Ten Ways to Create Shareholder Value

Alfred Rappaport's article "Ten Ways to Create Shareholder Value" (September 2006) is clear as an update of the "shareholder value" approach, but that very clarity reveals some problems with the theory.

I agree that companies should be managed so as to improve their long-term health and not just to accept or




improve the current year's earnings. But I feel strongly that pursuing shareholder value is not a good way to manage a company. It is based on the following axioms, which have no strong theoretical or practical basis and take an all too optimistic view of human nature:

• A company has "real value," and this lies in its market capitalization (number of shares multiplied by share price), which in turn equals the present discounted value of future cash flows from the company's operations.

• The stock market (the totality of investors) can accurately value companies, even including cash flow from projects to be introduced in the future.

• It is best for the long-term health of a company that management make decisions with the intention of continually increasing the share price.

• The CEO and executives can honestly and exactly estimate future earnings and cash flow.

• Paying CEOs and executives on the basis of shares or share options will induce management to find ways to increase its company's value and share price simultaneously.

Rappaport writes, "Do not manage earnings or provide earnings guidance." I absolutely agree. In fact, I think the SEC should prohibit the reporting of quarterly earnings. If executives might do something wrong in order to improve the share price, we cannot trust them to correctly report present earnings, much less to correctly estimate and publish future earnings and cash flow. So why should we suppose that market capitalization – which moves in accordance with expectations for the future – will give us a company's real value? And why should we forget that these executives have stock options that improve when the share price goes up? In other words, why should we give human nature too much of a chance?

As for "focusing on earnings," it is true that accounting data don't show a company's increase in real value during the

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reporting period. This would be feasible only if the balance sheet showed the real value of the company on the reporting date, which it obviously cannot. Apart from the possibility that management might "improve" financial statements, the balance sheets of U.S. companies have a number of problems:

• Expected shortfalls from pension funds and future health costs of at least $300 billion are not included in companies' financial statements.

• In many companies, the assets side includes considerable amounts of goodwill, which supports from 50% to 100% of stockholders' equity. Goodwill breaks two basic accounting conventions: that earnings from periods after the reporting date should not be included, and that earnings should not be included if there is no evidence as to their amount. In a number of cases, goodwill has been written off when it becomes clear that the projected earnings will not be realized (which is what happened with AOL Time Warner, for instance).

• Intangibles arising out of real costs, such as software, which amount to an investment of $1 trillion per year, are not shown as an asset reflecting the economic reality but are expensed in each year.

It is, however, important to note a company's yearly earnings figure, because if the company has not shown a sufficient margin, cash flow, or ROI in the present year, doubt is cast on its plans for improving value in future years. Also, accounting data do help to show where the company has been efficient, or could be more efficient, in its current operations.

It is not true that WorldCom, Enron, and Nortel Networks destroyed a large part of their value because they did not "meet investor expectations." Very simply, they were showing accounting losses, had a negative cash flow, and could not meet contractual payments. Curiously, the "infallible" market did not understand until the last moment that these companies were in great difficulties. Possibly many people thought, "Since Enron is valued by the market at $80 billion, there can't be anything wrong with it." Everyone believed everyone else!

**Peter Van der Heyden**
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*Rappaport responds:* Peter Van der Heyden introduces a curious contradiction when he asserts that companies should be managed to improve their long-term health and then goes on to claim that shareholder value is not a good way to manage. After all, a company's value depends on its long-term ability to generate cash to fund value-creating growth and pay dividends to its shareholders. What could be better for a company's long-term health than a management that embraces shareholder value as its governing principle? If companies are not in the business of creating value for their shareholders, where will the capital needed to grow the economy come from?

Equally puzzling is Van der Heyden's rejection of shareholder value management on the grounds that CEOs cannot exactly estimate future earnings and cash flow, and the stock market cannot accurately value companies. In a sea of uncertainty, there is no "right" forecast of future cash flows or "true" value of a company's shares. Indeed, pay for performance is all about rewarding management for how well it performs in the face of uncertainty. And equity investors recognize that they may not earn a premium over the risk-free rate to compensate them for the additional risk they assume. In brief, uncertainty is not an impediment to the use of shareholder value; rather, it's what makes the implementation of sound shareholder value practices absolutely crucial to an organization's success.

Finally, each of the financial reporting shortcomings Van der Heyden presents is addressed by the proposed corporate performance statement, which provides investors with substantially greater value-relevant and transparent information than traditional financial statements do.

## Mastering the Three Worlds of Information Technology

Andrew McAfee's article, "Mastering the Three Worlds of Information Technology" (November 2006), demonstrates the need for fresh ideas to help us break out of an intellectual rut. The fundamental problem is that his perspective is too technologycentric. IT is simply too narrow and confining as a concept; the conversation should be about enterprise information management.

