Challenges in implementing Value Based Management

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Mr. Daum, Mr. Schröder, Dr. Schüring, Mr. Johns, Mr. Read, Mr. Wagle,
Mr. Dolff, Mr. Langlade-Demoyen (from left to right) at the panel

Participants:

- **Jürgen H. Daum, Product Manager SEM, SAP AG, Walldorf/Germany (Facilitator)**
- **Jan Peter Dolff, Fund Manager at COMGEST, Paris, France**
- **Peter Johns, VP N.E.T. Research, MD of N.E.T. UK**
- **Francois Langlade-Demoyen, Director European Equity Strategy, Credit Suisse/First Boston, London, UK**
- **Cedric Read, Senior Partner PricewaterhouseCoopers, London, UK**
- **Jürgen Schröder, Chief Information Officer, Schering AG, Berlin, Germany**
- **Dr. Karl-Heinz Schüring. Project Leader Value-Based Management, Daimler Benz AG, Stuttgart, Germany**
- **Likhit Wagle, Partner PricewaterhouseCoopers, London, UK**

Mr. Daum:

- Welcome to the participants and to the audience to our panel discussion about ‘Challenges in implementing Value Based Management.
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- As we are all aware, today’s enterprises are quite complex business organizations. Many of the companies have global operations and they have often a very decentralized structure with independent business units. The decision to implement value-based management techniques is made typically far away from the day-to-day business at the corporate center, where people have to deal with analysts and with investors and are feeling the

pressure of the capital market. But to make VBM really happen across the entire organization can be a major challenge.

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- Dr. Schüring, you reported us this morning that you are currently training 16,000 managers at Daimler Benz in VBM as part of your VBM program. I can imagine that explaining ‘what is value’ to shop floor managers and link it to their world of e.g. managing the inventories or managing the quality of a production line is not an easy task. So what is your experience at Daimler Benz in making VBM operational ? What is your experience with the cultural issues in communicating such financial knowledge to nonfinancial managers ?

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Dr. Schüring

- Of course this required a lot of preparation but we were convinced that, if people want to understand what is value, what is value creation, they have to know the basics of economic business administration, they have to know what is a balance sheet, what is a profit & loss statement. We had people who asked, ”Why should I be informed about a balance sheet?”. But it’s a question of finding the right language. Top management has a very important job to do in the beginning. They have to come up with a clear vision, with financial beacons for top performance measurement, and then they have to act as enablers.

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- But all this is not just done because everybody knows that our CEO wants it.. We need something in addition that we call 'cascading'. We made a mistake in the beginning: We got this task from the management board (to implement VBM in the operations), then we went to the manufacturing plants. Then, all of a sudden there was resistance and we were surprised and wondered what was going on. We realized that we had forgotten to involve all the managers in between. You have to involve all the training personnel. Involve the people and then you'll find the right language, the right tone. So it requires a lot of education, not just developing an instrument and then trying to impose the tool which you developed in the head office on the people in the plant. That is impossible.

Mr. Daum

- How do you help such a foreman to understand how he can contribute to improve a certain balance sheet figure? Is it the job of the plant management or controller ? How do you do it on other levels in the organization ? I think it’s crucial that these people understand in detail, not only how a balance sheet works, and an income statement, but how these figures are linked to their day-to-day work.

Dr. Schüring

- For the top level, we did it with a team from the head office. But then, for the managers in the plants, in the subsidiaries, we trained what we called 'multiplicators'. These are the people who know the language, who know the environment. You cannot just come from the head office and try to do that. That is impossible.

Mr. Daum

- Mr. Langlade-Demoyen you are an analyst. When you are talking to companies and trying to get a picture of how well they are doing from an investor’s point of view, does it matter in your analysis how a company is approaching VBM internally, how they are trying to make it operational ? Does this play any role in evaluating a company in your analysis?

