Value-Based Management – It's Still Around And Evolving Into A "Best Practice" 3-Dimensional Operational Tool

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Third Part of 3-Part Series

PERFORMANCE MATRIX & MANAGEMENT ROLES

Manager Level	Shareholder returns	Economic Profit	EBIT Capital Utilization	Individual Operating Value Drivers
CEO	●	●		
Corp. Staff	●	●		●
Bus. Unit Mgr.		●	●	
Functional Mgr.			●	●
All Other Employees				●

In our May column we ended with "Action Plans & Budgets . . . How they must assist in the overall VBM success"

Action plans transform strategy into the specific steps an organization will take to achieve its targeted goals, with particular emphasis on the short term. These action steps must identify the actions that the organization will take to assure it can pursue its goals in a methodical manner.

Performance measurement and motivation systems trail movement in achieving targets and encourage managers and other employees to achieve them. It is not often front-line supervisors and employees have clear performance measures that are linked to their company's long-term strategy.

Value Based Management (VBM) many times, demands that a company modify its established approach to these systems. In fact, it shifts performance measurement from being accounting driven to being management driven. Nevertheless, developing a performance measurement system is relatively uncomplicated for a company that understands its key value drivers and has set its short- and long-term targets. Here are the key values:

- Tailor performance measurement to the business unit. Each business unit must have its own performance measures—measures it can influence.
- Link performance measurement to a unit's short- and long-term targets. As obvious as this seems, performance measurement systems are often based almost exclusively on accounting results.
- Combine financial and operating performance in the measurement. Often, financial performance is reported separately from operating performance, whereas an integrated report would better serve managers' needs.
- Identify performance measures that serve as early warning indicators. Financial indicators can only measure what has already happened. Early warning indicators are simple items such as market share or sales trends, or more sophisticated pointers such as the results of focus group interviews.

Once performance measurements are an established part of corporate culture and managers are familiar with them, revision of the compensation system must be made. Changes in compensation should follow, not lead, the implementation of a value-based management system.

Compensation plan

The first and most important principle in compensation design is that it must provide the incentive to create value at all levels within an organization. Compensation for the chief executive officer is something of a red herring. Managers' performance should be evaluated by a combination of metrics that reflects their organizational responsibilities and control over resources (Exhibit above).

At the chief executive level in a publicly-held company, increases in stock prices are directly observable, and therefore a CEO's bonus can take the form of stock options or stock appreciation rights. Even so, many stock price changes result from factors outside the CEO's control, such as falls in interest rates. Stock appreciation plans can, however, be adjusted to remove such general market influences so that they focus on the aspects of company performance that are directly attributable to the skill of top management.

Discounted cash flow (DCF) is not one of the performance metrics in Exhibit for good reasons. DCF is the present value of forecasted cash flows. If compensation relied on DCF, it would be based on projections, not results.

However, using DCF in conjunction with economic profit to establish benchmarks and reward performance at the business-unit level makes some sense. The long-term perspective provided by DCF can balance the short-term, accounting-based metric of economic profit. The latter is often negative in, for example, start-up or turnaround projects, even though value is being created. The role of DCF is to act as a corrective so that compensation can be calculated appropriately at the business-unit level.

At the front line of management, where financial information is rarely an adequate guide, operating value drivers are the key. They must be sufficiently detailed to be tied to the everyday operating decisions that managers have under their control.

We have tried to simplify a very important management tool in a short amount of space. Thank you for reading *Coatings World* and this column.**CW**