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FROM THE EDITOR

A Message from the Editors

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We devote this penultimate issue of the JACF to Bartley Madden, a leading management consultant, asset valuation specialist, author, and frequent contributor to this journal over the years. While much of Bart's work has involved the application of corporate finance theory and highly quantitative tools such as the CFROI (cash-flow-return-on-investment) valuation model widely used by investment management firms, he has also been critical of the economics profession for its failure to address the difficult issue of innovation.

In the lead article of our 2018 *Special Issue on Innovation & Growth*, Columbia Professor and 2006 Nobelist Edmund Phelps argued that while economies have continued to evolve, economic concepts have lagged behind and miss the character of a modern economy. Even individual firms are modeled simply as production functions in which managers adjust factors of production (e.g., employee labor) until marginal costs equal marginal revenue, thereby maximizing profits. Models assume the firm's boundaries are clear, that management allocates capital efficiently, and gives orders to employees who follow them without complication. Innovation is treated as an *exogenous* variable (outside of the model) that mysteriously causes a shift in a technology parameter in the model without any explanation for how and why such innovations occur.

Bart picked up on Ned Phelp's challenge to economists in the second article of that issue by identifying a firm's knowledge-building proficiency as most important in being able to prosper over the long term. He proposed a new and more sophisticated concept of the firm to position human capital in general, and knowledge-building proficiency in particular, at the center of value creation. He expanded upon those ideas in subsequent JACF articles, which are reproduced here along with several new pieces by him.

Bart Madden has always had a strongly *applied* approach to these issues (a very good thing from our perspective). He began his working career as an engineer and then transitioned to corporate finance and investments. His primary focus was on how firms create long-term value and drive economic progress.

After co-founding the financial research firm Callard Madden & Associates (CMA) in 1970, his early work focused on the development of the life-cycle valuation model, the CFROI (cash-flow-return-on-investment) accounting return, and a database applying these concepts. That database evolved into the HOLT global database currently used by many money management organizations worldwide. CMA's research was the foundation for HOLT Value Associates, which was acquired by Credit Suisse (now part of UBS). Madden retired as a managing director of Credit Suisse in 2003 and then accelerated his cross-disciplinary research with particular attention to systems thinking and knowledge building in order to build a more viable theory of the firm. Many of his ten JACF articles contribute to the development of the Pragmatic Theory of the Firm (PTF). A reviewer of his latest book, *Value Creation Insights: A Foundational Understanding of How Firms Build Knowledge and Create Value*, summarized Madden's passion for studying the histories of firms as "over half a century of examining what works, what doesn't, and why."

Bart's earliest JACF article, "The SEER Mechanism: A Proposal for Shareholder Voting on Reinvestment of Corporate Cash Flow" appeared in 1992. He proposed a low-cost way for institutional shareholders to convey their confidence (or lack thereof) to boards of directors regarding management's ability to reinvest cash flow successfully. This was SEER (Shareholder Election to Expand or Recycle), in which votes on dividend payouts would provide early signals to the board of directors as to when they should seriously re-evaluate management's strategy and skill.

His 2007 article, "For Better Corporate Governance, The Shareholder Value Review," provided an analytical tool for boards to fulfill their key responsibilities in monitoring and orchestrating the maximization of long-term value. Bart's proposed Shareholder Value Review (SVR) includes a board-controlled display of each business unit's long-term track record of life-cycle variables: accounting returns versus cost of capital and reinvestment rates. This allows management to incorporate the capitalization and amortization of key intangible outlays systematically, thereby improving the accuracy of accounting returns (e.g., RONA) and resource allocations.

"The Purpose of the Firm, Valuation, and the Management of Intangibles" lays the groundwork for a consensus on the purpose of the firm in a free enterprise society in which corporations are the primary engine of economic prosperity. Such a consensus would allow the public to overcome today's political polarization and endless debates about shareholder and stakeholder capitalism. And in "Management's Key Responsibility," Madden argues that the critical determinant of a firm's long-term performance is a knowledge-building culture. This is the root cause of process improvements (e.g., Toyota's renowned lean manufacturing), dynamic capabilities, and competitive advantage, all of which stem from such a culture.

"The Pragmatic Theory of the Firm" details a holistic view of the firm, stressing the connectedness of the firm's activities (e.g., work, innovation, and resource allocation), the need for clarity as to the firm's purpose, and the critical importance of a knowledge-building culture. The focus on *pragmatic* reflects that users of this theory make better value-creation decisions. These decisions are rooted in constructive skepticism about key business assumptions; feedback for early adaptation to a fast-changing world; and investments (intangibles) that nurture and sustain a knowledge-building culture.

The theme of "Bet on Innovation, not ESG metrics, to Lead the Net Zero Transition" is two-fold. First, systems thinking is needed to overcome the limitations of linear cause-and-effect thinking applied to ESG metrics. Second, bottom-up innovation by firms is the key to sustainable progress that delivers not only on financial performance but also on taking care of future generations. The obvious way is to reduce the firm's impact on the environment. Less obvious, and perhaps more important, is through products and services that enable the firm's customers to radically reduce their environmental impacts.

"Michael Jensen's contributions to the theory of the firm: A tribute in three acts" emphasizes the clarity of thinking throughout Jensen's remarkably productive career. He viewed societal progress arising from an active market for corporate control and an ability to withdraw capital from declining enterprises while reinvesting it in those with growth opportunities. Jensen emphasized that to maximize long-term value, management must gain support from all of the firm's stakeholders. This requires strong leadership, demonstrating integrity, authenticity, and a commitment to something bigger than oneself.

Bart grapples with management problems relating to GAAP (Generally Accepted Accounting Principles) in his last three articles, appearing here for the first time. Corporate management and boards of directors have long used standard accounting measures such as RONA (return-on-net-assets), to evaluate the performance of their firms and of their firm's business units. But this is complicated by the failure of GAAP to recognize the most important intangible assets. Relying upon inaccurate GAAP accounting results in misleading return on capital calculations and misallocation of resources. "Bridging the Gap Between Accounting Returns and Economic Returns" lays out a means to fix this problem. The Translator simulation software allows employees at different levels to understand how asset composition and reinvestment rates relate to both nominal accounting returns and fundamental economics, and how particular adjustments to GAAP accounting can improve clarity.

A firm's knowledge-building culture is shaped by its organizational structure, especially the number of layers of management separating the CEO from those doing the work. In "Value Creation Insights: Organizational Structure, Culture, and Freedom," Bart presents three case studies—Nucor, Haier Group, and Bayer—that showcase the advantages of a flatter organizational structure. Seven perspectives are discussed to better understand the challenges of transitioning to a flatter structure.

Finally, "Expanding the Pragmatic Theory of the Firm with Shared Values and Social Norms" makes a strong case for this expanded pragmatic theory (PTF) to enable managers, boards of directors, investors, and policy makers to make better decisions. This PTF is consistent with Michael Jensen's enlightened value maximization principle and helps develop shared values and social norms that strongly encourage good decisions even when strong financial incentives are not available to the employee. Clarifying the firm's purpose may help avoid endless and unproductive debates about shareholder and stakeholder interests and improve research on how firms contribute to economic progress.