Mr. Langlade-Demoyen

- Yes, certainly. That and how Value Based Management is applied is very important. This three points are signs for me, that the management is going in the right direction:
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  1. <u>Common definitions:</u> I think a lot of managers are using concepts or notions like return on capital, cost of capital in different ways. We also sometimes find different definitions of items such as after tax, pretax. All this can lead to serious misunderstandings and then big market disappointments. We see the results with strong share price reaction. Until we have clear definitions, standardized definitions of the concepts, I think it can undermine somewhat the credibility of Value Based Management in the short term. I would really stress this point.
  2. <u>Active management of the assets:</u> I think it’s quite important that a company, which may have different businesses, has a very good understanding of, and a clear definition of economic profitability for each business. This means not only sales and earnings, but also capital. You must have independent business units, units that are economically viable, that generate economic profitability and that can be compared with the other businesses. This is what I call active management of the assets.
  3. <u>Management compensation:</u> The right management compensation makes sure that the interests of managers and shareholders coincide. I would agree with Jan Peter Dolff from Comgest. I think it’s important that managers share the reward, share the return, share the upside, but also share the downside and that’s why this notion of cost of capital is important. I would prefer managers to be shareholders than holders of stock options. They have to put up their own money and then they feel how it is to be a shareholder. For me, this is the most important signal for the market. In the US, and more and more in Europe, when you see announcements of management compensation schemes which are related to shareholder value, you see the stock price going up 15 percent in one day sometimes. Clearly the market likes it, this is a very powerful signal.

Mr. Daum

– I think that's a good point about the stock options. This is a hot topic in Germany at the moment and also in other European countries. Some people fear that we may be moving too far towards American management compensation schemes and that we are paying too much to managers. Mr. Read, what is your opinion on this, on management compensation? My understanding so far is that stock options are not the only tool to tie management compensation to value. There are a lot of other tools, and I think you have a lot of experience in this field working with your clients.

Mr. Read

– I think some good things do come out of America, including a lot of the management principles that we work with today. Look at the business book shelves at the airport, look at the number of books and who they're written by. We in Europe do have something to learn from what is going on in the United States. If we take a European headquartered company which is global, quite often the incentive schemes which are being developed by the US subsidiary have a kick back into the European headquarters and influence what is happening here. But I agree with you, I think there's a balance, and quite often you can go off the scale, you can go too far down the stock option route. I think there's a balance in terms of management's involvement as investors in a company along with other shareholders, rather than having beneficial treatment in terms of stock options and so on. I think it's horses for courses. At different levels of management we begin to see different incentive structures. At senior level it's appropriate to talk in terms of shareholder value creation etc. but we're beginning to see a mixture of bonus-based incentive schemes, perhaps based on personal performance indicators. We're increasingly seeing a more balanced view in terms of what value has been created for a variety of stakeholders, not just shareholders, and we're also seeing a greater mix of more Key Performance Indicator(KPI) related incentives schemes.

Mr. Daum

– I think that's a good point, the last one. If an organization has opted for VBM as the method of managing it's business and wants to use KPIs on lower levels in the organization to link compensation to, how do you translate value measures like economic profit, cash flow return on investment, free cash flow or whatever value measure you use into operational KPIs? Mr. Wagle, you have a lot of experience in working with clients in that field. Can you tell us something about that ? I sometimes feel that it is a very hot topic on the one hand, but on the other, it's very new and a lot of companies are struggling with it.

Mr. Wagle

– I think the issue, and it's been raised by a number of people on the panel already, is the issue of transparency. A lot of the pressure which has come from investors has resulted in a number of corporations actually reacting to that pressure by changing the metrics that they are seeking to use. They're turning away from something like EPS (Earnings per share) to something like Economic Profit, and in our experience a lot of these corporations are trying to cascade value through the organization. What they are actually talking about is taking Economic Profit and trying to drive it down to different levels of the organization. And that does have some benefit, but I think the problem that you're left with is 'what actually drives the Economic Profit ?". What's important is to get an understanding at appropriate levels within the organization as to what actually drives Economic Profit. I think this is where key performance indicators are very, very important. If you can devise mechanisms by which you can understand lower level operating measures and therefore how lower level operating decisions drive Economic Profit, then I think you're starting to crack this circle of value creation. Compensation clearly is important because you can then start to link some of these lower level measures. You've got a composite of share option schemes, Economic Profit type measures, and lower level operating measures actually determining the compensation packaging of individuals.

