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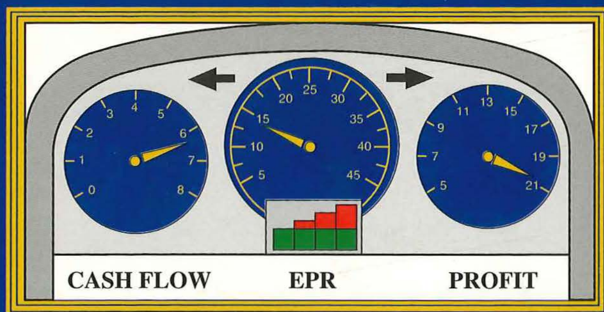
Will value based management make it to 2005 ?



Prof. Dr C.P. Lewy

Will value based management make it to 2005?

REDE

ter gelegenheid van zijn afscheid als
Hoogleraar Management Control aan de
Postdoctorale Controllersopleiding
van de Vrije Universiteit te Amsterdam

door

Prof.Dr C.P. Lewy

in verkorte vorm uitgesproken op 3 december 1998

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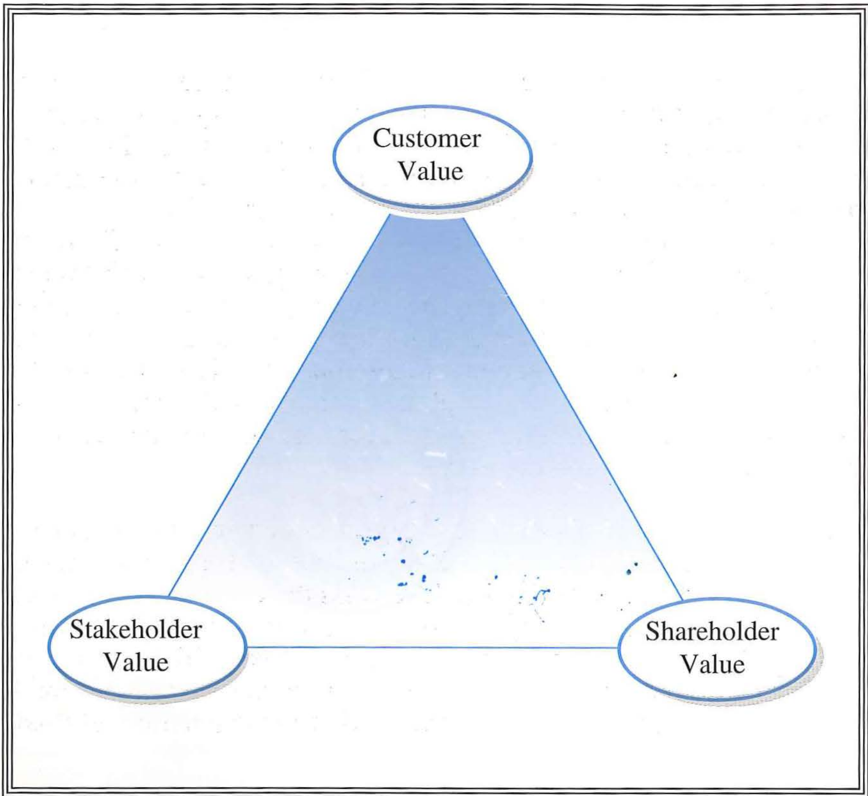


Fig. 1 Three sorts of value

Introduction

When Henk Meij delivered his valedictory lecture in this auditorium some four years ago, he prefaced his address by stating that when one hangs up one's toga, there is no longer any need for scientific profundity to prove one's point. I'm grateful to him for setting this precedent, because my address is about practice and not theory. While therefore not offering scientific proof today, I hope that what I have to say may be of interest to, and possibly even convince, some of you.

A recurring issue here and elsewhere in Europe when value based management is discussed, is the question "May or should a business consider maximizing shareholder value its overriding objective?" With his recently published book, Hans van Londen hit the nail on the head by appropriately titling his publication *Value or Values?*. Selecting a value based metric as a superior proxy for 'profit' is one thing; the question as to what extent management has the moral right to dedicate the business to the sole purpose of making money to the exclusion of all other considerations, is quite another. This important issue is Van Londen's main concern. My concern today however is with *value*, i.e. applying value based metrics to the business, and not with *values*; however relevant this last issue is, may be, it is not my subject today.

While limiting myself here to the question of value in the narrow sense, i.e. measurement, I would suggest that in practice, the management of any business in a free and thus competitive market has in fact to continuously try to maintain balance between *three* sorts of value: perceived customer value, stakeholder value, and shareholder value (howsoever measured), as depicted in figure 1. Needless to say, this balancing act is what management's ultimate task is really all about.

Before touching on some practical aspects of value based management and its implementation, I would like briefly to retrace my own 'value journey' which took place over the ten years during which I was priviledged to teach Management Control to students of the postgraduate controllers program at this university.

