The effects of the implementation of value-based management

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Abstract

Many managers are caught in a dilemma: between a desire to maximize the value of their companies and the demands of 'stakeholder theory' to take into account the interests of all the stakeholders in a firm. The way out of the conflict lies in a new way of measuring value. The purpose of this paper is to explore how value-based management is perceived, implemented, and utilized in leading automotive corporations in Germany, and to examine factors that influence the decision to utilize it. The data was gained by using in-depth interviews with financial managers of German automotive corporation to study their opinions of and experiences with value-based management systems and metrics. The findings of the empirical study and primary research shows the problems of value-based management implementation in failing to achieve the right balance between all actors of agency conflict.

Keywords: value-based management, shareholder-value, performance measurement, technique

JEL Classification: G32, M21

1. Introduction

Over recent years, the global automotive industry has generally experienced continual growth. The major market actors of this industry are original equipment manufacturers (OEMs), and suppliers of various value-added stages. As a result of the economic growth following the financial market and economic crisis, managers of OEMs, such as Daimler, refer to the past few months as being the most successful ones in their corporate history. OEMs of highly developed economies can maintain and expand their market position only if they increase their enterprise value continuously (Hekkert et al. 2007, p. 413). For this purpose, the corresponding department of OEMs uses value-based management tools which have also been established as a key objective in German automotive enterprises (Kaufmann / Götzenberger 2006, p 183).

Value-based management is a tool to reduce the lack of goal congruence between the objectives of the management and those of the shareholders of the organization. Surveys

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show that nowadays a large number of companies are using value-based management not only to increase shareholder value but also to make themselves more attractive to investors and creditors. However, value-based management is not rather a process that should be permanently implemented in the corporation, and which defines objectives as well as individual control instruments. Satisfactory with the result of the implementation of value-based management strategies is confirmed by some of the large multinationals, including Coca Cola and Briggs & Stratton, which have successfully implemented value-based management strategies. Several studies have been considering in connection with implementing value-based management can be found in the literature (Lewis, 1994; Rappaport, 1998; Ryan Jr., Trahan, 1999; Martin, Petty, 2000; Morin, Jarrell, 2001; Haspslagh et al., 2001; Koller et al., 2005). Nevertheless, there is little empirical evidence on the factors that explain if value-based management improves automotive companies' performance.

To answer this question, I provide some evidence for the effects of value-based management control and show to which extent value-based management affect the management control system.

The paper is organized as follows: Section 2 gives the basic theory of effects of implementation of value-based management in general. The third section presents in details the methodology of the research object and data. Section 4 and 5 present the results of this survey and conclusions of the paper.

2. Effects of implementation of value-based management

The value-based management approach is difficult to implement because basically it requires a distinct mindset. Profits, bonuses based on earnings and performance measurements associated with accounting returns influence the implementation process of value-based management. In such an environment, it is not easy to dedicate the whole organization to the creation of value. Weaver states that the whole administrative body as Chief Executive Officer, the board of directors or governors, top and middle level management and other key staff is the driving force to implement value-based management (Weaver 2003, pp. 5-10). It is important that they all are involved because each manager performs his duties under a different set of rules and regulations.

One feature of value-based management is that it splits up the whole organization into small branches or divisions; therefore it must be implemented by a cross-functional group. This dedicated group of personnel is used to carry out the transformation of traditional management to value-based management. This group of managers should be highly competent in managing day-to-day affairs and communication. The team must have the following goals (Ruth & Keith 2008, p. 55):

- Directing the implementation of value-based management,
- Open communication about value-based management,

- Organizing and manipulating the gradual implementation of value-based management around different divisions of the organization,
- Playing a vital role between the staff and the executive body,
- Resolving priority issues, i.e. what are the demands of higher authorities and what is possible with available resources,
- Conducting meetings to familiarize each individual with respect to value-based management,
- Arranging necessary training programs for key staff to convince them about the significance of value-based management,
- Modifying existing performance measurement tools or creating new standards of performance management which best suit value-based management, e.g. instead of profit, focusing on cash and
- Resolving minor problems between top level management and operational levels.

Due to the aim of creation of value the incentives to key staff must be correlated with their performance. Conventional incentive processes which are associated with money should be modified. An important point is that rewards must be given on the basis of existing standards, for example, the forecast of future value is a very subjective incentive approach. In fact, the process of creation of value takes a long time; therefore the best approach is to connect the growing measures with the value. It is better to estimate the incentive measures at the start of each financial year while managers should have real-time data about the value and cost of capital. This will increase objectivity in the organization. The value of the capital and the cost of capital must be clearly communicated to each manager. Establishing the mindset of the employees is a difficult task. In fact, it is one of the most challenging aspects of value-based management. Much depends on the manager's personal traits and how he convinces the staff to work harder for the increase of organizational value. He can stimulate the workers by informing them that with the growth of the organization's wealth, not only the shareholders but also the workers will receive benefits. Managers should apply different motivational theories to encourage employees to achieve the basic aims of the corporation (Stewart 1991, p. 25).