Mr. Daum

– If you link compensation schemes to KPIs and not just to the financial figures, one major problem you run into is that these figures have to be very reliable. Typically, companies can only guarantee this reliability for the financial figures. So you have to have some processes in place, that ensure for example, that a figure like scrap rate - a value driver on the shop floor – can be captured and reported in a reliable way. That means, such a measure can not just be collected and reported in an ad hoc uncontrolled way – as it is normally done today. You need a process to provide that information on a regular basis, on a reliable basis. This is where the CIO come into the game. Therefore let's put this question to Jürgen Schröder, CIO of Schering AG: What has the CIO to contribute to this process? As we heard, as companies are on the way to breaking down value-based management to more operational levels, we are going away slightly from financial figures to non-financial KPIs. Then we are in the field of information technology because to provide this figures in a reliable way you need IT. What your are thinking about it, not only for today, but also looking a little bit into the future, over the next five years: what is the challenge for the CIO in that area?

Mr. Schröder

– Basically, I can see three areas, where the CIO can contribute to value:
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– The first, in his very own area of responsibility. If you see for instance, that in the United States, 50 percent of total business equipment spending goes into IT, this is a large chunk. So he mainly influences with his strategy and investment decisions how effectively the money is put at work. One example: if you have invested heavily for the last years in OS/2 technology from IBM, then that might have been not a wise decision. So this is the first area the CIO can contribute: cost controlling.
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– Secondly, the more he goes into standard ERP software for instance, the more he can reduce maintenance costs. He can build on a common skill base so he makes his organization more efficient and can increase quantitative output. In addition I've seen in the two days here that there seems to be a growing role for IT in a new area: The demand for more qualitative output in the analytical area, e.g. to support VBM and provision of KPI information. This means that tasks, that have been performed so far either manually or not at all, will have to be covered by computer systems. Again, to have this systems available with minimal impact on the IT resources and within an acceptable timeframe one has to look for integrated off-the-shelve solutions, such as the SAP SEM system that has been presented today.
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– The last issue is mergers and acquisitions. Let me first make clear that I do not want to indicate that Schering is intending to make any acquisition, or that we are volunteering to be at the wrong end of a takeover. But there are findings that indicate that in a merger process in general you have a high success rate regarding integration in purchasing and in logistics. You have a medium success rate regarding integration in such areas as R&D (where nobody would expect it), marketing, and sales. In turn you have a high rate of failure in cultural integration and in information technology. So having the right systems in place is one key to success, when merging companies or acquiring companies. These are the three areas I can see.

Mr. Daum

– What's about skills in IT? The question is: to implement analytical applications such as SAP SEM to support e.g. Value Based Management or other new Performance Management techniques, do you require more business knowledge in the IT department? Is there a skill shift required, and what implications do you see for an IT organization internally?

Mr. Schröder

– What we see at Schering - and I think we are very successful in that - is that most of our project leaders for implementing R/3 modules formerly very often have worked in the user departments and have chosen not to continue their career there, but rather in IT. So we definitely have a shift of skill sets. And if I see that the whole work in shaping modules is primarily driven by those people, then they are acting as business analysts. They are moving away from system analysis to business analysis and they need to know a lot of the underlying business methods, when they shape the system, when they do the customizing. Yes, there will be an increase of business know-how in IT departments, and at Schering fortunately that has already taken place to a large extent.

Mr. Daum

– Dr. Schüring, you are the leader of the VBM project at Daimler Benz and we are also implementing R/3 together there. How can you imagine linking value-based management with an ERP implementation? How do you see value management in the context of an R/3 implementation?

