# UNDERSTANDING VALUE CREATION


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# CONTENTS

# UNDERSTANDING VALUE CREATION

This report supplements The CFO and Finance Function Role in Value Creation.

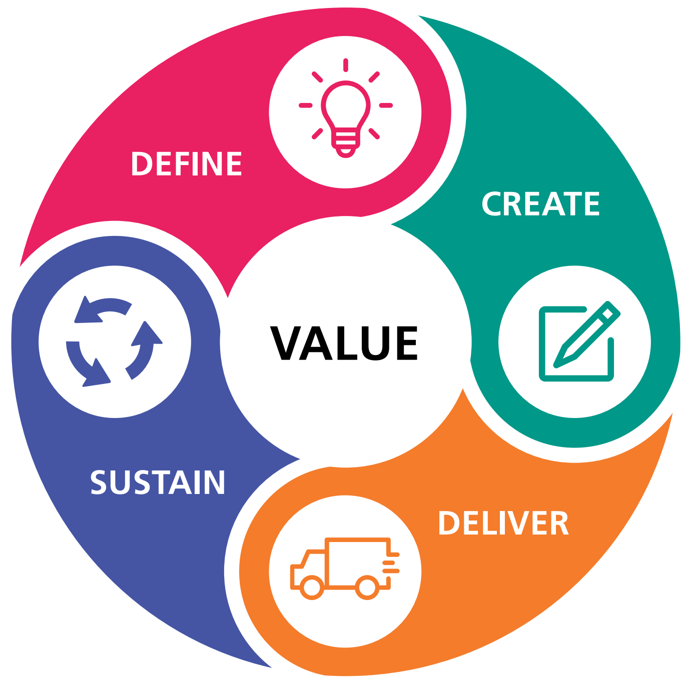
Before being able to measure, track and communicate on value creation, it is important to understand value creation and enable a value creating business model.

This can be achieved through a management process of defining, creating, delivering and sustaining value. Value is ultimately

- **Defined** by customers, investors and other stakeholders
- **Created** through the organization's purpose, strategy, and business model taking into account all resources, capitals, and relationships in an integrated way
- **Delivered** to ever-more demanding and sophisticated stakeholders through responsible products and services, and through new channels, at an appropriate price
- **Sustained** by retaining and protecting value internally, and by appropriate reinvestment and distribution to shareholders and wider society.

Each of these areas informs strategy, goals, metrics, and incentives.

Additional resources on value creation from the global accounting and business communities are available here.



# DEFINING VALUE

**How value is *defined* is by customers, investors, employees, suppliers and other stakeholders. Value itself, as well as priorities for value creation, are defined in the context of meaningful engagement with key stakeholders, and opportunities and threats facing the organization. These inform an organization's purpose, values, strategy and measures of success.**

Defining value involves establishing and prioritizing stakeholders, understanding how they are relevant to the organization's purpose and strategy, and assessing how to balance their respective needs and expectations. Effective stakeholder engagement allows a breadth of perspectives from different stakeholders to inform on the issues which are most pertinent to the resilience of the business and critical to its long-term success. For example, ABN AMRO N.V. discloses its value-creating topics based on a full assessment of its operating environment and stakeholder engagement, as well as where it believes it can create most value for stakeholders and society.

Stakeholder engagement needs to be meaningful and frequent to add value to decision making and capital allocation. AA1000 Stakeholder Engagement Standard (AA1000SES) 2015 provides practical guidance on how to assess, design, implement and communicate effective stakeholder engagement, as well as how to enable stakeholders as active contributors to value creation. Meaningful engagement with key stakeholders enhances understanding of the positive and negative impacts of doing business, and consequently informs a continuous assessment of the material issues informing strategy and its implementation through the activities in the business model.

The process of defining value through engagement also helps to reveal areas of misalignment and trade-off. For example, in capital allocation, investors might prefer the short-term deployment of capital, whereas the board might prefer long-term projects. Consequently, it is important to understand and communicate how short-term expectations from different stakeholders might influence long-term choices and prospects. This provides the basis for communicating how short-, medium-, and long-term trade-offs are managed.

Leveraging data is an important part of identifying value creation drivers. Understanding and properly managing data across the business is crucial for CFOs to create better stakeholder outcomes.

## DEFINING VALUE—KEY QUESTIONS

What are the relevant issues in the context of the changing external environment that need to be considered in decision making and capital allocation?

