CMA — The Institute of Certified Management Accountants

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What's On?

May 31st 2007
Melbourne, Australia
ICMA Strategy Day

June 8-11 2009
Bandung, Indonesia
2nd CMA Program on Strategic Business Analysis
Conducted by UNPAR University
www.unpar.ac.id

July 18-26, 2009
Colombo, Sri Lanka
12th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by ICBS
www.cmasrilanka.com

June 12-21, 2009
Jakarta, Indoneisa
5th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by IPMI
http://www.ipmimba.ac.id/cm/

July 18-26, 2009
Colombo, Sri Lanka
12th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by ICBS
www.cmasrilanka.com

Oct 18-24, 2009
Istanbul, Turkey
Proposed 1st CMA Program on Strategic Cost Management and Strategic Business Analysis

Nov from 11-17, 2009
Dubai, U.A.E.
5th CMA Program on Strategic Cost Management and Strategic Business Analysis
Conducted by Wisdom Institute
http://www.cmadubai.org/

On Target

Newsletter of the Institute of Certified Management Accountants pr/May 09 Volume 12 Issue 6

Inside this issue:

Are you ready for the upturn?

Doom and gloom, or time to prosper?

There is so much in the news about the economic turmoil. Bear Sterns, Lehman Brothers, AIG, General Motors, CitiBank - we're questioning the very make up of your firms. Financial Scandals, over here and abroad - the list goes on and on. There are commentators all over the media predicting the worst recession ever and the British Prime Minister calling it a Depression!

So at such a time, can we ask whether we're ready for the upturn?

The ICMA borrows from President Obama, and says "Yes, we can".

Set the Stage for the Next Wave of Economic Upturn.

This recession has given all industries in all countries an opportunity for having some breathing space and a chance to be creative. It is exactly the right moment to "change the game", i.e. use the recession as an opportunity to introduce change and innovation.

For years in the "good times" we've wished for a period of consolidation to shore up the foundations. A chance to get those IT systems "sorted" a chance to really look at costs and get even better deals with suppliers, exploit the systems we have rather than add more systems, a chance to exploit Knowledge Management and show the value it can really deliver.

This is the time to be wary and look after your remaining staff. Growth will bring churn into your departments, there will be opportunities galore for people as other firms grow and need to move beyond the skeleton staff they've had to operate with under current times. Your best people will be out the door first if they haven't been "looked after".

From Ground Zero to Full Throttle

Maybe now it's time to use any downsizing to re-organise and refresh your teams, mould them for what's to come. Not for what is now!

There's more. What about your products and services? Is it time to weed out your loss making products, services and customers? The old excuses of "loss leaders" and "sentimentality" will not be relevant in the upturn. And what about your stakeholders? The new economic order brought about by the WTO and Globalisation has perhaps caused this global economic crisis. Is it time to re-think such issues as 'World Trade' and 'Trademark Protection' that appear to

CMA — not just the numbers

be heavily biased in favour of large industrialized nations? Finally, your biggest stakeholder is the Earth itself. Has this recession given us time to consider how we tackle the much larger issue of 'Climate Change'?

Snapshot Series 3

Performance Measurement Metrics

"The fact is, EVA, CFROI, and all the others are premised on fundamental economics that 20 years ago was called residual income"

One of the criticisms of using accounting based measures as financial performance measures is that they are historical in nature and do not reflect a firms strategic investments which are necessary for future success, and are the foundation of a firm's value. For example, it is critical for business survival that firms invest in R&D for future growth, yet traditional measures such as ROI are poor at reflecting R&D appropriately; and in fact may report negatively on managers.

Drawn from EP and Residual Income concepts, value analysis focuses primarily on the economic rather than the accounting principles and is considered to link finance to strategy, thus providing a future orientation to performance measurement.

Interest in value-based measures created a consultants field day in developing "new glamour metrics" and a proliferation of metric acronyms. For example there is Stern Stewart's Economic Value Added (EVA) and the spin off Market Value Added (MVA), HOLT value associate's Cash Flow Return on Investment (CFROI), Boston Consulting Group's combination of CFROI and a concept called Total Business Return (TBR), and LEK/Alcar Consulting Group's Shareholder Value Added (Myers, 1996). Despite the many strategic value performance metrics, this editorial shall limit its discussion to EVA and Strategic Value Analysis (SVA).

