FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 18, Nº 4, Special Issue, 2021, pp. 357 - 367
https://doi.org/10.22190/FUEO210618025M

Original Scientific Paper

VALUE-BASED MANAGEMENT, LONG TERM SUSTAINABILITY AND CORPORATE SOCIAL RESPONSIBILITY

UDC 005.52:330.133.1

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Abstract. *Today's companies, especially large multinationals, are supposed to be financially successful in accordance with the shareholders' expectations, to operate in compliance with the requirements of sustainable development, taking into account the interests of future generations, as well as to act in a socially responsible manner, serving the interests of key stakeholders, including the interests of the community. In such circumstances, managers are expected to create enough value to satisfy all these interests. The adoption of Value-Based Management (VBM) approach has contributed to a better understanding of shareholders and managers and the alignment of their interests. In this paper, we analyze the compatibility of VBM with the requirements of other stakeholders, including the requirements regarding sustainability and corporate social responsibility. In this context, it could be said that a broader concept of VBM further enhances the interest-based logic behind the corporations' functioning, but at the same time it enables the integration of the requirements related to sustainability and corporate social responsibility.*

Key words: *value-based management, value creation, sustainability, corporate social responsibility, growth*

JEL Classification: M14, M40, G30, L21, Q01

1. INTRODUCTION

In today's world, the issues of sustainability and corporate social responsibility come to the fore more explicitly than ever before. Global challenges such as climate change,

Received June 18, 2021 / Revised August 06, 2021 / Accepted August 14, 2021
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environmental protection, depletion of natural resources, high social costs, occasional crises, including the latest Covid-19 pandemic cause a major blow to economic activity. The magnitude of these problems, which affect companies, national economies and global economy, and the feeling of helplessness as a result of the failure to resolve them more efficiently are particularly troubling.

In this paper, we address the issues of corporate sustainability (CS), corporate social responsibility (CSR) and the concept of value-based management (VBM). Corporate sustainability is a prerequisite for the survival and continuity of companies, corporate social responsibility actualizes the company as a socio-economic institution, while VBM approach is aimed at making the process of value creation more feasible. Obviously, the importance of individual issues is not called into question. We rather seek to find out whether and how they could be interlinked in order to preserve the logic behind the corporate economy functioning, while simultaneously respecting the social responsibility. This is related to the reexamination of key corporate goals and their prioritization.

The current global crisis caused by the COVID-19 pandemic has further highlighted the topic of balancing the interests of various stakeholders. On the one hand, in the situation where social costs have increased significantly, the crisis has explicitly reinforced the importance of corporate social responsibility. On the other, when a strong focus is simultaneously placed on the company's continuity and need for value creation, then sustainability becomes a matter of central importance. In such circumstances, balancing different interests undoubtedly becomes more complex, but we believe that the question of setting the priorities from a wide spectrum of goals turns out to be much clearer.

The structure of the paper is suited to the intention to recognize the importance of the connection between value-based management, long term sustainability and corporate social responsibility. In the first part of the paper, the emphasis will be on valued-based management and valued based metrics, whereby VBM metrics will be seen as an instrument to help managers in making decisions that enable value creation. In the second part, there will be a broader interpretation of value-based management, which should show that value creation is not only in the interest of shareholders, but also the interest of other stakeholders. Finally, in the third part of the paper, the focus will be on the reexamination of value-based management in the context of long-term sustainability and corporate social responsibility.

2. Valued-Based Management and Valued Based Metrics

Globalization of goods and services markets, internationalization and deregulation of capital markets, outstanding development of information technologies, higher standards of product and service quality and stricter regulatory requirements with respect to environmental protection have created major challenges in managing corporations. Besides, if we take into account an increased role of institutional investors and threats of hostile takeovers, then it becomes obvious that managers are under tremendous pressure to maintain the competitive advantage of companies and their ability to generate expected returns. The awareness of the risks that in such circumstances managers may not act in the best interest of shareholders has paved the way for the concept of value-based management.