Who are our key stakeholders and how are they relevant to our purpose and value creation? This involves

- Prioritizing stakeholders and their legitimate needs, expectations and preferences
- Identifying what outcomes are needed to deliver stakeholder expectations
- Establishing whether purpose, values and strategy fulfil relevant stakeholder outcomes.

Do we have a process in place for stakeholder engagement and understanding and prioritizing the significant opportunities and challenges facing the business?

What are the value propositions that meet the needs of high priority stakeholders, and the strategic assets and capabilities (i.e., those that generate benefits and are generally difficult to imitate) that form the basis of delivering value?

What are the areas of potential conflict and trade-offs among stakeholder interests, including within stakeholder groups (e.g., providers of equity versus debt)?

## CONNECTING PURPOSE TO STAKEHOLDER OUTCOMES AND MEASURES OF SUCCESS

For an increasing number of companies, their purpose is focused on delivering value to customers, stakeholders and society through their products and services. Connecting purpose to stakeholders and their desired outcomes provides a basis for measuring success.

**Example:** ***Purpose***

**"Enhancing quality of life and contributing to a better working world through our innovative products"**

What are the desired outcomes for each stakeholder if the purpose is fulfilled?

- Society: Improved well-being through healthier living, and longer life
- Employees: Innovative working environment, and improved well-being from work
- Investors: High dividends as a result of innovative products
- Customers: Reduced healthcare expenditure resulting from healthier population
- Government: Healthier population resulting in increased productivity and improved well-being.

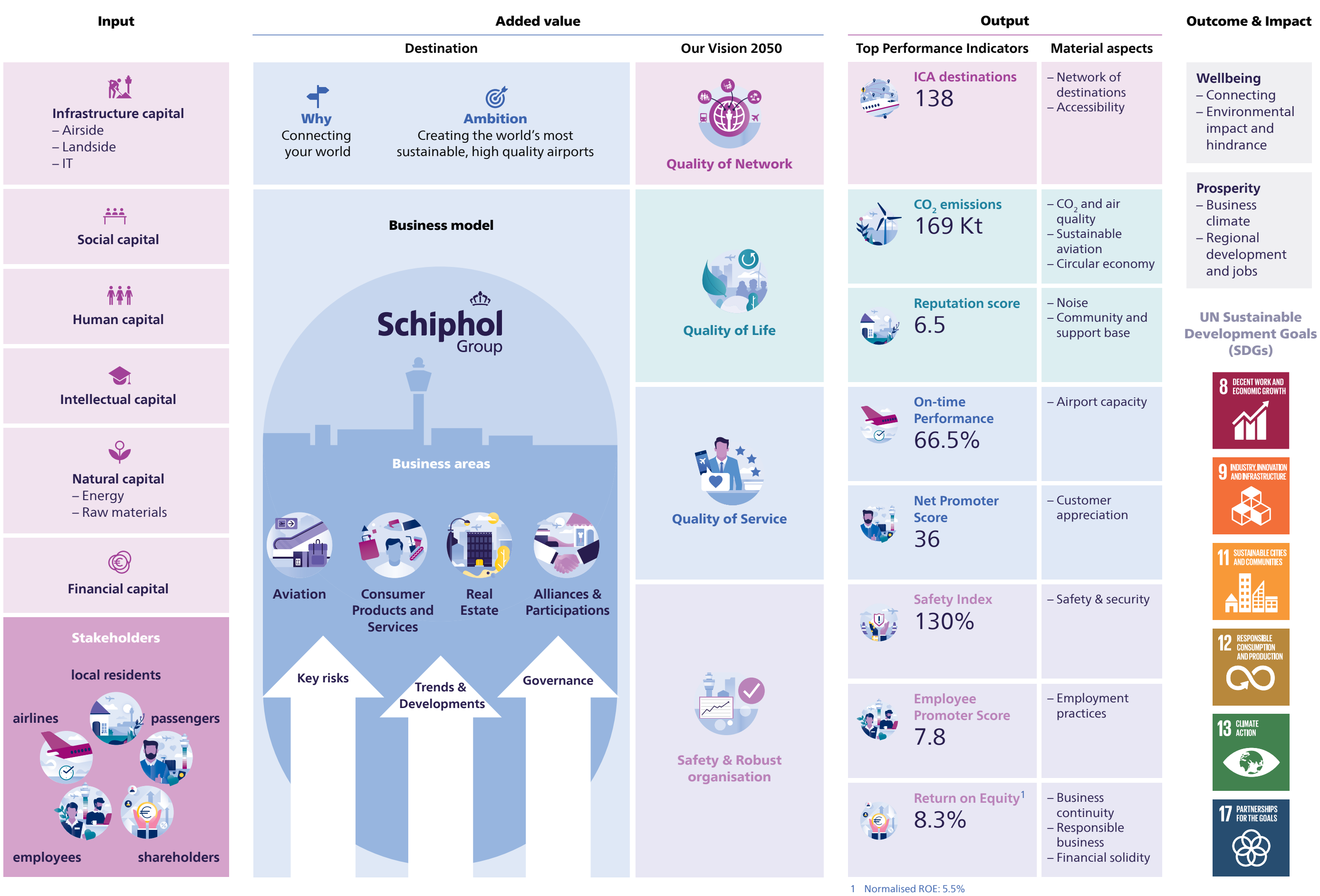
Reference: the Embankment Project for Inclusive Capitalism