Dr. Schüring

– Maybe I should start by explaining what we expect when we say we want to introduce value-based management thinking, value driver thinking on the operating level. It all comes down to two or three points. They are: knowing your processes, knowing what establishes the effectiveness of the processes (and these are for me the value drivers), and then, what would that mean for the key performance measurements of that unit. And using this way of thinking, continuing improving these figures is the business. When it comes now to projects, also to order projects and especially to planning and implementing systems, it is just applying these principles. I talked to my colleagues in our Nakos project (our R/3 implementation project) and it was really great to see how they use already this way of thinking. They are reshaping the processes and they are looking at what drives these processes, how can we change them. They also try to put figures to it, to value it and then, following up that’s basically what we want to achieve on the operating level, this continuous demand for improvement.

Mr. Daum

– Mr. Read, what is your experience at PWC if you help to reshape operational processes in a company? Do you make such evaluations, what is the contribution of this reengineering effort to the overall value of a company for example?

Mr. Read

– I think we see two messages coming through. One is thinking big. I think if you are going to do a big program like this, the expectation in terms of the growth in shareholder value you expect to achieve should be clearly articulated and communicated. One company I visited wants to double total shareholder return over the next three to four years, move up their peer group ratings in terms of benchmarking shareholder performance. "We’re currently number ten in our peer group and we want to be in the top three." These are big ticket objectives. Then make the case for change within the organization and pick a big substantive slice for implementing value-based management, but make it new, make it different. We did some work at a large pharmaceutical company, it was valued at about 25 billion pounds. They picked one product group world-wide and valued it. This came to 900 million pounds and then said the target was to grow the value of this product, in shareholder value terms, from 900 million pounds to 1.5 billion pounds. They then built in some processes and some systems to help them fill the value gap. And you know, I think there is a big impact when trying to implement value-based management. But to turn to a second theme a particular a hobby horse of mine is that middle management is dead - long live middle management. Because I think, middle management is that vital thread in connecting strategy and reality. And I think, we have for a long time not middle management but bureaucracy in our organization. We're going to replace it with something new, something different and something distinctive and I think, implementing the shareholder value is the absolutely key to making strategy work in practice. So, we've got to equip these middle managers with processes, with tools, with systems, with the incentives, they can relate to and some currency to act big.

Mr. Daum

– To extend this thinking: If mid sized companies have implemented R/3 or other integrated transaction systems, this is often perceived as a sign, that the company has well structured processes and a well organized business. This gives them a better reputation e.g. in front of banks. If you translate this now to VBM, you could think along the same lines. If a company has implemented good strategic enterprise management processes, is this a sign for you as an investor, Mr. Dolff, to evaluate a company in a different way to another one which has not applied such techniques?

Mr. Dolff

– Your first question, when I visit a company I always ask which software system do they use, do they use SAP? But that's because I have SAP in my portfolio, that's just to know if they are doing well. And the second question, I actually don't mind, I don't care if a company uses value-based management or whatever. When I see the management, I just want old fashioned divisional sales, divisional results, capital employed by division. I don't expect the company to do my job. I don't expect them to make a value report. That's my job. If I get all the numbers I need, I can work.

Mr. Daum:

– But if this company has to deal with private investors, not professionals like you, it could be helpful.

Mr. Dolff

– It's probably the best sign, and there are good examples of when a company has shifted over to value-based management that the performance has improved very much. Sometimes it's sufficient if a company says "we are going to implement value-based management", and the share prize goes up 10 percent.

Mr. Wagle

– Just to add to that point. One of the things that is really important from a shareholder-value perspective is the credibility of the management team in the organization. I think a large element of that credibility is the extent to which a company actually surprises the market place (the capital market). The market place doesn't seem to like surprises irrespective of whether they are good surprises or bad surprises. And I think systems have a very important part to play. If management can be kept informed as to what is actually happening in terms of performance of the company, and is therefore able to communicate in a reliable way to the market place, then I think that is very important. It impacts drivers very directly like competitive advantage. Look at companies that have delivered results on an even basis for years, like the Procter & Gambles of this world. Look at the competitive advantage period[1] of that business despite the fact that they're in a highly competitive industry where technology is changing quite fast.

