Chapter 3: Financial management

3.1 Introduction

This chapter focuses on financial management, which is an important element of general business management, and the various elements (constructs) that have an impact on corporate reputation. Figure 3 illustrates financial management in relation to other business processes and corporate reputation.

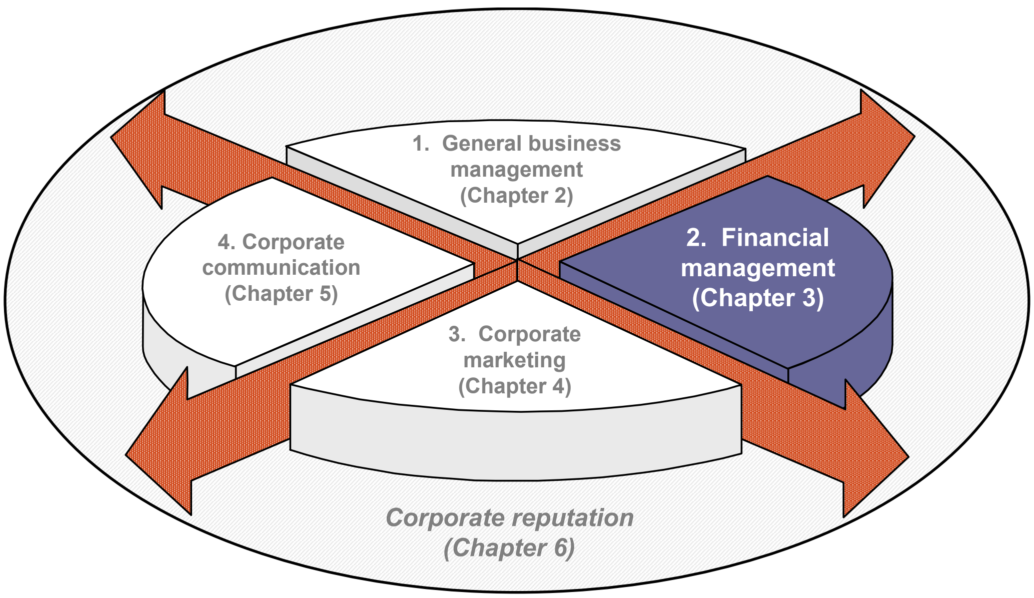

Figure 3 Financial management in relation to corporate reputation

Financial management emanates from the organisation's general business management. It is important to note that there are many elements that contribute to financial management, but that for the purposes of this study; only specific elements relating to corporate reputation will be discussed. These elements include share price, which has a direct impact on shareholder value and investor attractiveness, which influence the profitability of an organisation. A profitable organisation that is sustainable will influence commercial viability positively, which will be enhanced through its transparency. Financial management has a significant influence on all the areas of the organisation as it dictates the budget in terms of the monetary spending of an organisation.

3.2 Share price value as influencer on corporate reputation

Einwiller and Will (2002:104) assert that although organisations have to be aware of the needs of all stakeholders, some stakeholders are more important than others. They view the financial community as the most important stakeholder group for the organisation and thus for corporate branding efforts. Gary and Smeltzer (1985:75) and McNaughton (2003:13) agree that the impact of an organisation's reputation on the financial community is dramatic. A favourable reputation is regarded as a prerequisite to succeed in the global financial marketplace. Shareholders can ultimately give or withhold their approval of management through their votes. In addition, their decisions on buying and selling influence share prices; there is a direct and measurable impact on an organisation's share price.