VBM has its roots in the agency theory. The concept was created in response to the dysfunctional behavior of managers in situations where they, as agents, are in an informationally superior position in relation to shareholders. In these conditions, managers tend to pursue their own interests at the expense of shareholders' interests. This situation first leads to the agency problem, and then to agency costs that undermine a company's performance and its market value. Moreover, the managers and shareholders attitudes toward risk may be different, which may also provoke the behavior that is inconsistent with the best interest of shareholders (Ameels et al., 2002, pp. 5-6). In this regard, VBM was created to alleviate the problem of aligning the goals and interests of shareholders and managers, encouraging managers to think and act in the interest of shareholders.

We could agree with J. Knight to VBM "instills a mind-set where everyone in the organization learns to prioritize decision based on their understanding of how those decisions contribute to corporate value" (Young & O`Byrne, 2001, p. 18). In this regard, "it aligns strategies, policies, performance, measures, rewards, organization, processes, people, and systems to deliver increased shareholder value" (Black et al., 1988, p. 292). VBM has two distinctive characteristics. First, it is oriented to value creation, which represents a significant shift relative to the accounting approach and measures of a company's performance. Its application involves raising the bar significantly as regards the criterion which differentiates successful from underperforming companies. This threshold implies that, in addition to common expenses included in the income statement, the opportunity cost of equity, which is equal to the returns that would be generated by investing in companies with a comparable risk, should also be covered. Second, a different perception of a company's success reveals that VBM is primarily focused on shareholders' interests, which basically means that the paramount goal of corporations is shareholder value maximization. Therefore, managers need to demonstrate the ability to create shareholder value, which further implies that only under such conditions can they be entitled to bonuses and other privileges. VBM Pyramid, which clearly points to the strategic importance of the shareholder value creation goal, is presented in Figure 1.

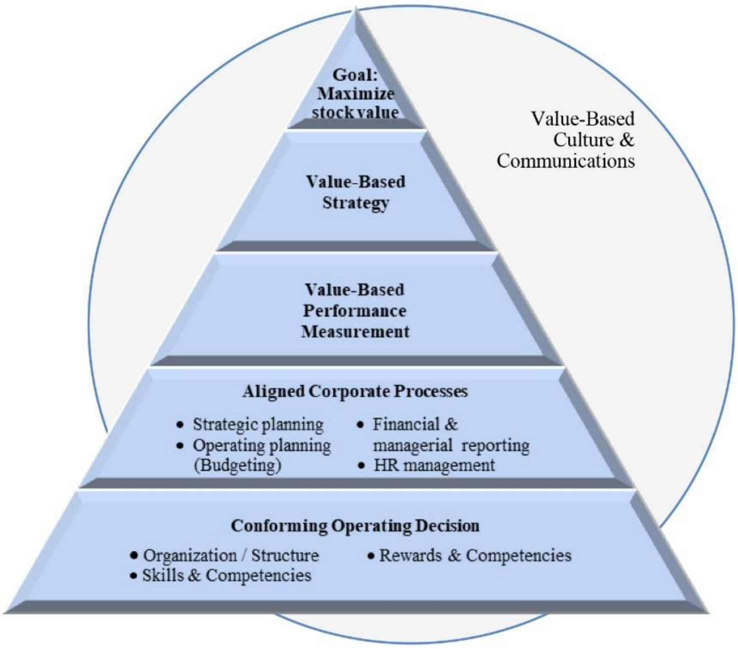

Fig. 1 Value-Based Management Pyramid
Sources: Ashworth, 2000, p. 42; Knight, 1998, p. 3., in: Holler, 2009, p. 19

The fact that the shareholder value creation is positioned at the top of the pyramid suggests that it represents the primary goal of a company and a basis for the setting of value-based strategy. Strategy formulation, its implementation and performance control require underpinning VBM metrics, so there is a need to set up Value-Based Performance Measurement. A logical prerequisite for the efficiency of VBM involves ensuring alignment and providing guidance for corporate processes, as well as coordinating operating decisions in such a manner that all activities are aimed at the accomplishment of value creation goal. All these activities together are transforming VBM into a corporate culture (Holler, 2009, p. 19).