Mr. Daum:

– I would like to throw a little light on another topic, the finance function. What has to be changed in the finance function? I think VBM it's a cultural change for the finance function also, even if this is itself a financial strategy. Mr. Johns, you worked as a CFO at Eurocontrol, which is perhaps not a normal business because it's more publicly owned, but you've had some experience with changing management culture in a company and you've implemented the "Management Cockpit" there (The Management Cockpit is an innovative concept of an 'Enterprise War Room' based on KPI Information). What do you think about the cultural change for the finance function, no matter in which direction?

Mr. Johns

– You know, it's absolutely clear, as soon as you start thinking in terms of the concept of value-based management, you are totally reviewing the role of the CFO on two fronts. First, he has to completely review his attitude to the external world. He has to start thinking in terms of what it is that shareholders want, and is he actually able at the moment to meet those requirements, and this is a totally different focus. The second front is, of course, the internal role. If you start talking value-based management, what you are doing essentially, is bringing what used to be the arcane science of book-keepers and accountants into the open world. You are talking to the shop floor in terms of perhaps activity-based costing, you are trying to explain to people all the way through the organization that cash flow isn't something that happens upstairs in the petty cash office, it is something that is going to affect the very future of the organization. So you need to completely redefine the role of the CFO, and you have to be able to convince the whole of the organization that the role of the CFO is no longer that of bean counter. He is going to be one of the key facilitators in implementing this new management philosophy which is driving the business forward through what used to be considered as boring book keeping, accounting things. These now become crucial to the existence, to the life of the organization. You mentioned the Management Cockpit. I used that as a facilitator tool in an intergovernmental organization that had no concept of shareholder value or stakeholder value. I used the MC as a method to start driving out of the organization these key indicators, these key performance cost drivers that were actually forcing this organization into problems with the member states because the cost base was multiplying and nobody knew why. So, you have a whole series of tools at your disposal once you've made that decision to go for value-based management, but the implementation role, the facilitation role of the CFO is, generally speaking, one that an awful lot of CFOs are not happy with. You have to take that into account before you go down that road.

Mr. Daum:

– I heard this morning in your presentation, Mr. Read, a very interesting statement from one of the CFOs (in the CFOs video statements). I think it was the CFO from Campbell. He said that in 5 or 10 years maybe, there won't be any more CFOs. My understanding was,

[1] The 'competitive advantage period' is an important driver of the market value of an enterprise. It represents the number of periods/years a corporation is able to outperform it's peers on the stock market.

that it means the finance function will move into the business itself and maybe we will have something left like a corporate consultant who advises these business managers in finance or in techniques on how to manage the business. What is your opinion?

Mr. Read

– Yes, first of all, a general perspective: Finance is embedded in the business, it is embedded in every manager - the responsibility to act in the interest of the shareholders. It is for everybody, it's not just for the finance function. It's a fundamental point. Secondly, I think, to return to a point Mr. Johns made. I think the finance function is in a unique position in terms of connecting the external world of the investor with the internal world of management. And the issue that is being thrown up now, is to what extent do we have systems internally, which reflect the systems that are being used externally by people such as Mr. Langlade-Demoyen (Analyst) and Mr. Dolff (Investor). What information do our systems generate internally and do we communicate that externally? Traditionally, we do this in historical accounts, but in terms of predictive information, the lead indicators in terms of what our performances are going to be in the future, there are some risks associated with communicating to the external market. What is it we intend to do? Do we give that away to our competitors, do we hold ourselves hostage to fortune? What happens if we fail to meet our anticipations? Is the market going to mark us down, are we going to fail in our statutory duties in those regards? So, there is a very big responsibility on the CFO. I think there is going to be a role there in the future. In terms of letting go the processes of yesterday in order to adopt the processes of tomorrow, there is a danger that you lose control of the business. I think Dr. Schüring referred to that this morning. I think he was concerned that if we didn't have proper systems for reporting monthly actuals, we might not want budgets to compare them with, but we might want to compare them with last year and update our views in rolling forecasts. But I think there's a danger is making the change too fast. As to whether or not the finance function still wants to be called the finance function in the future: we had that debate with a client recently. They really would like to see themselves as decision supporters rather than finance functions. But they said we don't want to lose the title, because there is a value attached to that, it means something in terms of our discipline.