Against the competition, value-based management needs the creation of benchmarking value. Value-based management should be linked with the basic aim and strategy of the organization as well as the standard operating procedure and decision-making processes. It is the responsibility of managers to differentiate between good and bad capital. If capital is generated at a level higher than the cost then it is called good capital, and in the opposite case, it is called bad capital (Chen & Dodd 1998, p. 73).

In order to determine the organizational and employee's performance through the value-based management approach, it is necessary for the managers to acquire information about performance aspects. Generally the main purpose of the measure is to check and enhance individuals' and collective performance. The performance measure normally considers the evaluation, control, budgeting, motivation, promotion, learning and improving aspects of the organization with respect to personnel, strategies, process and systems (Behn 2003, p. 600).

More detailed advantages, as illustrated on valuebasedmanagement.net, are as follows:

- Maximizing value-creation,
- Improving strategies for coping with increased complexity and greater uncertainty and risk,
- Preventing undervaluation of stock,
- Encouraging value-creating investments,
- Streamlining planning and budgeting,
- Increasing transparency of a company,
- Supporting transactions in globalized and deregulated capital markets,
- Aligning interests of high level managers with those of shareholders and stakeholders,
- Facilitating the use of stock for mergers or acquisitions,
- Facilitating communication with investors, analysts and stakeholders,
- Improving internal communication,
- Setting management priorities clearly,
- Facilitating improvement of decision- making,
- Helping balance short-term, mid-term and long-term trade-offs,
- Improving resource allocation,
- Setting effective compensation targets and
- Preventing takeovers.

Ronte stated that recognizing that value-based management is a paradigm shift, management must have the drive to make it succeed, and the quality and quantity of communication is essential. It also requires resources, often more than normally required. It helps if the process is implemented in small stages, in order to build confidence and learn along the way (Ronte 2010, p. 40).

According the Chartered Institute of Management Accountants value-based management has a positive impact on almost all areas of an organization, especially in management and decision-making. In Europe, its implementation varies. In Germany, Ireland, Switzerland and Austria, 75% of the largest corporations are implementing value-based management, in the UK about two thirds, half in France and about a third in Norway and Sweden. There were few negative comments about it, and the difficulties encountered in implementing it were all related to people rather than technology. Cultural change was mentioned as the biggest issue. Only a quarter of people interviewed said that implementing value-based management was difficult (The Chartered Institute of Management Accountants (CIMA), 1999).

Selected works on the implementation of value-based management have been already published. Since the issues raised in these works often differ considerably from one another, it seems reasonable to provide some categorization and structure. An essential difference between the works is that some of them are based exclusively on theoretical considerations, while others are based on empirical data. The issues raised in the papers in connection with implementing value-based management can basically be organized as follows:

Table 1: Categorized papers

Article	**Training**	**Participation of the employees**	**Internal communication**	**Support of top management**	**Goal system**	**Planning system**	**Control system**	**Information system**	**Compensation system**	**External communication**
Lewis (1994)	X	X	X	X	X	X		X	X	
Rappaport (1998)	X		X	X	X	X			X	X
Ryan Jr./ Trahan (1999)	X	X		X			X			
Martin/ Petty (2000)	X			X	X				X	
Morin/ Jarrell (2001)	X			X		X			X	X
Haspeslagh/ Noda/ Boulos (2001)	X			X					X	
Koller/ Goedhart/ Wessels (2005)	X	X		X	X		X	X	X	X

Source: Author's own illustration

It seems reasonable to bring together the categories of 'Training', 'Participation of the employees', 'Internal communication' and 'Support of top management' into a single success factor, 'Assuring acceptance'. The other categories represent very different facets of business, and cannot therefore be compressed into one or more success factors.

Consequently, each of these categories corresponds to a success factor. Organizational structure determines whether conditions are appropriate for the implementation of a value-based controlling system, and is therefore the deciding factor in whether or not it is a suitable approach. Personnel management and whether or not the system is accepted are, however, crucial aspects in determining the extent to which it reaches its full potential. Consequently, these three factors determine the basic conditions within the company for the implementation of value-based controlling.