Economic Value Added (EVA®)

Though the concept of EP has been known for decades and Residual Income has its origins in a paper published in 1890, it has recently been made popular as a performance measurement by Stern Stewart in a calculation that they term Economic Value Added (EVA®). In practical application, though EVA is a relatively new measurement that approximates EP (Kimball, 1998), its predecessor Residual Income (RI), was implemented by General Motors in the 1950s. Conceptually, there appears to be no difference between RI and EVA save for the 160 plus accounting adjustments that advocates say overcomes the accounting distortions introduced by GAAP. These accounting adjustments are necessary because EVA, and other measures of RI, depend on accurate measures of economic income and investment and thus accounting biases should be identified and eliminated before judging or rewarding performance.

Equation 4:

EVA = Net Operating Profit after Tax (NOPAT)
*- (Total Invested Capital * Cost of Capital)*

Many consider EVA to be a "throwback to the net present value rule", and it can be shown mathematically that the present value of the EVA of a project over its life is the NPV of the project. Logically, since there is a link between EVA and NPV, and NPV is the fundamental basis of valuation of any asset (including a company), then the value of the firm can be linked to the EVA added by it. Thus, maximising EVA will be consistent with maximising firm value and subsequently, shareholder value.

Note from Equation 4 it can be seen that if profit is greater than the capital charge, then economic value has been added. Therefore, are four key drivers of EVA:

1. Net Operating Profit after Tax (Revenue – Total Costs)
2. Total Assets (Working Capital + Fixed Assets)
3. Capital (Equity + Long-Term Loan)[1]
4. Capital Charge

Subsequently, the decisions managers will consider when attempting to increase EVA will include:

1. Improving NOPAT relative to Total Assets (i.e. increase revenue, profit margins or decrease costs)
2. Dispose of assets returning less that the cost of capital (i.e. sell marginal fixed assets and/or reduce working capital)
3. Invest in assets that will return more than the cost of capital
4. Reduce the cost of capital

It is EVA's ability to be tied into manager's incentive schemes via undertaking value enhancing actions that adds to its appeal to business (see Grant, 2003). The management accountant provides much of the decision oriented information requires for such value enhancing actions. Further, the management accountant will subsequently evaluate the resultant performance in of such actions and the effect of such on managers' compensation plans.

Strategic Value Analysis (SVA)

SVA is comprised of seven value drivers that can be grouped into three categories: operating, investing and financing. SVA can be viewed in terms of EVA but draws the value drivers together somewhat differently. outlines these drivers.

While EVA measures performance from a corporate finance perspective, SVA looks upon performance from a shareholder wealth creation perspective. Despite the different perspectives of EVA and SVA, because the present value of EVA over a project's life is equivalent to the NPV of a project and SVA is built on the assumption that the value of a business is the present value of its future cash flows, it is not surprising that given the same inputs, the two measures yield the same result.

A benefit of SVA over EVA is from the linking of decisions, over the planning period, to the key value drivers which encourages managers to plan as far into the future as possible to maximise the value of strategic decisions compared with the continuing value of the firm. To illustrate this, consider the example of an increase in sales volume (usually seen as desirable) that may destroy value because of the additional working capital needs.

In the next issue of On Target we will explore Performance Measures of Financial Health

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Table 1: Strategic Value Analysis Drivers

	Categories	*Driver*
1	Operating Decision	Sales Growth Rate
2	Operating Decision	Operating Profit Margin
3	Operating Decision	Cash Tax Rate
4	Investment Decision	Fixed Capital Needs
5	Investment Decision	Working Capital Needs
6	Financing Decision	Cost of Capital
7	Financing Decision	Planing period

COMMENT

The operating and investment decision, together, approximate a firm's free cash flow

1. Because Total Assets will be bought with Total Capital (Equity plus Debt), Total Assets = Total Capital