This way of looking at the corporate purpose appears quite provocative because the company's goals do not take into account the interests of other stakeholders. Such an approach seems to overlook the fact that a corporation is actually a coalition of various constituencies which bring some inputs into that coalition with the intention of achieving their objectives. We hereby refer to managers and other employees, customers, suppliers, creditors, government and local community. The stakeholder theory extends the scope to other constituencies as well and, inter alia, draws attention to the risk that shareholder value creation might occur at the expense of other stakeholders. For example, the payment of too high dividends, excessive borrowing, the implementation of high-risk projects and similar activities may lead to shareholder value creation, but they may also expose creditors to a greater risk and jeopardize their interests. Fraudulent reporting may lead to better short-term performance, but the accumulation of hidden losses will certainly do great harm to investors who will lose dividends and invested capital, employees may lose their jobs, while the government may be deprived of tax revenues. A local community may suffer damage from the use of obsolete technology and the society from environmental pollution and high social costs. Therefore, it is emphasized that a corporation has a more profound purpose than just making money for its shareholders.

So, unlike VBM, which assesses a company's success based on its ability to generate long-term returns to shareholders, the stakeholder theory evaluates a company's performance based on its contribution to all stakeholders, including the community (Wallace, 2003, p. 120). Of course, defining the corporate purpose in this way, at least at first glance, sounds far better than insisting on the dominance of only one interest group (shareholders).

The application of VBM concept also requires a suitable VBM metric. Bearing in mind that VBM entails a different management philosophy which focuses on value maximization, its associated metric differs from traditional one, predominantly based on the use of accounting measures. The imperative of shareholder value creation calls for the calculation of the cost of capital that needs to be covered. The logic behind the creation of value added implies a need to cover not only interest expenses, but also the above-mentioned opportunity cost. On the other hand, incorporating the interests of all stakeholders and embracing the concept of social responsibility result in a necessity to complement shareholder value added measures with market value added measures. In this paper we only provide an overview of a wide range of available options (Figure 2).

The systematization of the presented measures is in accordance with the understanding of the company's goals. Accounting measures (stand-alone or combined with market measures) correspond to the beliefs that income is the primary goal of a company, measures of economic value added reflect the philosophy of creating shareholder value, measures of market value added enable the integration of the broader interests of different stakeholders, while the cash flow-based measures take part in each of the mentioned groups of measures. Furthermore, we must keep in mind that these measures are necessary both in the stage of performance budgeting and in the stage of control of the achieved performance against targets.

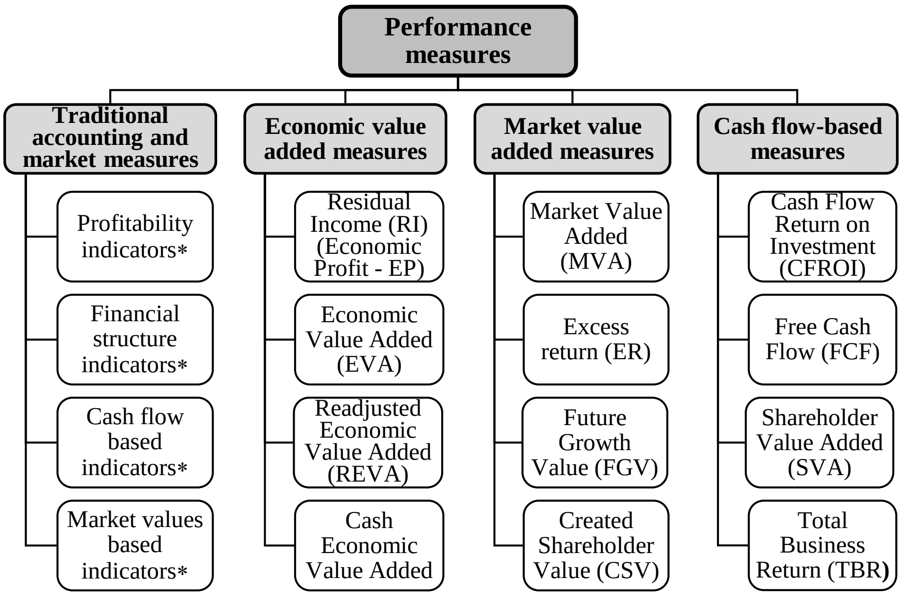

Fig. 2 Performance measures systematization

* See more about these indicators in: Malinić et al., 2019, pp. 85-150.