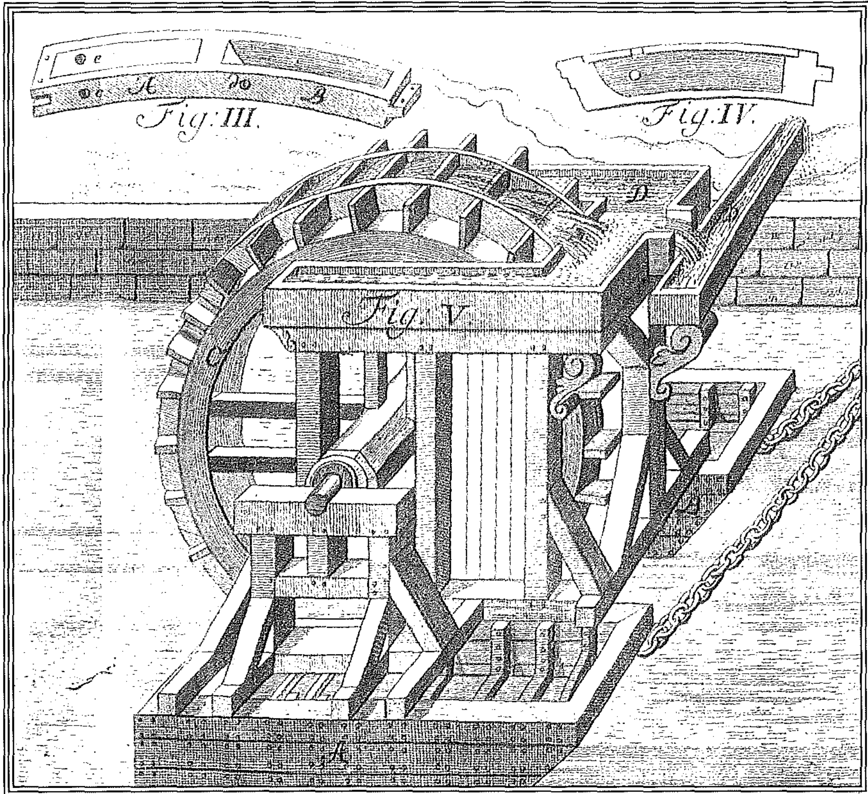


Fig. 2 Eighteenth century water wheel

2. Learning isn't linear

My value journey to date seems to have been one of frequent stops and starts, like the turn of a water wheel whose water inflow has been reduced to a steady trickle: long periods of standing still until the bucket has filled up with water, followed by a quarter turn of the wheel, standstill again until the next bucket is full, then another quarter turn of the wheel, and so on.

Getting to grips with the practical implications of value theory was consequently a jerky and lengthy process, rather than steady progress along a linear route. Being absorbed in detail, I occasionally failed to recognize what should have been obvious at that moment. An example of my myopia was an assertion which I made in my inaugural lecture in September 1994 and which I am happy now to retract.

Assertion
EVA does not provide a practical yardstick for entity valuation and consequently is not, as Stewart suggests, a multi-purpose metric suitable for use both as a measure of short term value realized and as a tool for estimating the net present value of entities or projects; a case of 'different measures for different purposes'.

Retraction
Since accrual accounting profits and free cash flow converge in infinity, it is in practice possible to use residual income, EPR or EVA (irrespective of whether accounting adjustments are made or not) as a multi-purpose metric to measure both economic performance and to perform entity valuations. By discounting future EPR's the resultant net present value plus initial capital employed will equal the NPV of the corresponding discounted free cash flows. A working illustration is included in Appendix 1. Stewart was right!

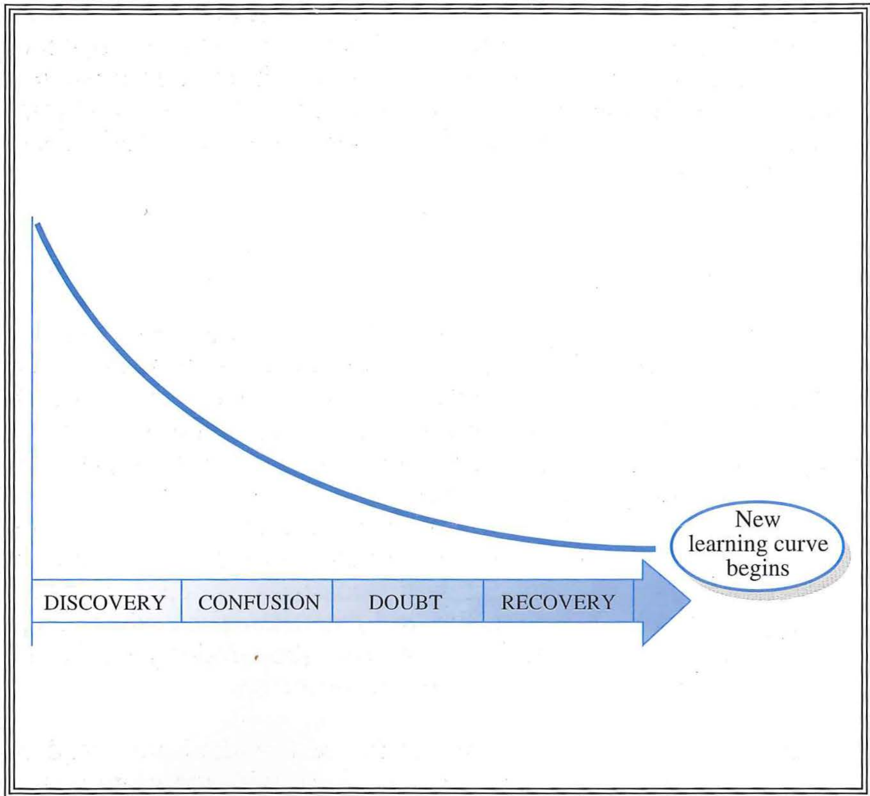


Fig. 3 A personal VBM learning curve

3. A personal VBM learning curve

Cumulatively and in retrospect, the water wheel journey appears after all to have roughly resembled a parabola, recognizable as the experience, or learning curve, according to which each cumulative doubling of experience is supposed to lead to a 20% increase in effectiveness.

It may be of comfort to past students who grappled with 'value', and maybe relevant to future ones, to know that this learning curve was not smooth either, but actually went through four stages: discovery, confusion, doubt, and recovery. Having sometimes sensed my students passing through similar stages, I shall briefly sketch each one.

Discovery

Although I had read Rappaport in 1989, it was the prize-winning article on *applying* value in practice, by McKinsey's Wenner and LeBer: *Managing for Shareholder Value from Top to Bottom* (1990) which first really fired my interest in this area. Living in the USA at that time, I was able to visit the authors, who not only patiently answered my many beginner's questions but were good enough to present me with a copy of Tom Copeland's freshly published book *Valuation*. They also introduced me to Donald Weber, the CEO of Atlanta-based Contel Corporation, the company which their article described. Contel had just been through a value-based strategic review and Weber's enthusiasm for the underlying value applications sharpened my appetite for more.