However, O'Connor (2001:58), Berman and Woods (2002:45) as well as Grupp and Gaines-Ross (2002:19) concur that it is widely accepted that traditional accounting models provide an inadequate means of reflecting true share value. Historically the value of intangible assets was considered as relatively modest compared with tangible assets such as buildings, inventory and equipment. The gap between book, net assets and share price can only be bridged by a more meaningful risk assessment of those factors that affect reputation. In today's fast-changing, knowledge-based economy, intangible assets such as brand strength, client relationships, intellectual property and human capital can make up a large portion of an organisation's value. It has been estimated that intangible assets can provide three times as much value as tangible assets. Reducing stock market volatility by identifying and valuing unrecorded intangible assets could help organisational stability. A more inclusive reporting system will build operational capability and enable rationalisation of organisational strategy to occur, which is critical to managing reputation and share price. Accounting for broader social and ethical organisational practices could not only improve transparency and accountability with stakeholders; it could also limit scope for malpractice such as insider dealing.

Share price can be directly related to shareholder value, which is the focus of the next section.

3.3 Shareholder value of an organisation

The shareholder value principle, according to Doyle (2000:20) and Froud, Haslam, Johal and Williams in Morgan and Takahashi (2002:170), describes that a business should be run to maximise the return on the shareholders' investment. The heart of shareholder value analysis is measuring whether in any one year the organisation has earned more than its weighted average cost of capital. From shareholders' point of view, this is an indicator of whether they could earn more by putting capital into money accounts rather than taking a risk on shares. Creating shareholder value is essentially about building a sustainable competitive advantage; the reason why clients consistently prefer to buy from one organisation rather than others. Marketing thus provides the tools for creating this competitive advantage. Mitchell (2002:28) concurs and adds that the only way to maximise shareholder value is by delighting clients and motivating employees.

The discourse on shareholder value, according to Morgan and Takahashi (2002:170), is crucially important to organisations and investors on a number of levels. It expresses the dominance of a particular set of shareholder interests in the process of managing the organisation. In theory, an organisation which does not deliver shareholder value (i.e. by whatever metric is being used, does not achieve higher returns than the average cost of capital) should see its share price fall as investors sell. However, where failure to achieve shareholder value is perceived to have occurred because of 'poor' management, the organisation's share price will fall and this will lead to it becoming vulnerable to takeover.

This specific metric of shareholder value analysis provides investors with a way of deciding which organisations are providing them with value as the comparative yard-stick is already built into the measure. It then becomes the basis for action in the capital markets. Metrics act as disciplinary devices on management through the mechanism of trading in the stock and bond markets. On the basis of these metrics, investors move funds around the marketplace, with the consequence on the aggregate of weakening some organisations and strengthening others. This occurs most obviously in relation to share price but also in terms of the interest rates and conditions on short-, medium- and long-term borrowing. The pressure for shareholder value is therefore translated into a measurable form, which acts as a disciplinary force on management and strategies of organisation growth and development. Rajaji (2002:60) comments that there is no single metric that can be used on an operational level to measure shareholder value. It is a high-level, multifaceted and long-term concept, and there is no single number one can use to guide decision-making. The best way to measure shareholder value is to break it down into a series of smaller-scale metrics that, put together in the right proportions, demonstrate shareholder value. Guidelines requiring executives to own a large number of shares in their organisations do not necessarily translate into better shareholder returns. The bottom line is therefore that shareholder value is a long-term notion that is very complex to compute. Short-term indicators such as revenue, share price and growth do not necessarily say anything about shareholder value, especially when looked at in isolation.

Attractive shareholder value through the creation of competitive advantage will influence investors positively to invest in an organisation. The investor attractiveness of an organisation is discussed in the next section.

3.4 Investor attractiveness

Haller and Boyd (1981:68) comment that the primitive investor automatically assumes that an organisation with entries in many growth markets is a winner. The more pragmatic strategist recognises growth markets as a double-edged sword: on the one hand, it is important to be in them or else the business has no future; on the other hand, they usually produce negative cash flows. Hence, being in too many growth markets at the same time can spell disaster.