# CREATING VALUE

**How value is *created* through the organization's purpose, strategy and business model taking into account all resources, capitals, and relationships in an integrated way.**

The value creation process is at the heart of integrated thinking and value creation. Strategically, the business model is a central cog in the value creation process which turns valuable resources and relationships (inputs) into results (outputs) that create value for stakeholders and society (outcomes and impacts). Value for customers and other stakeholders is ultimately created or destroyed through the business and operating model.

Many organizations undertaking integrated reporting using the International Integrated Reporting Framework to set out their value creation and business model as a central part of their integrated reporting. This approach provides a tool to connect purpose, strategy and the value creation process across relevant capitals, outcomes and impacts. An example is Royal Schiphol Group which includes an explanation of its value creation model in its Annual Report 2019.




Reference: Royal Schiphol Group, Annual Report 2019

The Royal Schiphol Management Agenda aligns all added value activities within the Group to eight top performance indicators across five key stakeholder groups: local residents, passengers, airlines, employees and shareholders (their process is further highlighted in Understanding and Communicating Value Creation, page 6). Another example, is the ABN AMRO value creation model in its Integrated Annual Review 2019, which also connects to the impacts of its banking activities set out in its Impact Report 2019.

In many industries and sectors, business models are being disrupted through, for example, technological advancements and digitization, resource depletion, climate impacts or other societal changes that involve substantial business and operating model rethinking. The capacity of the business model to adapt to changes (e.g., in the availability, quality and affordability of critical resources or capitals) is likely to affect a company's longer-term resilience and viability.

Ensuring that value is created over time involves making significant decisions on where the business competes (e.g., markets, geography, segments), identifying the principal opportunities and risks related to the strategy and business model, ensuring products and services meet customer needs and respond to societal challenges, and collaborating with critical partners in value creation. To create long-term value, organizations need to put in place the infrastructure, capability and relationships (tangible and intangible assets) that enable them to meet the needs of their customers and stakeholders.

Consequently, capital and resource allocation decisions are a critical part of how value is created and sustained. Investments in capital maintenance and development of strategic assets and capabilities such as talent, innovation, infrastructure, brand and intellectual assets enable value to be created. They need to be considered beyond estimated financial returns and in the context of internal and external stakeholder outcomes, and a wider set of impacts.

## CREATING VALUE—KEY QUESTIONS

**How is value to be created through the strategy and business model considering all capitals and resources in an integrated way?**

- Where do we compete (product/service segments, regions/territories, segments?)
- What are the principal opportunities and risks related to the business model?
- How are resources procured and transformed to deliver value and what changes are needed to ensure a resilient and sustainable business model?
- How do products/services meet customer needs and respond to societal challenges?
- Who are our critical partners and collaborators in value creation?

**How do we balance the achievement of value creation objectives against all potential impacts?**

- How are resources allocated to meet objectives and trade-offs between stakeholder interests managed?
- What tools and approaches enable us to incorporate additional forms of analysis in capital allocation and investment decisions, such evaluations of external impacts, social impacts (e.g., health and safety or labor practices), economic impacts of decisions (e.g., for communities and suppliers), and environmental impacts (e.g., biodiversity and pollution)?
- What are the key strategic, operational and financial value and performance metrics and indicators that need to be captured?

# DELIVERING VALUE

**How value is *delivered* to customers and society through responsible and profitable products, services, and channels to market. This involves understanding and leveraging strategic and intangible assets to deliver value in new and more effective ways. It also requires delivering value at an appropriate price, cost, and level of performance. Delivering value requires integrated and relevant strategic, operational, and risk information that takes into account the changing external environment and ensures that performance is aligned to business and value creation objectives.**

Delivering value involves doing things right in terms of delivering responsible products and services to the right stakeholder at the right time, place and price. Value can only be delivered when products and services and other outputs from the business model deliver stakeholder outcomes as well as long term economic profitability.