Stimulated by *Valuation*, still one of the best books I have read on the subject, I visited Copeland in New York with yet more beginner's questions. He not only corrected some of my misconceptions but also coached and helped me to delve deeper into VBM, a field that was at that moment starting to attract growing interest in the US business community. During this discovery stage, I concentrated on getting to understand and apply the principles of value based strategic *valuation*.

Confusion

Just as I thought I was beginning to master the subject of value based strategic valuation and its practical applications, Copeland recommended I read Stewart's *The Quest for Value*. This I accordingly did, and so began a period of confusion.

This book expounds the ideas of Joel Stern, a New York consultant, alumnus of the University of Chicago and Stewart's senior partner. The central theme is that Economic Value Added, or EVA, is superior to all other value measures. EVA is arrived at by starting with residual income and reversing many accounting entries normally applied under accrual accounting principles, resulting in a quasi-cash flow metric net of capital cost.

The author's rhetoric in acclaiming EVA's superiority over every other value metric failed to convince me. The myriad of accounting adjustments advocated by Stewart seemed to me impracticable and his attacks on accrual accounting overdone. Sidetracked as I was by all this detail, I overlooked what should have been obvious: if EVA including adjustments provided such a good value based metric, why should EVA *without* adjustments (i.e. residual income) be so terribly 'bad'? After all, value is a long term concept, so any short term measure is an approximation anyway. Moreover my focus was still mainly on valuation, while Stewart claimed to cover both valuation *and* performance measurement.

Absorbed as I was by the issue of accounting adjustments, I also ignored the significance of Stewart's demonstration of the equivalence in infinity of EVA (and therefore, although not explicitely referred to by the author, also of residual income) and free cash flow.

Finally, because I still had both eyes firmly fixed on the application of value to strategic valuation, I failed at the time to spot the fact that what the (US) business market was *really* interested in, was the application of value to *performance measurement*, a trend mirrored in Europe a year or so later.

Doubt

Since the early 90's value had begun to become a relevant topic for local seminars, conferences, and a small but gradually growing number of publications, mainly in professional journals of accountancy and business economics. Most of these dealt with the broad principles of shareholder value or on how value could or should be measured, whether and why free cash flow was 'superior' or not to accrual accounting profit, and so on, while *implementing* value was only rarely discussed.

Nevertheless, by the beginning of the second half of the 90's, several local value try-outs had been or were being attempted. Few if any of these early initiatives proved really successful, and interest on the part of non-financial managers in seminars and conferences on the subject of value was waning judging by the falling number of participants. Consequently, I began to question my own preoccupation with the value theme. Was I perhaps overdoing it?

Recovery

Luckily there were sufficient others - including a gratifying number of my students - who kept the faith. Also, the stream of publications, both local and from abroad, continued to grow. Happily, some of these publications were starting to address more practical implementation issues, both on strategy deployment and on demystifying and simplifying some of the value measures on offer. McTaggart's *The Value Imperative* was an example of the first, and several publications by Lou Traas of the second.

Speaking for myself, the real recovery began when I was engaged by Philips in the autumn of 1997 to develop a rollout program to introduce value based performance measurement and VBM throughout the organization. The performance measure selected by Philips was residual income, termed EPR (Economic Profit Realized), the addition of the R having been made at the suggestion of Traas. Since March 1998 the rollout is under way; to call it a learning experience would be an understatement.

By the end of this year the rollout should be complete. At this time all concerned are well into the next learning curve: removing implementation roadblocks. The water wheel's bucket is once again filling up!

4. Lessons learned

Observing a number of VBM implementations, at times from close by, at times from a distance, I learned a number of lessons. Although largely common sense, and applicable to most projects involving major changes in management control, it has struck me how often precisely those so *obvious* do's and don'ts appear to have been overlooked or neglected. Here are five for which I make no claim for originality, but recommend they receive special attention.

The CEO's ongoing involvement is essential

Initial CEO commitment is of course a must, but is definitely not enough. The CEO's ongoing involvement is necessary in what will usually be an 18 to 24 months transformation process. There will be moments at which the transformation process falters, and roadblocks will emerge (see below). Without CEO involvement, particularly when problems arise, VBM deployment may lose steam and peter out altogether. I have seen this happen several times.

Relevance is more important than precision when selecting value indicators

Understandably, the CFO and financial staff will want to invest effort in selecting the most 'accurate' possible value indicator. In fact *simplicity* and *transparency* should become the overriding criteria, since managers can only be expected to make use of the new indicators if these are readily understood, something which seems to have been largely overlooked in several local implementations. Unsurprisingly, these failed to produce many significant changes in the way the operating managers in these companies made their everyday strategic decisions.

Managers need to identify their own value drivers

At the heart of successful VBM deployment lies the application of improved leverage by operating managers of their business's specific value drivers. These value drivers should include both financials as well as non-financials, and need to be identified for each business independently. If left to consultants or even the business's own financial staff, the identification of these drivers is not likely to lead to real 'ownership' by the operating managers of the business in question. Ownership is best achieved via discovery, so operating managers need to be directly involved in this discovery journey, which should be facilitated by the financial staff.

Focus the VBM rollout on enhancing the everyday strategic decision process

Introducing and explaining the new value indicators is an integral part of the rollout, but should not dominate it. Operating companies' strategies, as McTaggart pointed out, manifest themselves largely in day to day choices, i.e. trade-offs, between delivering customer value and economic (shareholder) value. These daily choices are seldom determined via singular insight from the top, even though the broad lines of the strategy may originate there. It is the sum of these everyday strategic choices which ultimately drives the quality and amount of value creation.

Consequently, the VBM rollout should accord much attention to these everyday strategic choices, and in particular the mindsets of the operating managers making these decisions.