Value-based management is a quest for prosperity and profit for both the employees and of course for the shareholders. Although, the literature review provides evidence that companies which attach importance to human values provide high standards of life for their shareholders and employees, even so, only a comparatively small number of value-based organizations exist in the competitive market.

Shareholders and top order management definitely receive more benefits by the implementation of shareholder value theory, and economists also logically assert that when the business activities make the best use of the shareholder value, then employees, customers, contractors and distributors will be more affluent. In order to run organizations under value-based management, shareholders have to depend greatly on their top level managers. But it has been observed that the managers who control the allocation of corporate assets and returns cannot create value for shareholders. In this situation, the free cash flow should be distributed to the owners, who can then dedicate these assets to some other standby use (Ryan Jr./ Trahan, 2007).

Value-based management deals with numerous performance measures which are implemented by top level management based on reliable information. Thus, a comprehensive value-based management system comprises strategic planning, establishment of value drivers, financial measures, analysis of internal and external factors, and the consistent supervision of skilled, efficient and active top level management.

3. Methodology

An empirical study was carried out to contribute to this research field. The framework of the study was to determine the effectiveness of value-based management in companies in the automotive sector. The hypothesis was formulated and analyzed:

"Value-based management improves automotive company's performance."

The following questions were to be addressed:

- What are the effects of value-based management control?
- To which extent does value-based management affect the management control system?

In-depth interviews were carried out in 16 German companies of the automotive industry. Interviewees were OEMs and suppliers in the automotive sector. The companies that are represented in these segments can be assumed to be intensely engaged with the questions surrounding value-based management. The selection criteria for the survey were revenue, employees, and regional relevance of the respective companies. This resulted in a baseline total of 16 companies for the study, 11 of which participated in the survey. The interviewed companies were clustered into OEMs and suppliers. In cluster 1 the most well-known German OEMs were selected for interviews based on revenues. Also in cluster 2 the most important suppliers were selected regarding the revenues. The response rate of 68.75% is extremely satisfying. It should also be noted that the OEMs surveyed represented almost the entire sector in Germany.

Table 2: Survey response rate

	Response	**Response %**
OEMs	4 of 6	66.67
Suppliers	7 of 10	70.00
Total	11 of 16	68.75

Source: Author's own illustration

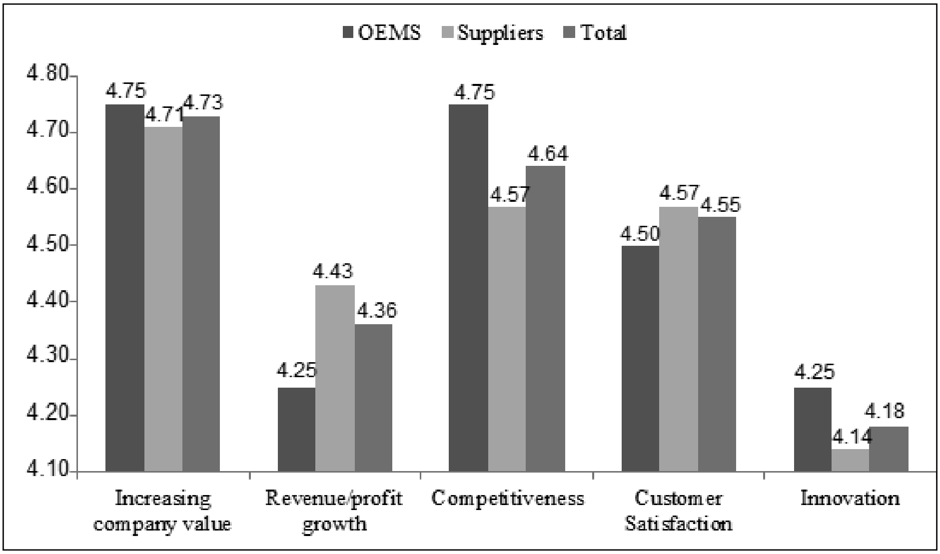
The aim of these interviews was to find out how value-based management improves automotive company's performance. After analyzing and interpreting the data, surprisingly, the results do not confirm the significant improvements through value-based management in all aspects as assumed, especially not at strategy development and the power of decision.