Source: Author

However, some measures, such as EVA, go beyond the scope of a simple "metric". EVA is not just a measure of a company's performance. It plays a central role in a strategy formulation process (since managers are supposed to strive to maximize the company's stream of future EVAs), capital allocation toward value-added investments, aligning the management compensation with the interests of shareholders, facilitating communication between managers at operating unit levels as well as the communication with the capital market (Young & O`Byrne, 2001, pp. 18-19).

Of course, the logic of calculating individual measures follows the logic of setting goals that are to be achieved. Despite the fact that performance measures are highly important, we must not forget that they do not create value in themselves. In other words, even the most excellent measures cannot help companies that lack an attractive production program, make low-quality products, have no customers or ignore demands of other key stakeholders. We could agree with the opinion that today we are witnessing a kind of "metric mania", but the essential purpose of metrics is "...to help managers make value-creating decisions and to orient all company employees toward value creation" (Copeland et al., 2000, p. 55).

At the core of VBM approach lies the effort to create value added by managing value drivers. Hence, the successful implementation of VBM requires the management to have the ability to identify value drivers and manage them in a way that leads to value creation. Also, value drivers can be found at different levels. For example, in the case of EVA, key value drivers at the first level include Return on Invested Capital (ROIC), Weighted Average Cost of Capital (WACC) and invested capital. This means that value could be created by increasing ROIC, reducing WACC, increasing investments with positive net present value, as well as by disinvesting or selling assets that do not contribute to the creation of value added.

However, even the foregoing steps do not suffice to ensure successful management. If we follow the line of return on invested capital, then at the second level we can see that ROIC, as a broader performance measure, also has its own value drivers, including profit margin and turnover. Revenues are an important determinant of both value drivers (profit margin and turnover). A more thorough analysis shows that revenues are determined by market size, market share, sales prices, and sales mix. The situation is similar with other value drivers that determine EVA or some other measures of value. In the context of VBM approach, the managers must know what is behind each value driver and take actions that create value. Managers must adopt a value-based mindset, which directs their attention to value drivers rather than to EVA score.

3. The Broader Interpretation of Value-Based Management

After all, the question arises as to whether VBM is in conflict with the requirements for satisfying the interests of all stakeholders. This issue is closely related to the answer to the question as to whether it is possible to create shareholder value without taking into consideration the claims of other constituencies. Anyway, there is an additional problem here. When it comes to multiple goals (from the perspective of various constituencies), then we might ask what would be a priority (decision criterion) in conflict situations where the interests of different stakeholders collide.

Value creation is important for any profit-oriented organization, and therefore indisputable. However, putting a strong focus on shareholder value creation does not necessarily mean ignoring the interests of other stakeholders. It is just not possible, as ignoring the customers' interests concerning design, functionality, provision of after-sales services and product quality obviously cannot lead to shareholder value creation. The same goes for other constituencies, including the community as a whole. In fact, we would rather say that the best way to satisfy the shareholders' interests is to provide that the interests of other stakeholders are met.

On the other hand, when it comes to the tradeoffs in the decision-making process, i.e. when interests collide, the situation appears to be much more complex. In such circumstances, while publicly advocating the idea of "balancing the interests of all stakeholders" some managers might actually cover up the company's poor performance and bad investments (Rappaport, 1997, p. 7). If there is a great number of goals, it becomes more challenging to make optimal decisions and control managers' behavior. Shareholder value creation stands out as the best criterion for decision making because it represents a clearly defined goal, which enables to make rational decisions that lead to an increase in value. The efficient use of resources should enable the generation of return that exceeds the total cost of capital (Ameels et al., 2002, p. 11). Jensen points out that "without the clarity of mission provided by a single-valued objective function, companies embracing stakeholder theory will experience managerial confusion, conflict, inefficiency, and perhaps even competitive failure" (Jensen, 2001, p. 9). Undoubtedly, stakeholders also tend to be very sensitive to the management's failure to create value.