High-performance organizations recognize IT as a tool that can help connect people, information, and enterprise objectives. In the workplace, people integrate information tools and technologies. Over the course of an hour, a knowledge worker may write an e-mail, read (or write) a blog, check a spreadsheet, use computer-aided design, and employ supply-chain management to check or calibrate production sequences. A team might use a wiki and software for enterprise resource planning. Yet McAfee separates IT into three discrete categories – functional, network, and enterprise – rather than integrating it.

Several questions demand new answers: How can information be managed strategically to benefit the organization? What information is needed, when, in which form, and accessible to whom? How do people actually create, move, store, access, and use information? How can technology create more robust, useful, and creative links between organizations' two greatest resources: people and information? McAfee may be on the right track, but his analysis does not break out of the restrictive bounds of a now-outdated focus on IT.

**Bruce W. Dearstyne**
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*McAfee responds:* Bruce Dearstyne's comments illustrate the belief, common in some academic circles, that it's vital to study the effects of information technology yet somehow inappropriate to study the technologies themselves. Instead, we should concentrate on "enterprise information management" and ignore the actual tools used to do the managing.

I find this akin to advising the mayor of a city that she should concentrate on municipal transportation management while at the same time discouraging her from thinking about the important differences among subways, light-rail, buses, taxis, and private cars. To achieve her goals, the mayor will have to select from transport technologies that offer divergent capabilities and are perceived very differently by their users.

The same holds true for business leaders trying to achieve their goals with IT. In both cases, decision makers must understand what the different technologies will do for them and what they need to do to ensure that their choices are successfully adopted and fully exploited. My article presents a model to help IT decision makers with this work.

Focusing on information blurs important distinctions rather than highlights them. For example, e-mail, an ERP system, and a wiki all facilitate information flow. That does not mean they're interchangeable. Benefits will not necessarily triple if all three are deployed. And there is no guarantee that users will embrace them all equally.

The executives I've taught, and the companies I've studied and worked with, spend a great deal of time and energy on IT decisions and efforts. They'd be very surprised to hear that their focus is "now outdated." And they'd be nonplussed at the suggestion that they can or should think about information without explicitly thinking about information technologies.

## Can Science Be a Business?

I read Gary P. Pisano's article, "Can Science Be a Business: Lessons from Biotech" (October 2006), with interest. Given the economic performance of the biotechnology industry as a whole over the past 30 years, why do the public markets continue to invest in non-revenue-producing companies? Simply stated, the hope that biotechnology can create a dramatically better tomorrow for patients helps make the industry great for stock pickers. The outcomes for small companies tend to be binary and driven by a visible event (usually a clinical trial), and the payoffs are large. The few successful companies have created enormous returns for their investors. Stock analysts invest a great deal of energy in collecting information,


BIG PICTURE

Biotech has not delivered on its promise because the industry's structure – much of it borrowed from Silicon Valley – is flawed. Businesses engaged in advancing basic science as a core activity need a new design.

Can Science Be a Business?
Lessons from Biotech
by Gary P. Pisano

In its 30 years of life, the biotechnology industry has attracted more than $300 billion in capital. Much of this investment has been based on the belief that biotech could transform health care. The original promise was that this new science, harnessed to new forms of entrepreneurial businesses that were deeply involved in advancing basic science, would produce a revolution in drug therapy. Unencumbered by the traditional technologies and organizations of the established pharmaceutical giants, these nimble, focused, science-based businesses would break down the wall between basic and applied science and produce a trove of new drugs; the drugs would generate vast profits; and, of course, investors would be handsomely rewarded.

So far, the promise remains largely that. Financially, biotech still looks like an emerging sector. Despite the commercial success of companies such as Amgen and Genentech and the stunning growth in revenues for the industry as a whole, most biotechnology firms earn no profit. Nor is there evidence that they are significantly more productive at drug R&D than the much maligned behemoths of the pharmaceutical industry.

This disappointing performance raises a question: Can organizations motivated by the need to make profits and please shareholders successfully conduct basic scientific research as a core activity? For 30 years, debate has been intense about whether business's invasion of basic science – long the domain of universities and other nonprofit research institutions – is limiting access to discoveries, thereby slowing scientific advance. But the question of whether science can be a profitable business has largely been ignored.

As always, the prevailing outlook in the industry itself is that the revolution in drug creation will succeed; it will just take a little longer than anticipated. That may be wishful thinking. Over the past 20 years, I have conducted extensive research on the strategies, structure, performance, and evolution of the biotechnology and pharmaceutical sectors. I learned that the "anatomy" of the biotech sector – much of it borrowed from models that worked quite well in software, computers, semiconductors, and similar industries – is fundamentally flawed and therefore cannot serve the needs of both basic science and business. Unless that anatomy changes dramatically, biotech won't be able to attract the investments and talent required to realize its potential for transforming health care.

By "anatomy," I mean the sector's direct participants (start-ups, established companies, not-for-profit laboratories,

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