For the purpose of examining the research questions, a poll was chosen using a standardized questionnaire guideline, in order to include as many automotive companies as possible within a manageable period of time, and to thus gain a broad overview of the status and the factors influencing a value-based management of the company. The questionnaire was developed in different processing stages (Lamnek 2010, p. 349), and according to more recent macro-economic theory, as well as current national and international literature on the subject of value-based management. The questionnaire was subsequently put through a preliminary test in September of 2013, in the context of which interviews were conducted with five scientific and practical experts (Helfferich 2009, pp. 182-185). Following this, after the adaptation/revision of the interview guideline, data collection was conducted in a period from October to December 2013. Interviewees were departmental heads, such as Chief Controllers. The interview guideline was conceived to result in a complete as possible picture of the implementation status of value-based management in the automotive sector. The interviews are problem-oriented, with open, semi-structured questions (Mayring 2002, p. 67). The interviews allow the interviewee to speak as freely as possible, but with a focus on the research subject, which the interviewer explains at the beginning of the interview.

4. Analysis and discussion

Depending on company conditions, these are subject to various influences. The questions under "Relevance of value-orientation as corporate objective" were originally focused on the primary corporate objectives and target groups. Seven of the 11 companies regard the increase of company value as their primary corporate objective. Overall, this objective is in first place, with an average relevance of 4.73 points. Among the OEMs, however, first place is shared between increasing the company value and competitiveness.

Figure 1: Primary corporate objectives (answers are on a scale of 1 "not relevant" to 5 "very relevant")

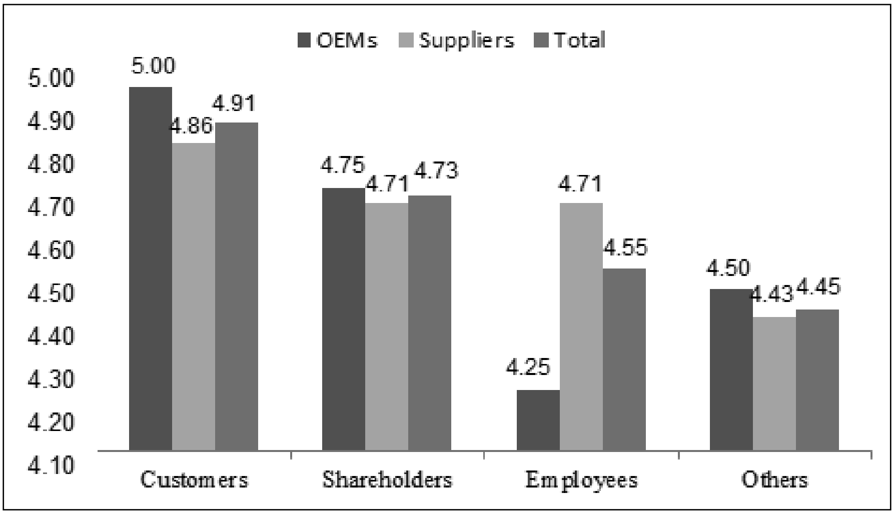


Source: Author's own illustration

When asked about the primary corporate objective, interviewees frequently emphasized that the corporate objective was in safeguarding all interests. This is a strong indication of the presence of the stakeholder perspective in German automobile companies. Furthermore, the companies state that the control of operative areas is important.

In the questions about corporate target groups, it becomes evident that the customer target group is weighted higher than the shareholder group (e.g. stockholders). One obviously wants to maintain a strong focus on the interests of other stakeholders.

Figure 2: Corporate target groups



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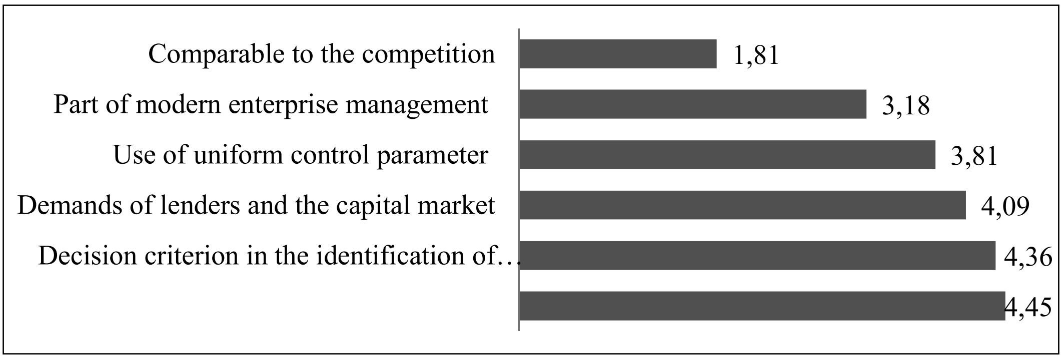
The question about factors relevant to the introduction of a value-oriented management system resulted in the following figure.