Expect 'roadblocks'; they can be removed

Accountability for results is central to successful VBM deployment. Where accountability is blurred, the VBM implementation process will mercilessly highlight such anomalies. Removing these may not be easy, particularly if internal politics stand in the way. Without senior or top management's involvement,

such roadblocks may persist, limiting the effectiveness of the value based approach.

Anticipate a major roadblock (which can be taken care of in advance of VBM deployment) when the intention is to couple the introduction of VBM to changes in existing executive bonus plans. Such adjustments involve many more issues than initially meet the eye and really require careful attention by a senior level group, including representatives of finance, HRM and - in my opinion crucially - the CEO or a very experienced and senior non-financial line manager. An example of ten typical bonus plan-related issues to be considered - and there are many more - is included in Appendix 2.

Aside from these two major roadblocks, *business-specific roadblocks* may be expected, often related to additional insights and information required to support VBM at operating levels. The VBM rollout process can be used to identify these. The necessary diagnosis can best be performed by the operating managers themselves with the help of a scanning aid. Appendix 3 illustrates an example used in a recent VBM introduction.

5. Measuring value with Keynes in mind

"*It's better to be approximately right than precisely wrong*"
John Maynard Keynes.

Why choose complex or arcane indicators?

Value is realized only when profits exceed capital costs. By measuring the *monetary spread* (rather than just the *percentage* as ROI does) between profit and capital costs, the *amount* of value realized or destroyed in a particular period can be determined. This spread is simple to calculate, is easy for managers to understand, and is not new (it was first introduced in the 50's by General Electric to assess divisional performance; they coined it *residual income*).

Not being new turns out to have its disadvantages, witness the considerable publicity accorded in the last decade to more complex value based indicators such as SVA, CVA, CFROI, TSR and EVA, each claimed by its supporters to provide a better measure of value than residual income. The claims for each of these measures by their respective proponents may differ on detail but usually include three propositions:

1. Most claim to avoid the alledged shortcomings of accrual accounting by substituting either cash flow or quasi cash flow for accounting profit, frequently drawing on the proposition that '*profit is an opinion, while cash flow is a fact*'.

2. Some claim to deliver a single metric which can be applied to measuring both short term and total value created.

3. Several claim to provide a better-than-the-rest proxy for long term share price trends.

The closer these claims are examined, the less convincing they seem. Consider briefly the following.

'Cash flow is a fact'

Of course this is so, but as Traas points out, it is equally a fact that yearly free cash flow does *not* provide management with an indicator of the year's *economic* performance, i.e. the return over or under capital cost. This being so, the all-important question which remains is: which - if any - adjustments to accounting profit are needed to obtain an 'accurate' measure of 'return' and 'capital employed' during a single period? The truth is that it is precisely the answer to *this* question which is and will remain *a matter of opinion*, notwithstanding what the proponents of various proprietary metrics may argue.

Single measure for short and long term

Since total accounting profit and the corresponding total cash flow equal each other in infinity, it follows that *any metric howsoever calculated* which is derived from accrual accounting will meet this condition of equivalence. Bear in mind also, that future value *can only be estimated*, so that the term *measuring* is not really appropriate at all, the more so as the usually dominant *continuing* (or terminal) value is no more than an educated guess, whichever formula is applied to calculating it.

Superior proxy for long-term share trends

Several supporters of various metrics contend, and offer statistical evidence to back up their claims, that *their* value metrics represent better proxies of long term share price trends than all competing metrics. These claims frequently contradict each other, so who should we really believe? Interestingly, recent research by a group of academics (Biddle c.s., 1997) even suggests that net earnings before exceptional items (EBEI) actually beats residual income, EVA and cash flow as proxy for explaining share price movement over a recent 5-year period! (See Appendix 4)

Nevertheless, *cash flow-converts* abound and the promoters of cash flow-based value measures claim a growing number of users both in the USA, UK, and - in the last few years - continental Europe.

The most widely propagated performance indicator is Stern Stewart's quasi cash flow EVA, whose promoters advance a total of 164 accounting adjustments, but concede that a far smaller number of adjustments, say four or five, may also do "if less accuracy is acceptable". Was it this that prompted a speaker at a recent US conference on accounting to remark that Stern Stewart "are accountants introducing their own accruals"? Or to put it another way, isn't EVA simply *Stern Stewart's* opinion?

Residual income, the parent out of which EVA was concocted, can be adjusted for specific accrual items (e.g. goodwill) if such items are considered by users to distort the picture of the business's performance. An adjustment to capital employed to reflect the real value of fixed assets can also be considered. Beyond these two, relevance and recognizability need to have priority over so-called precision.

While annual or forecasted free cash flow certainly provides management with essential information, annual free cash flow is *not* a proxy for yearly value realized or destroyed, and I remain sceptical as to whether performance indicators *derived* from cash flow really provide a better proxy for yearly value realized than accounting-based residual income. In my experience residual income is easier for managers to understand than yearly performance indicators derived from cash flow, the more so as their dashboard *anyhow* will continue to include *conventional* cash flow information (though *not* for measuring economic performance!) and accounting profit data.

Therefore, whatever the perceived intrinsic merits or demerits of the one value indicator over the other, I would argue in favour of recognisability and simplicity rather than intellectual elegance, since the most important thing of all is that operating managers must be able to *recognize* and *understand*(!) the new metric, as otherwise they won't readily understand it and thus won't use the new metric. **Remember Keynes**!

6. *Fatal Attraction*

Measurement methods or management mindset?

Mention value based management to a financial manager and the odds are that the ensuing discussion will be about how best to *measure* value based performance: the respective merits and demerits of indicators such as EVA, SVA, CFROI etc., the pro's and cons of various accounting adjustments, how best to account for goodwill, and so on. Relevant (and professionally satisfying!) as these questions may be, too much attention for the value metric can prove a *fatal attraction*, distracting the effort from the ultimate task, which is actively supporting *the creation of a 'value mindset'* at all management levels.

