European Journal of Operational Research

Volume 198, Issue 1, 1 October 2009, Pages 1-22

Invited Review

Splitting up value: A critical review of residual income theories

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https://doi.org/10.1016/j.ejor.2008.09.018

Abstract

This paper deals with the notion of residual income, which may be defined as the surplus profit that residues after a capital charge (opportunity cost) has been covered. While the origins of the notion trace back to the 19th century, in-depth theoretical investigations and widespread real-life applications are relatively recent and concern an interdisciplinary field connecting management accounting, corporate finance and financial mathematics (Peasnell, 1981, 1982; Peccati, 1987, 1989, 1991; Stewart, 1991; Ohlson, 1995; Arnold and Davies, 2000; Young and Oâ€™Byrne, 2001; Martin, Petty and Rich, 2003). This paper presents both a historical outline of its birth and development and an overview of the main recent contributions regarding capital budgeting decisions, production and sales decisions, implementation of optimal portfolios, forecasts of asset prices and calculation of intrinsic values. A most recent theory, the *systemic-value-added* approach (also named *lost-capital* paradigm), provides a different definition of residual income, consistent with arbitrage theory. Enfolded in Keynesâ€™s (1936) notion of user income, consistent with arbitrage theory. Enfolded in Keynesâ€™s (1936) notion of user cost and forerun by Pressacco and Stucchi (1997), the theory has been formally introduced in Magni (2000a,b,c; 2001a,b; 2003), where its properties are thoroughly investigated as well as its relations with the standard theory; two different lost-capital metrics have been considered, for value-based management purposes, by Drukarczyk and Schueler (2000) and Young and Oâ€™Byrne (2001). This work illustrates the main properties of the two theories and their relations, and provides a minimal guide to construction of performance metrics in the two approaches.

Keywords

Finance; Economics; Accounting; Investment analysis; Residual income; Excess profit; Net present value; Opportunity cost; Counterfactual; Performance measurement; Management

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