To deliver value therefore involves effective decision-making processes, including profitability planning and improvement and project appraisal. These are enabled by an enterprise performance management approach that provides the necessary information around resources and processes, revenue, costs and risks in the context of business and value objectives.

Organizations deliver value by providing products and services to customers that meet their, and society's needs, at a price they are prepared to pay. To achieve this, the CFO and finance team need to understand the business including different customer segments, the channels to reach each segment, and the key resources and processes that underpin value delivery many of which will be intangible and not reflected in accounting information, such as sales, marketing, research and development, production, logistics and financing.

CFOs and their teams need to capture revenue and cost models based on an operational perspective of the business to help support the delivery of value. This modeling also needs to incorporate environmental, social and governance (ESG) factors which cover environmental or social performance and impacts, and broader governance issues related to conducting business responsibly. These models are an important basis for understanding and capturing value, making decisions, and deciding where to invest and how a financial surplus is distributed and used.

Accounting for resources and costs reflects levels of activity, channels to market, the efficiency of processes, and resources consumed by activities, as well as prices paid for resources.

Resource allocation decisions need to incorporate those costs and benefits that are external to the organization (i.e., those that accrue to society or to identifiable third parties). External impacts can be internalized by incorporating appropriate costs and benefits into the decision-making process. Approaches such as environmental management accounting, full cost accounting (FCA), lifecycle assessment, and costing or whole life costing, and enterprise risk management help to identify and quantify costs and benefits, and risks and opportunities related to both current and future strategies and operations. These approaches bring in important additional forms of analysis, including evaluations of social impacts (e.g., health and safety or labor practices), economic impacts of decisions (e.g., for communities and suppliers), and environmental impacts (e.g., biodiversity and pollution). Such impacts will relate to the identification and quantification of cash and non-cash costs and benefits accruing to both the organization and to others.

## NEW WAYS OF DELIVERING VALUE TO CUSTOMERS AND KEY STAKEHOLDERS

The way value is delivered is also changing rapidly due to changing business models in the digital economy that reinvent channels to market, and production methods (e.g., industry 4.0). Digital manufacturing provides huge amounts of data that can enable a better understanding of how to deliver value in new ways to meet unmet needs and desires.

Many organizations are undertaking digital transformational enhancements involving data, artificial intelligence (AI) and machine learning capabilities to facilitate their digital transformation. This can relate to all aspects of the business model including new digitally enabled processes, AI and machine learning to drive information insights, speed and accuracy, and technology driven products and services.

### DELIVERING VALUE—KEY QUESTIONS

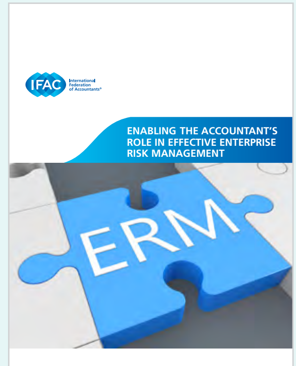
How do we deliver value to customers and society through our products and services, and channels to market?

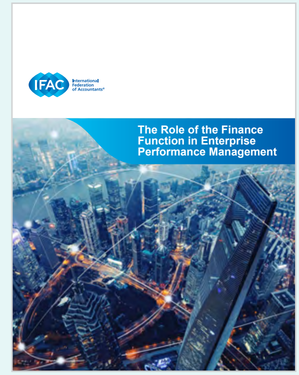
How can technology, digital and data help us deliver value?

How do we deliver value to customers and society profitably and sustainably?

Are the customers of the finance function including the board, management and operations receiving the necessary revenue, cost and risk information to evaluate the achievement of value objectives?

Where and how are capital and resources allocated to deliver strategic and value objectives?




### Enabling the Accountant's Role in Effective Enterprise Risk Management (ERM)

As businesses face rapid change and increasing uncertainty, there are three ways in which CFOs and finance functions can ensure ERM links to managing for value creation:

- Align risk management with value creation and preservation;
- Drive insights and enable decisions through provision of risk modeling and analytics, data governance and identification of organizational risk appetite; and
- Enable integration and interconnectivity by breaking down siloes across the organization to share information.

### Identifying the Role of the Finance Function in Enterprise Performance Management (EPM)

For finance professionals to be viewed as business partners, they must contribute effectively to EPM beyond traditional financial reporting and financial systems.