Antunovich, Laster and Mitnick (2000:1) note that individuals and organisations investing in the stock market often prefer to buy shares of high-quality or blue-chip organisations. Some asset managers advocate a policy of investing exclusively in shares of leading organisations. Investors who favour the glamour shares of well-managed organisations argue that these organisations experience superior growth and profitability, which ultimately translate into superior share price performance. A high quality organisation is indeed a high-quality investment. Buying shares in organisations with fast sales growth and attractive prospects has proved especially popular with investors. Recent academic research, however, argues that glamour shares are unlikely to yield unusually high returns. Investors are willing to accept more modest returns from investing in high-quality organisations because these organisations pose a lower level of risk. Lakonishok, Shleifer and Vishny in Antunovich *et al*. (2000:2) speculate that investors may accept a smaller return because they derive pleasure from owning shares of blue-chip organisations.

Doyle (2000:15) states that the value of an organisation measures the views of professional investors on the ability of management to master this changing market environment. When investors perceive an organisation to be stuck in unattractive markets (such as the current IT industry in South Africa) and to be lacking a competitive advantage they naturally do not want to invest. The value of the organisation then declines, making it difficult for the organisation to attract resources and making it prone to being acquired. The key to economic value creation is the organisation's ability to achieve or maintain competitive advantage in a changing market environment.

Attracting investors to an organisation is driven to a certain extent by the organisation's profitability; this will be discussed in greater detail in the following section.

3.5 Profitability of an organisation

According to Schwartz (2000:4) and Kitson and Campbell in Fisher (2002:96) a good organisation is profitable. If one is not profitable, one is not in business and the organisation will not survive. La Berge and Svendsen in Testa (2002:260) add that relationships lie at the heart of corporate profit making and sustainability in today's global economy.

George (2001:39) states that the mission-driven, value-centred organisation is able to motivate employees to create innovative products and superior client service that is sustainable over a long period. This in turns leads to increased client satisfaction and a competitive advantage that drives high revenue growth, with high profit margins and high rates of growth in profitability.

In today's interlinked world as described by Mastal (2001:57) corporate reputation, which is the cumulative perceptions of an organisation by its key stakeholders, is increasingly recognised for its bottom-line impact. In fact, a large body of research shows that organisations with good reputations achieve higher-than-average profitability compared to their peer groups. Therefore reputation ultimately has an influence on the organisation's sustainability.

3.6 Organisational sustainability

To be competitive, to survive and to grow in the market, according to Van der Walt *et al.* (1996:544) the organisation must have competitive advantages over competitors. In all cases the advantage must be sustainable over a certain period. A sustainable competitive advantage can be defined as the ability to deliver superior value to the market for a protracted period of time. Sustainable competitive advantages are necessary to outperform the competition.

Barney in Kowalczyk and Pawlish (2002:163) adds that an organisation with a positive reputation can enjoy a significant competitive advantage, whereas an organisation with a negative reputation, or no reputation, may have to invest significant amounts over long periods to match the differentiated organisation.

An organisation that proves to be profitable and sustainable will also prove to be commercially viable.

3.7 The commercial viability of an organisation

Grupp and Gaines-Ross (2002:18) explain that calculating a return on investment (ROI) puts a financial value on achieving the organisational objective, which is usually revenue. Corporate reputation becomes increasingly dependent on an organisation's ability to execute an organisational model. Execution results in good reputation and correlates highly with strong financial performance and overall success. Therefore a favourable organisation reputation delivers financial payoffs. Corporate reputation correlates with financial performance and return on investment.

3.8 Transparency of an organisation

Christensen (2002:162) and Mayo (2002:1) articulate that organisations face increasing pressure to report publicly, not just on financial performance, but also on non-financial, social, environmental and ethical performance and on remuneration policies. In turn, reporting of non-financial performance is becoming increasingly more specific and measurable and more subject to independent scrutiny and audit. While advertising standards and the law provide some regulation of the standards of reporting, the challenges remain to keep the focus on substance as well as form and to balance law and best practice.