However, all this does not necessarily mean that VBM is irreconcilably opposed to the stakeholder theory. In this regard, Jensen sees a possibility that VBM may embody some elements of the stakeholder theory, calling that form "enlightened value maximization" or "enlightened stakeholder theory". This theory "…uses much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders" (Jensen, 2001, p. 9). Wallace also supports the idea of the complementarity between VBM and stakeholder theory, emphasizing that each key stakeholder could be considered as value driver. Nevertheless, value creation remains the predominant goal (Wallace, 2003, p. 122).

Speaking of the corporate form of business activity, one should not neglect the fact that returns have to be risk-adjusted. In other words, the hierarchy of interests with regard to the correlation between return and risk must be preserved. For example, in the context of the risk borne by the company's constituencies, the greater returns to creditors in comparison to the returns to shareholders would make no sense. Besides, this situation cannot be sustainable in the long run. If such an environment even existed, then the interest of shareholders as providers of the riskiest capital would vanish, so there would be no primary issues and, consequently, no trading material for the secondary capital market.

In addition to all previously mentioned issues, we should bear in mind that benefits are not distributed exclusively to shareholders. In different phases they are also distributed to other stakeholders: to customers by delivering the products of required quality, to employees in the form of monthly salaries, to creditors through interest payments, to suppliers by making payments within agreed deadlines, while shareholders participate in the created value through dividends and capital gains. All this is possible only if value is created. The problem lies in the fact that value distribution is largely understood as the distribution of generated income which, formally and legally, belongs to shareholders. At the same time, it seems to be forgotten that in this case the interests of other interest groups must have been settled before. Clearly, there will be no income for distribution if a company does not pay off its liabilities to suppliers, ignore the customers' requests, does not pay interest to creditors or taxes to the government. So, it turns out that as long as VBM enables an efficient internal capital allocation and creates value, it suits not only the interest of shareholders, but also the interest of other stakeholders.

4. Reexamination of Value-Based Management in the Context of Long-Term Sustainability and Corporate Social Responsibility

Sustainability, as a global imperative, along with sustainable growth and corporate social responsibility at the company level are essential features of the environment in which companies operate. Economic responsibility has been a primary concern of the companies operating in a market economy, but it is obvious that in today's business environment companies' activities are also becoming a socio-economic phenomenon. "Though society expects business organizations to be profitable, as this is a precondition to their survival and prosperity, profitability may be perceived as `what business does for itself,` and obeying the law, being ethical, and being a good corporate citizen may be perceived as `what the firm is doing for others`, society or stakeholders" (Gal et al., 2018, p. 6).

Sustainable development is often defined "... as development that meets the needs of the present without compromising the ability of future generations to meet their own needs" (WCED, 1987. p. 43). It is originally based on the requirement for balancing the exploitation of non-renewable and renewable natural resources with the needs of economy and society in the long run. If the use of natural resources exceeds the capacity for their renewal, that leads to unsustainable consumption of the resources that belong to future generations and, consequently, to intergenerational inequality. Speaking of growth from a macro perspective, it has been emphasized "… that growth should be smart (implies the development of a knowledge-based economy), sustainable (calls for promoting a more efficient use of resources, competitive economy and corporate social responsibility), and inclusive (supposes the equal opportunities for everyone, high level of employment, social protection, and fight against poverty)" (Malinić, 2019, pp. 57-58).