Having once made this mistake myself, I can testify to the danger of the fatal attraction. Happily in my case, two colleagues recognized my error, and helped the project back on track in time. Others have however been less lucky; neglecting or underestimating the critical importance of changing management's mindset, their VBM projects have either vaporised or degenerated into a more or less sterile numbers exercise, with little or no impact on the everyday strategic decision process.

Examples of value based mindset

'Mindset' is about how one looks at things, and consequently partly a matter of individual preferences and perceptions; we tend to see the most clearly that which is recognizable, and puzzle at or overlook that which is not. Concrete examples of mindset therefore tend to be personal. Here are some examples of value based mindset which I have found very useful in practice.

A business can destroy value even though it is profitable

If profits are insufficient to cover capital costs, value is destroyed notwithstanding a positive *bottom line*. This can be the result of overinvestment, excessive working capital requirements, inadequate operating margins, inefficient financing, or a combination of several of these. Longer term value destruction is a typical symptom of flawed strategies, or poor execution of these.

Financial problems are usually strategic problems in disguise

Value destruction can result from striving for expansion in marginally attractive markets, or starting from a disadvantaged competitive position, or a combination of these. Applying a financial tourniquet may limit the damage, but only a major change in strategy can lead to sustainable value creation.

The vital difference between 'good' growth and 'bad' growth

'*Good*' growth occurs when expanding a business or activity whose operating profit exceeds its capital costs. '*Bad*' growth is the result of expanding activities which, although profitable, regularly fail to cover their capital costs. In such cases, even though operating profits grow with expansion, *growth will actually magnify the amount of value destruction taking place*! Shrinking the activity - if this is possible - will probably reduce the value destruction.

Long term value creation is more important than short term value improvement

Sustainable year on year improvement of value realized counts for more than spectacular one-off improvements. Losing sight of this can pose a real threat to the business's continuity and open the door to longer term value destruction.

A suitable value based metric is more than just a performance indicator

A suitable metric provides a monetary platform for developing value based strategies, recognizing that in any business there are only three ways of creating economic value:

- 'OPERATE' or fine-tune i.e. improve inadequate returns earned on existing capital employed, without undertaking major additional investments
- 'BUILD' i.e. expand and invest in activities whose returns exceed capital costs
- 'HARVEST' i.e. divest or scale down activities whose returns are inadequate to cover capital costs, and redeploy capital thus released into activities or businesses whose returns exceed capital costs.

None of these mindsets are 'new' or particularly earth shaking, and when presented to, and discussed with, operating managers, these mindsets are usually greeted as sound and both-feet-on-the-ground common sense. Be that as it may, applying these mindsets vigorously is tougher than talking about them. Once they become part and parcel of a manager's intuition, these and similar mindsets start to impact everyday strategic decisions. That, essentially is what value based management should be about.

I hope that I have convinced you that when introducing VBM, the first priority is communicating with operating managers about its application to everyday strategic decisions. Of course a suitable value metric has to be selected and communicated. But don't allow this to dominate the project. And whether you are a CEO, a CFO, or a financial manager, make sure that neither the company, you, or your colleagues become the victims of **Fatal Attraction**!

Ebbs, Flows and Residual Impact of Business Fads* 1950 - 1990

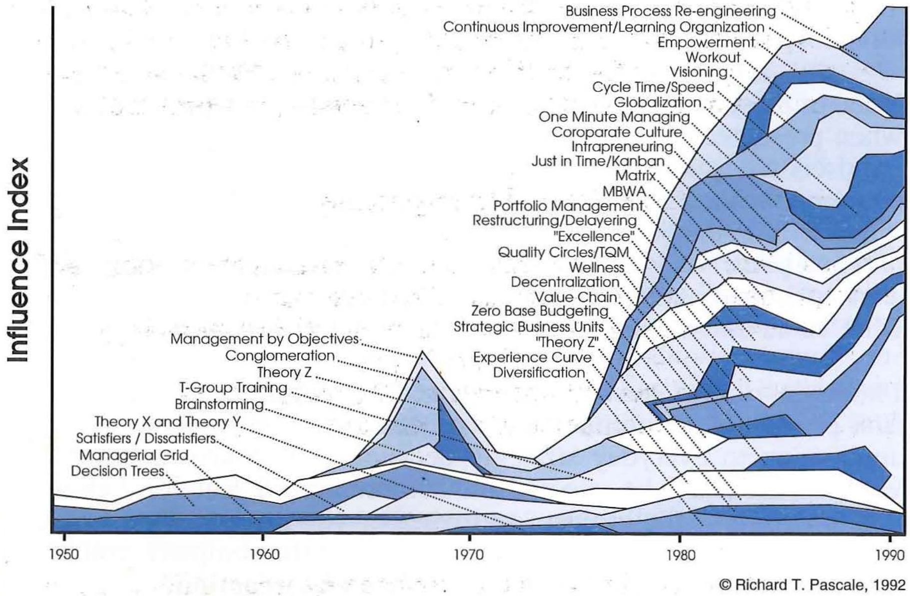


Fig. 4 Ebbs and flows of business fads according to Pascale

7. Will VBM make it to 2005?

The ebb and flow of business fads

Every time I step into a bookshop or open my mail, I'm surprised by the flood of new publications about management methods and tools, and start to worry that I may be missing out on something important. Fortunately, many new ideas turn out to be either common sense revisited or the preoccupation of specialists seeking to demonstrate (sometimes successfully) the validity of their concepts. Today's business world being as complicated as it is, it is hardly surprising that the average company's pipeline contains something like 15 nascent management tools and techniques, the majority being replaced or discarded within a few years. Pascale's drawing (see fig. 4), dating from 1992, titled *The Ebb and Flow of Business fads* speaks for itself. So the question is: "Will value based management make it to 2005 or is it yet another business fad?".

Functionality, simplicity and transparency

An acid test to help separate durable management tools and concepts from mere fads is to ask three questions:

- does it meet a real management need? (functionality)
- is it simple to apply? (simplicity)
- will management understand it? (transparency).