Mr. Johns

– What Mr. Read is talking about, I actually wanted to do this in one organization. The problem with accounting functions is that they're parasites. More often than not they don't actually produce any added value. I actually wanted to completely destroy the whole finance unit and get it done elsewhere, outsource it. You still have the problem of course that you need to be able to meet your statutory requirements, your legal requirements. So, there has to be somebody somewhere, perhaps a controller, and as Mr. Read suggested, you would have a 'business decision support manager' who would previously have been the CFO. But I think, if organizations are prepared to look openly at that question, that role, then they will actually find themselves working towards their objectives of added value and actually broadening the skill base available to the decision makers. It's a very good point.

Mr. Daum:

– Here is a question from the audience:

Dr. Milan Juranovik

– I'm a researcher. We have heard the key words, shareholder value, stakeholder value and enterprise value. I believe that the problem Mercedes Benz has in training 16,000 managers very quickly is a critical problem in the world today. The Economist published an article last September with the title "The Puzzling Failure of Economics" and it states that it is due to the fact that most people don't understand the economic game. We have actually two ways to understand the basis of economics, management and accounting that are needed in the scenario of a business. One is to study these disciplines as sciences, which I am doing. Who can invest so much time in the science of these disciplines? Yet, there is another way to study these disciplines in a form of game. There is a business or economic game that can be played in one day with all the value drivers, all the players which actually play a daily economic game in enterprises. If they play it live, exchanging symbolic business cards, representing a universe of goods and services, they can understand in one day the economic game and the whole process may be speeded up. The theorists like me, and other scientists may continue their work and may complement high level management as needed. I would like to hear Dr. Schüring's opinion, whether there is any research in the company about the knowledge profile, about the need for knowledge at different levels of Mercedes Benz. Time can be saved by not giving full theory to those who don't need it but just giving them practical instruments and the understanding of the game in which they are engaged. In fact, the economy is everybody's life game.

Mr. Daum

– Well I think that fits very well with the first topic we discussed. Can you use some game models, for example, to explain to operational people the implications of the economic game, that is of the business itself? We have that idea in our concept, in SEM-BPS, where you can simulate even dynamic business models and scenarios. Mr. Schüring; do you have any ideas in that direction at Daimler Benz?

Dr. Schüring

– When we planned the whole project, I mean this education process, we did some research and then we thought it doesn't make sense to go to our people and teach them like a professor at university. We found a Swedish method. That is a kind of game that is called "apples and oranges". We adjusted it for our case. People really come together, they have a kind of game. They get their (game) money, and they know that if they want to start a business they need cash. As soon as they build up stocks then they see their cash is there in the stocks and they recognize the problem with that in a very practical way. So I think, the idea to use business games and simulations to teach non-financial people economics is absolutely right. You cannot just do this in an academic way. You have to adjust it to the needs of the people. That's very important.

Mr. Daum

– I'm sorry, but I will have to stop this very interesting discussion now because we have run out of time. Thank you very much for participating. Thank you also to all the people here in the audience for coming.

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Public: http://www.sap.com/sem (media center / SAP SEM conference 1998)

SAP Customers / Partners: http://www.sapnet.sap.com/sem (media center / SAP SEM conference 1998)

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The following white papers about SAP SEM are available at www.sap.com/sem:

- SAP Strategic Enterprise Management – Enabling Value Based Management (1998)
- SAP Strategic Enterprise Management – Translating Strategy Into Action: The Balanced Scorecard (1999)
- SAP Strategic Enterprise Management – The Functions – A Closer Look (1999)