MEASURING SHAREHOLDER WEALTH CREATION WITHOUT MARKET DATA: THE DEVELOPMENT OF ANNUAL AND THREE-YEAR COMPOSITE MEASURES (INTERACTIVE PAPER)

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INTERACTIVE PAPER SESSION

MEASURING SHAREHOLDER WEALTH CREATION WITHOUT MARKET DATA: THE DEVELOPMENT OF ANNUAL AND THREE-YEAR COMPOSITE MEASURES

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Principal Topic

The basic purpose of entrepreneurship theory and research is the improvement of new venture performance. However, after numerous studies spanning more than 40 years, there is still no consensus regarding the best measure(s) of new venture performance. Consequently researchers have not adopted, or used in practice, a common set of variables to represent the performance construct. The validity of research studies that use arbitrary dependent measures to represent new venture performance is highly questionable, making extension from one study to the next dubious at best.

Robinson’s 1995 research demonstrated that “return to shareholders” provided the greatest power in new venture performance research. However, since market values are generally not available for private companies, this finding is limited in its applicability for entrepreneurship researchers. This research develops two new composite measures (one annual and one three-year) that do not include market data, but that do explain a significant percentage of the variation in total return to shareholders.

Method

To develop a proxy for shareholder wealth creation, 48 financial ratios were tested to determine their effectiveness in explaining the variance in total shareholder returns in a sample of 1,152 public companies. Based on these results, both one and three-year composite measures were developed that maximized the explanation of variance of total market adjusted shareholder returns. Finally, these two composite measures were shown to provide accurate discrimination among firms that generated high, medium, and low returns to their shareholders using samples of 2,894 annual firm-years and 925 three-year periods of data respectively.

Results and Implications

The one-year composite measure developed in this research explained 46% of the variance in shareholder returns vs. 4% and 2% for ROA and sales growth, respectively. The three-year composite measure explained 62% of the variance in shareholder returns, vs. 12% for ROA and 7% for sales growth. These two new composite measures should assist researchers in studying how decisions made by entrepreneurs affect shareholder wealth creation. They also provide researchers dependent measures that have greater statistical power than any other financial measures for testing hypotheses, and they provide entrepreneurs and managers another financial tool for evaluating organizational financial performance.

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