Does value based management pass this test?

Functionality

It is a simple precondition, first formulated by Adam Smith, that in a free market any business employing capital will need to earn returns which exceed its capital costs if the business is to grow and prosper. That management needs to track whether this financial precondition is being met, is therefore axiomatic for all businesses where 'capital employed' is positive. Thanks to Modigliani and Miller, a theoretical model, CAPM, is available, providing us with a rough proxy of the cost of risk adjusted equity enabling us to

estimate - if not determine precisely - how much that capital cost is. A value based approach simply *recognizes* Adam Smith's financial precondition and makes use of CAPM to assist and support managers to steer a strategic/financial path within the boundaries of that financial precondition. Until someone develops a better way to provide this support, VBM's functionality would seem to me to be beyond serious doubt.

Simplicity

Managers have to keep both eyes on the road and consequently must be able to read their dashboard indicators at a glance. Knowing *whether* value is being realized or not is 'need to know' information; *exactly how much*, while relevant in the longer run, is less important on an everyday basis. A value based mindset is, as I hope has become evident, no more than applied common sense. By combining it with an *uncomplicated* dashboard indicator, the criterion of simplicity is met.

Transparency

The complexity of a dashboard indicator is inversely proportional to the management attention it gets. We all recognize that which we understand, and operating managers are no exception. They are not paid to deal with accounting complexities, and cannot be expected to invest the time necessary to master financial abstractions. The logic behind a simple value based indicator must be transparent enough to retain managements attention; *relevance*, and not precision, is the key to meeting the criterion of transparency.

Will value based management make it to 2005?

As already indicated, the underlying principles of value based management are not new at all: ROI dates back to the 20's and even the original monetary indicator, residual income, is some 40 years old. More recent perhaps is the revival of *awareness* amongst senior managers of the relevance of 'value' to their strategies, and

the notion that by including a value indicator on management's dashboard the business's everyday strategic decision processes will receive improved support.

But the real point is not whether VBM is yesterday's meal warmed up and repackaged or whether it's new. The question is: *will it last*? I think that value applications which fail the 'acid test' of functionality, simplicity and transparency will in the longer run have difficulty in living up to the claims put up for them, and will be discarded by companies whose initial high hopes are not realized. In retrospect, these applications will join Pascale's list of *business fads*.

This will *not* be the case for value applications which successfully pass the 'acid test ' of functionality, simplicity and transparency. The intrinsic truth and relevance of the simple statement *value is only created when returns exceed capital cost* is so undeniable that I, at any rate, believe that value based management - under the proviso's I have mentioned - can and will be successfully deployed in a growing number of European companies. If not forever, than certainly until and beyond 2005.

Ik heb gezegd.

Appendix 1 Demonstration of equivalence of NPVs of Free Cash Flow and EPR

Date	**01-01-98**	**31-12-98**	**31-12-99**	**31-12-00**	**31-12-01**	
Period (project currency = NLG	*0*	*1*	*2*	*3*	*4*	*CV*
IFO	not appl.	30	60	90	100	90
% tax (effective country tax rate)	*not appl.*	*0%*	*25%*	*25%*	*50%*	*50%*
NOPAT	not appl.	30	45	68	50	45
Depreciation	not appl.	40	50	40	30	10
Change in Working Capital	(50)	(20)		10	10	-
Changes in Provisions	-	20	-	-	-	-
Cash Flow from Operating Activities	**(50)**	**70**	**95**	**118**	**90**	55
Capital Expenditures	**(400)**	**(50)**	**(10)**	**(10)**	**(10)**	(10)
Grants/subsidies (after tax)	25	-	-	-	-	15
Continuing Value (after tax)	not appl.	not appl.	not appl.	not appl.	not appl.	**600**
Free Cash Flow	**(425)**	**20**	**85**	**108**	**80**	**600**
Discount factor (WACC = 10%)	1.000	0.9091	0.8264	0.7513	0.6830	0.6830
NPV of Free Cash Flow	(425)	18	70	81	55	410
Cumulative NPV(FCF)	(425)	(407)	(337)	(256)	(201)	209

NPV of Project	**PI**	**PVAPP**
209	**1.40**	**11**

Source: Royal Philips Electronics NV, reproduced by permission(continued on next page)

Appendix 1 Demonstration of equivalence of NPVs of Free Cash Flow and EPR (continued)

Period	*0*	*1*	*2*	*3*	*4*	*CV*
NOPAT	not appl.	**30**	**45**	**68**	**50**	**45**
Capital	**450**	**460**	**420**	**380**	**350**	
Return on invested Capital (ROIC)		6.7%	9.8%	16.1%	13.2%	12.9%
EPR spread (= ROIC - WACC)		-3.3%	-0.2%	6.1%	3.2%	2.9%
Grants/subsidies (after tax)	25	-	-	-	-	15
Continuing Value						250
EPR (incl. grants/subsidies)	**25**	**(15)**	**(1)**	**26**	**12**	**250**
Discount factor (WACC = 10%)	1.000	0.9091	0.8264	0.7513	0.6830	0.6830
NPV (EPRs)	25.0	-13.6	-0.8	19.2	8.2	170.8
Cumulative NPV (EPR)	*25*	*11*	*11*	*30*	*38*	*209*

NPV of Project
209

Source: Royal Philips Electronics NV, reproduced by permission

Appendix 2 Implementing VBM bonus plans

Ten questions on value based executive compensation plan

1. **Status quo financial performance-related bonus programs**
   What are the current programs, are they formula-driven, and will they be replaced or augmented by the value based bonus plan?

2. **Envisaged value based bonus program**
   What are your company's intentions in regard to the following:
   - bonus to be target (i.e. budge/SP) based or not?
   - bonus to be capped or uncapped?
   - bonus based on uniform pay/performance for all divisions or risk-adjusted per division?
   - bonus based on single year performance or multi-year or combination?