However, our attention is focused on the issue of sustainability at the level of business entities. In this case, the issue of sustainable growth could be addressed in a more concrete manner. First, sustainable growth implies cautiously differentiated financing (due to risks, cost of capital and the effect of financial leverage), reasonable income distribution policy (relating to dividends and the portion of income that will be retained in the company), and the required level of operating efficiency (to ensure expected ROIC). Second, when it comes to sustainable growth, VBM approach goes a step further regard to both of required returns and the use of metric. The relationship between ROIC, EVA, MVA and growth rate could be expressed as follows:

$$\boldsymbol{MVA} = \frac{(ROIC - WACC)\ x\ Invested\ Capital}{WACC - Growth\ Rate} \tag{1}$$

Growth is deemed to be attractive only if ROIC is greater than WACC. It enables to create value for shareholders as well as for other constituencies. Therefore, "positive expected returns spreads are the source of value creation, and negative expected returns spreads are the source of value destruction" (Hawawini & Viallet, 2007, str. 530). Obviously, growth does not always lead to value creation. "Sometimes, high-growth companies may even destroy value. By contrast, companies with lower growth may create value. Only the growth that is accompanied by a positive spread can generate value" (Malinić, 2019, p. 59).

Sustainable growth based on VBM mindset enables the fulfillment of economic responsibility in terms of creating value for key stakeholders. Nevertheless, this is not enough for a company to operate successfully in a complex environment. Another important dimension is corporate social responsibility. CSR implies that companies' activities should always be considered in the context of their impact on the community and environmental protection for the purpose of ensuring long-term sustainable development. This further involves balancing the needs of society and other stakeholders with the needs for making a profit. Such behavior goes beyond the legal obligations of companies and one-dimensional corporate goals. As such, CSR is based on the respect for moral values and ethical behavior, and implies a broader perspective of the role and importance of companies in the society.

There are moral and economic reasons behind the commitment to embrace social responsibility. Moral reasons stem from the belief that the goal of "making money" is too narrow and that the community expects far more from companies. Besides, it is an undeniable fact that companies are responsible for the pollution of air, water and soil and the disposal of toxic substances, so it would be fair that they bear a portion of the costs of environmental damage (Mowen & Hansen, 2011, pp. 688-689). Moreover, responsible behavior means "doing more with less" (producing more output with less consumption of natural resources and less environmental pollution) and moving towards cleaner production and environmentally-friendly processes.

Economic arguments in favor of social responsibility seem quite convincing. Given that VBM approach calls for the efficient allocation of resources and creation of more value for all stakeholders, it could be concluded that VBM approach is also compatible with the requirements for environmental protection and the fulfillment of other needs of the society. Orlitzky, Schmidt and Rynes, analyzing 52 studies examining the link between corporate financial performance (CFP) and corporate social responsibility, concluded that CSR is profitable for companies. The results of the analysis have shown that (1) there is a positive correlation between CSR and CFP, (2) the relationship tends to be bidirectional and simultaneous (companies with better financial performance spend more on socially responsible activities, but such activities help them to be even more successful) and (3) reputation appears to be an important mediator of the relationship (Orlitzky et al., 2003, p. 427).

Based on the analysis of 42 studies which also focused on the relationship between CSR and CFP, Wang, Dou and Jia showed that there is a positive relationship between CSR and CFP whereby it was confirmed that CSR improves CFP, but a similar impact was not confirmed in the reverse direction. Furthermore, the authors have concluded that CSR has greater social visibility in developed countries with strong institutions and developed capital markets, than in the case of companies in developing countries (Wang et al., 2016). Another research study analyzed 120 companies belonging to the Dow Jones Sustainability Indices (DJSI) and 120 non-DJSI companies (all from North America, similar in size and from related industries). The authors have found that the companies from the DJSI have a higher gross profit margin and greater return on assets than non-DJSI companies. They also believe that higher return on assets has a long-term character associated with sustainability (Byus et al., 2010). Let us add "that the U.S. and European companies that created the most shareholder value from 2007 to 2017 - measured as total shareholder return – have shown stronger employment growth" (Koller et al., 2020, p. 13-14).