This report identifies how the finance function must evolve to support EPM, including:

- How EPM supports all levels of an organization to support value creating decisions, from daily issues on operational efficiency and customer service to major strategic shifts of direction;
- How accountants in business and the finance function can drive effective EPM; and
- The four key enablers of EPM.

# SUSTAINING VALUE

**How value is *sustained* by retaining and protecting value internally in the organization and distributing value externally to shareholders and stakeholders. Ideally, there needs to be a balanced approach between the retention of value derived by the organization and the distribution of value to its stakeholders aligned to purpose and value objectives.**

Sustaining value and trust in the organization involves actions and communication on both value created and protected through the stewardship of tangible and intangible assets, and financial and non-financial performance. In sustaining value, CFOs and their teams fulfil value protection and stewardship by ensuring transparency and accountability including fair and balanced presentation of value creation related to both growth and value-creating opportunities in the context of stakeholder expectations and market changes, and efforts to protect value and safeguard critical financial and non-financial assets.

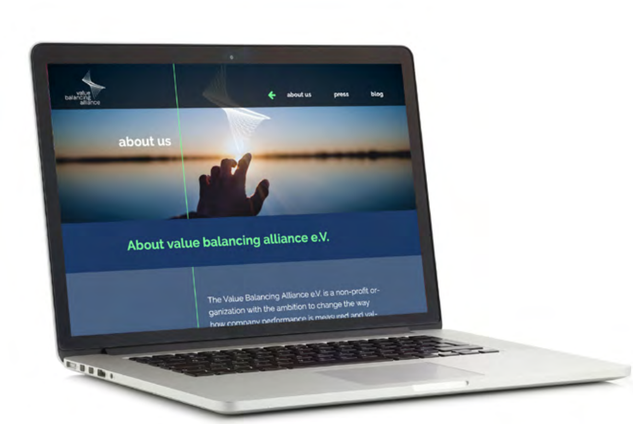

Adequately sharing the benefits of value creation helps to create trust and incentivizes key stakeholders to continue partnering with the organization to sustain value creation in the future. The distribution of value to various stakeholders can be in the form of government (taxes); shareholders (dividends) and debtors (interest); incentives for executives (performance-related pay) and wages and benefits to employees; and the organization (retained income for reinvestments and depreciation for reinvestment in machinery and equipment).

Value distribution needs to be sensitive to the interactions in the operating environment so that it does not harm reputation, or the creation and delivery of future value. The key bases for decision-making include tax strategy, dividend policy, desired capital structure, investment opportunities, as well as remuneration and benefits for employees and social and environmental outcomes more broadly. Value delivered to shareholders, whether through dividends or other financial returns, may satisfy their needs in the short-term. But, if that value is being created at the expense of others and the environment, the company will fail quickly.

The factors to consider when sharing value with key stakeholders include ongoing priorities for use of cash (e.g., dividend policy, returns to shareholders and capex), tax strategy, desired capital structure, remuneration and benefits for employees, and social (e.g., job creation) and environmental (e.g., enhancing nature and biodiversity) outcomes. Value distribution can also be subject to new thinking such as dividend policy reflecting both shareholder value creation as well as monetized positive and negative externalities.

An increasing number of companies are also developing integrated impact profit and loss accounting based on economic assessments and valuations. Various initiatives are focused on advancing impact measurement and valuation including the Value Balancing Alliance (VBA), the Impact Management Project, and the Impact Institute.

There are also various ways of presenting priorities for value distribution and sustainment. The Compass Group provides a factsheet that highlights among other priorities and key metrics how it plans to use and distribute cash. An increasing number of companies capture their value distribution through a value added statement which shows the wealth or value created and attributed to various stakeholders.




## SUSTAINING VALUE—KEY QUESTIONS

How do we deliver balanced representation of both value creation and protection?

How will we distribute value amongst our key stakeholders: shareholders (dividends) and debtors (interest); incentives for executives (performance-related pay) and employees (wages and benefits); government (taxes); and the organization itself (retained income for reinvestments)?

How do we capture value distribution in a way to safeguard and enhance reputation? E.g., tax strategy, dividend policy, capital structure and investment

What are the positive and negative outcomes and impacts we have on stakeholders, and in terms of the economy, environment and society, and how do these change the way we distribute value?

What return should our investors expect from investing in the business and what resources are needed to deliver this return?

Will our financial return be superior if we optimize value creation more broadly?

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