3. **Envisaged impact of mix of selected bonus criteria**
   What is the approximate intended mix?

	single year	mult-year	total
Value related			
Other financials-related			
Non-financials-related			
Total			100%

4. **Accountability for unit performance after job transfer**
   Will managers retain responsibility and be bonussable for unit results during a limited period after they have been transferred to another unit?

5. **Existing stock option plans**
   Will these be integrated in all or part with the value based bonus program?

Appendix 2 Implementing VBM bonus plans (continues)

6. **Interaction between accountability levels within divisions**
   What is the level of interaction between accountability levels within individual divisions? What are the perceived benefits of having a portion of the bonus determined by value-based performance of the unit one level above the one for which a manager is directly accountable?

7. **Impact periodic adjustments of WACC**
   (How) will value-related bonus levels be affected if WACCs are adjusted from time to time? In particular how would this affect the bonus portion based on multi-year value based performance?

8. **Launch date and rollout communication program**
   What is the launch date, how will the program be communicated, and is there a companywide rollout plan including communication plan, help desk, and supporting software or other standardized calculation models?

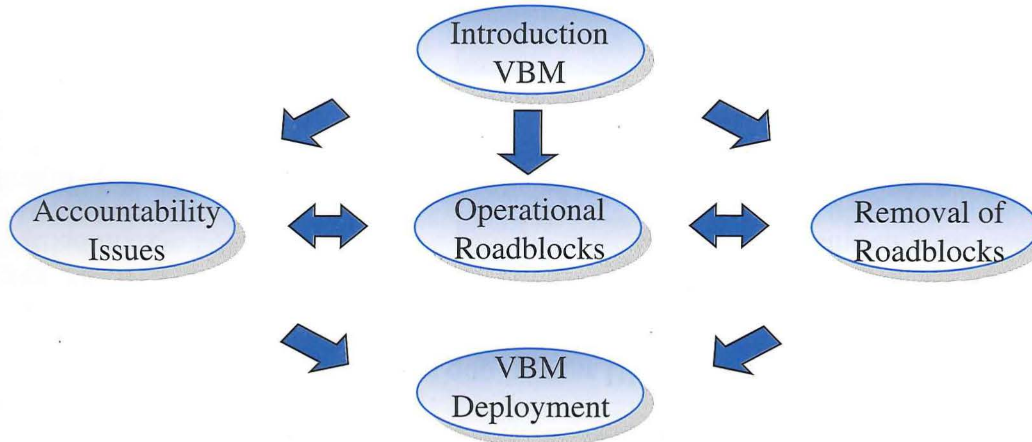
9. **'Big Bang' or step-by-step implementation?**
   Has consideration been given to the possibility of implementing the value based bonus program in stages (e.g. over 2-3 year period) or is the Big Bang approach preferred?

10. **Availability draft plan**
    Is a draft plan of the value based bonus program available at this stage?

Appendix 3 Example of diagnostic Scan for VBM operational roadblocks

VBM deployment includes anticipating and duly removing 'roadblocks'

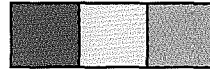
Roadblocks can be expected ... and successfully overcome ...



Appendix 3 Example of diagnostic Scan for VBM operational roadblocks (continued)

Some examples of frequently encountered roadblocks

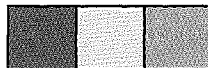
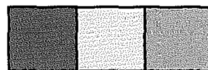
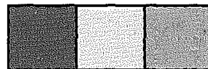
To assess the status quo in your BU/business area, please enter [√] in the appropriate box

Roadblock		Removing the roadblock
Insufficient consensus on precise nature of business's Critical Success Factors (external and internal)		Involve managers in Quick Scan focusing on strengthening understanding of business's current Critical Success Factors and expected major competitive and other external changes
Managers not yet familiar with using EPR		Hands-on exercises in scenario-building/sensitivity tests, using FINANCIAL PERFORMANCE DASHBOARD 2.0
Insufficient insight into the business's non-financial value drivers and/or their relationship to the financial value drivers		Organise workshops in which managers identify the business's non-financial value drivers and establish linkages with the financial value drivers

Appendix 3 Example of diagnostic Scan for VBM operational roadblocks (continued)

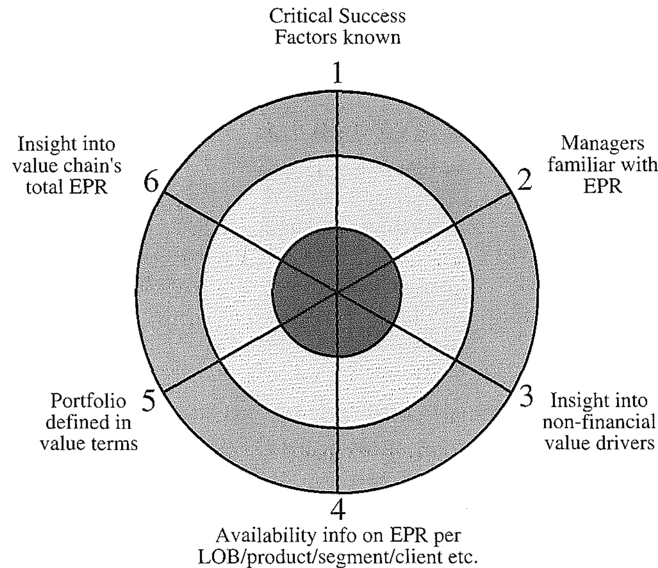
Some examples of frequently encountered roadblocks (cont.)