There seems to be, according to Christensen (2002:164), an implicit assumption in literature on the subject that external stakeholders in general want or even demand organisational transparency. As Fombrun and Rindova in Christensen (2002:166) point out, a primary mechanism for achieving transparency is expressive communication with stakeholders. This expressiveness is organised around the organisation's identity. If internal and external audiences agree on interpretations, there is in effect transparency. Since this transparency is established through the means of communication, external stakeholders demand more and more communication. Bickerton (2000:43) postulates that communication benefits may result not only from the amount and frequency of communications but from the variety of issues about itself that an organisation reveals through its communications. Communication that makes an organisation transparent enables shareholders to appreciate the organisation's operations better and so facilitate ascribing it a better reputation.

Pruzan (2001:57) comments that perhaps the major single characteristic that accounting reports share is that almost all are either built around the concept of stakeholder dialogue or profess that they will be in the future. They are not just one-way communications prepared by experts; almost all the reports invite the stakeholders to participate in the development of the reports, the methodology employed and the development of new actions to improve corporate performance. In other words, rather than being solely based on management's perceptions of what is important to measure and on 'objective' measures of performance, the reports also focus on the values and aspirations of the various parties who affect and/or are affected by the organisation's decisions and actions. Anon. (2003a:10) notes that organisations that release these financial results earlier than their industry peers achieve an average 15.5% premium in their price-to-earnings ratio.

Christensen (2002:162), De Chernatony (2002:106) as well as Einwiller and Will (2002:105), comment that the possibility for every stakeholder to access almost any information directed at other stakeholder groups, for example clients or activists accessing investor information, has led to much greater transparency than ever before. The consequences of these new possibilities are evident: any contradiction in what is being communicated to different stakeholder groups can be unveiled without a person having to undertake great efforts. Apart from information conveyed by the organisation itself, Kartalia in Nakra (2000:36) comments that the growing commercialisation of the World Wide Web (www) has led to the increased availability of corporate information via the Internet, enhancing the organisation's transparency. The plethora of Internet sources available includes independent sites for corporate information, client communities, anti-corporate sites and discussions in newsgroups, to mention only a few.

Morgan and Takahashi (2002:173) postulate that as critical accounting research has revealed that financial accounting is not simply a reflection of an underlying reality, it constitutes that reality by giving it a particular shape and form of visibility to both insiders and outsiders. In this sense the claim of shareholder value discourse to create an objective measure of performance based on the transparency of organisation accounts is spurious because all accounting systems are constructs with various forms of biases which can be exploited by corporate management. High levels of transparency and frequency of information disclosure are therefore crucial to enabling investors to make choices between various shares, bonds and other financial instruments. Without such transparency, investors are cautious because they are uncertain about what they are buying into. The information released to outside investors drives the internal process of information collection and analysis. The shareholder value discourse is integrally related to the ability of managers to engage in rapid and major organisational restructuring in order to respond quickly to poor figures.

Anon. (2002b:[5]) notes that it is essential for organisations to make shareholder value a key management goal to improve competitiveness and to push for greater transparency and corporate governance. Investors appreciate the value of more comprehensive information from organisations as this helps them evaluate future financial performance. To attract capital, organisations need to understand the importance of good corporate governance and focus on areas that create shareholder value, which employs both financial and non-financial information.

3.9 Conclusion

It can therefore be concluded that the impact of an organisation’s image on the financial community is dramatic. A favourable reputation is regarded as a prerequisite to succeed in the global financial marketplace as it influences financial payoffs. Corporate reputation correlates with financial performance and ROI.

Although it is acknowledged that all these factors form a major portion of the aspects that influence investment decisions, it is important to understand that these factors should not be regarded in isolation when a perception of an organisation is formed in terms of corporate reputation. Investor decisions are also driven strongly by the corporate marketing and corporate communication of an organisation.

Financial management drives the money spent throughout the organisation, especially in terms of marketing and communication initiatives, influencing intangible assets of the organisation, which in turn affect profitability and shareholder value positively, increasing commercial viability and sustainability, all culminating in a positive corporate reputation.