An ever-increasing number of companies grasp the importance of social responsibility and the necessity of bearing a portion of social costs. So, they think proactively, and socially responsible behavior is becoming an integral part of their strategy. A one-sided observation of the issue of CSR, i.e. from the perspective of only one stakeholder group, obscures the reality of companies' functioning. At first glance, it seems that providing assistance to the community through various projects and donations may reduce returns to shareholders, giving more favorable terms to suppliers may partially spill over to customers in the form of higher prices, and overly generous compensation packages may mean less value left to other stakeholders. However, a more thorough analysis shows that these activities also bring some benefits. Helping the local community may result in increased sales, better negotiating position, more favorable reputation, exemption from local taxes, etc. Providing better terms for suppliers may contribute to optimal long-term supply contracts, better quality of production inputs and greater customer trust in product quality. Investment in employees could help retain and recruit a high-quality workforce, which could have a substantial impact on the creation of value added. It is obvious that stakeholders are interdependent, i.e. creating value for one stakeholder at the same time may also signify creating value for other groups (Freeman & Dmytriyev, 2017, p. 13). Incorporating CSR into a company's strategy as a means of creating long-term value leads to the conclusion that VBM actually directs a company to a win-win situation (Martin et al., 2009, pp. 116-117). Companies that invest in CSR projects can simultaneously achieve both goals: to be socially responsible and to make a positive impact on value creation through these activities.

5. CONCLUSION

The environment in which today's companies operate has significantly changed. Companies are increasingly seen as socio-economic institutions whose role does not boil down to just profit making. In this regard, managers must take into account broader social, environmental and regulatory trends. Consequently, there is a need to cover some additional costs arising from operating in a socially responsible manner, including the costs related to environmental protection. All this does not negate the economic responsibility of business entities, which is considered a key characteristic of market economies. On the contrary, value creation, which is based on VBM approach, is a necessary precondition for satisfying the interests of all stakeholders, including the community. It therefore follows that VBM is compatible with CSR. This is a two-way relationship so that VBM cannot ignore CSR, while CSR cannot be achieved without VBM.

Finally, we should not overlook a significant role of the government that participates in companies' income and has to allocate a portion of income for socially responsible projects. Also, we must not lose sight of the fact that the government is the owner of public companies and, consequently, it should bear a part of social costs just as private owners. Its responsibility goes a step further. It is responsible for providing an effective regulatory framework and conditions for transparent reporting. Governments may create regulations, taxes and other incentives that encourage companies to migrate away from environmentally unacceptable sources of energy. Such an approach would facilitate replacing aging technologies with cleaner and more efficient sources of energy and would not be at odds with the market forces (Koller et al., 2020, p. 10). Socially responsible behavior of the government could definitely contribute to the creation of a business climate in which corporate social responsibility would be highly valued.

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UPRAVLJANJE ZASNOVANO NA VREDNOSTI, DUGOROČNA ODRŽIVOST I KORPORATIVNA DRUŠTVENA ODGOVORNOST

Od današnjih preduzeća, posebno velikih multinacionalnih kompanija, se očekuje da budu finansijski uspešna u skladu sa očekivanjima vlasnika, da posluju u skladu sa zahtevima održivog razvoja, vodeći računa o interesima budućih generacija, kao i da se ponašaju na društveno odgovoran način, uvažavajući interese ključnih stejkholdera, uključujući i interese društvene zajednice. U takvim okolnostima od menadžera se očekuje da kreiraju vrednost koja će moći da zadovolji sve ove interese. Primena Value–Based Management (VBM) pristupa doprinela je boljem razumevanju vlasnika i menadžera i usklađivanja njihovih interesa. U radu je analizirana kompatibilnost VBM sa zahtevima drugih stejkholdera, uključujući i zahteve u pogledu održivosti i korporativne društvene odgovornosti. U tom kontekstu može se reći da šire shvatanje VBM osnažuje logiku funkcionisanja korporativnih preduzeća koja se zasniva na interesima, ali da istovremeno omogućava integrisanje zahteva koji se vezuju za održivost i korporativnu društvenu odgovornost.

Ključne reči: *upravljanje zasnovano na vrednosti, kreiranje vrednosti, održivost, korporativna društvena odgovornost, rast*