To assess the status quo in your BU/business area, please enter [√] in the appropriate box

Roadblock		Removing the roadblock
No or insufficient info available on approximate EPR per Line of Business (LOB), product(lines) or main clients/market segments		Involve managers in quick scan using activity-based costing to determine or verify EPR per LOB, product (lines), main clients /market segments,etc
The business portfolio has not yet been redefined in Value terms, combining strategic positioning with EPR data per LOB, product(line) and main clients or market segments		Involve managers in Strategic Positioning Assessment (SPA) exercise including EPR Waterfall charts and final positioning on Bubble charts
Some of the BU's products are part of cross-boundary value chains involving other BU's, but there is no or insufficient insight into the value chain's total EPR		Arrange a Total Value check, a rudimentary internal analysis of the BU's cross-boundary value chain, in cases where inter-BU product transfers take place on a significant scale

Appendix 3 Example of diagnostic Scan for VBM operational roadblocks (continued)

Please complete this "spiderweb-diagram" by plotting the status of each of the 6 items you assessed on sheets 5 and 6 in the diagram below. Thereafter please join the points plotted, creating a "spiderweb",providing a quick overview of which roadblocks need to be removed



Appendix 3 Example of diagnostic Scan for VBM operational roadblocks (continued)

Steps to removing VBM roadblocks own BU/Business area

Experience suggests that a step-by-step approach will give better results than a head-on frontal assault ...

Suggested steps:

- Invite and collect initiatives/suggestions from all MT-members
- Discuss and review all proposals; most will (and should be) based on setting up internal workshops (objective: combining 'discovery' + 'ownership')
- Prioritize workshop projects; if possible, try to pick the low-hanging fruit first, thus leveraging own success and boosting internal motivation
- Designate a champion per project and assure that he has access to necessary resources to prepare and facilitate the workshops and/or other supporting events
- Assess each project ex-post: has the roadblock truly been removed?

Appendix 4 Extract from *Journal of Accounting and Economics, volume 24:3, December 1997*

Does EVA beat earnings?
Evidence on associations with stock returns and firm values

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Abstract

This study tests assertions that Economic Value Added (EVA®) is more highly associated with stock returns and firm values than accrual earnings, and evaluates which components of EVA, if any, contribute to these associations. Relative information content tests reveal earnings to be more highly associated with returns and firm values than EVA, residual income, or cash flow from operations. Incremental tests suggest that EVA components add only marginally to information content beyond earnings. Considered together, these results do not support claims that EVA dominates earnings in relative information content, and suggest rather that earnings generally outperforms EVA.

Summary and potential limitations

Motivated by increased use in practice and increased interest in the media and among academics, we examine the value-relevance of EVA and residual income compared to currently-mandated performance measures - earnings and cash flow from operations. There is little evidence to support the Stern Stewart claim that EVA is superior to earnings in its association with stock returns or firm values. In no case does EVA significantly outperform EBEI in tests of relative information content. On the contrary, in most cases the

evidence suggests that earnings outperforms EVA. Further, while the charge for capital and Stern Stewart's adjustments for accounting "distortions" show some marginal evidence of being incrementally important, this difference does not appear to be economically significant. Possible reasons why we do not detect stronger value-relevance for EVA include:

- Our research design uses current realizations, not future flows, of each performance measure. Equity valuation is ultimately the discounted present value of future equity cash flows (or dividends or RI or EVA). Even if EVA is a good proxy for economic profits, realized EVA may not outperform the current realizations of other performance measures such as earnings in proxying for future equity cash flows. This is similar to the rationale used to explain why EBEI generally outperforms CFO in relative information content.

- Stern Stewart's estimates of the charge for capital and accounting adjustments may contain measurement error relative to what the market is using to value firms. Further, we use Stern Stewart's publicly available database which does not include many custom adjustments they use for their clients.

- There exists little or no "surprise value" in components unique to EVA including the capital charge and Stern Stewart's accounting adjustments. For example, if the cost of capital and the amount of capital are slow to change (or the changes are predictable months or years in advance), the market should long ago have impounded these data. However, over five-year return intervals, theopportunity for surprise should be larger, and results reported in section 5.3 do not lend support for the superiority of EVA over this longer return interval.

- Data needed to compute EVA are not easily estimated and the market does not have these data during our test period. Recall that we assume that the market has access to sufficient data within 3 months of a firm's fiscal year end such that EVA (and its components) can be reliably estimated by that time. his potential issue is mitigated in tests that use alternative

notes:

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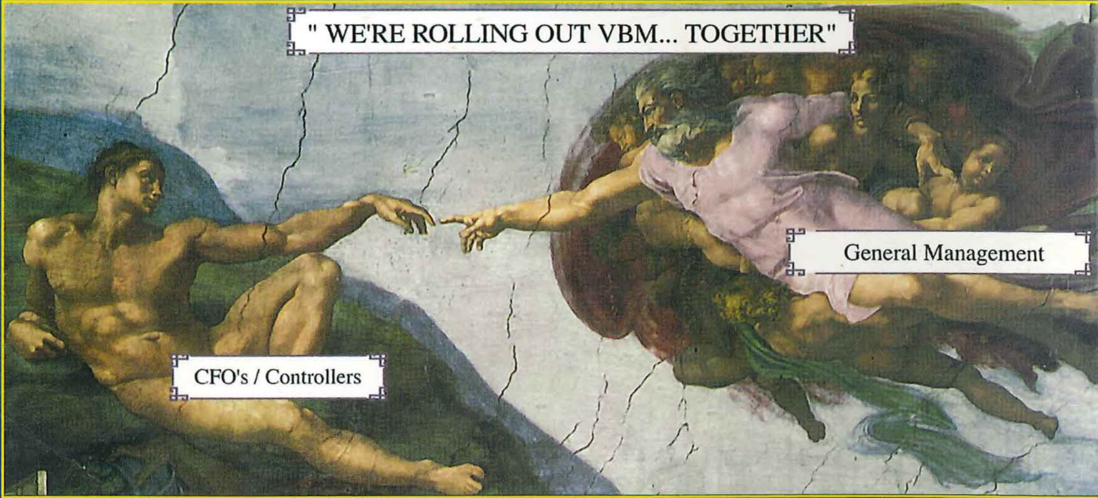
" WE'RE ROLLING OUT VBM... TOGETHER"
General Management
CFO's / Controllers