Figure 3: Relevant factors for the introduction of value-based management (weighted average number)



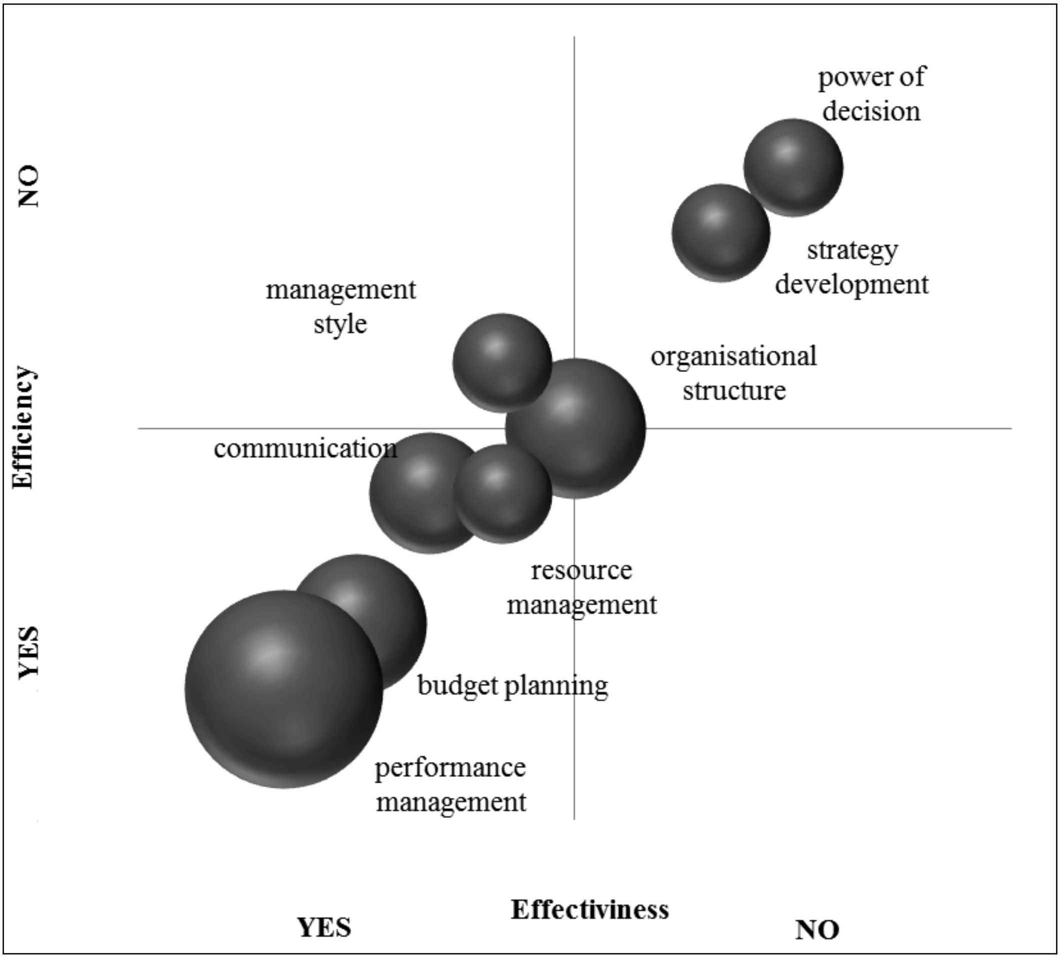
Source: Author's own illustration

The majority of companies acknowledge that the implementation of value-based management resulted in an efficient allocation of capital, and thereby to an increase of company value. External factors, such as the demands of lenders and the capital market for high rates of return may be relevant, but are not decisive to the implementation of a comprehensive shareholder value-orientation.

To the question "What has value-based management achieved in your company thus far", companies responded that above all, the level of confidence in value reporting has been increased. This has created a standard for success that is less vulnerable to manipulation, and which can be used as a comparative factor in the international context. Furthermore, it has resulted in opportunities to synchronize the internal and external accounting organizations, thereby creating a uniform and consistent data basis and control foundation.

Regarding the aspect of the affetctiveness of value-based management control systems the companies gave following answers:

Figure 4: Affected characteristics of value-based management control systems



Source: Author's own illustration

The interview partners also gave the range of importance (scale: 4 very important to 1 not important) of affected characteristics of value-based management control systems. The importance factor is shown in the figure 4 in the size of the bubble. Figure 4 shows that the most important aspect of value-based management for the interviewees is the performance management. At the second place the budget planning and organizational structure was mentioned. Communication was ranged with the third place and at least the management style, resource management, strategy development and decision power.

The following conclusions can be drawn: The companies apply predominantly flat, decentralized structures. Such structures make it possible to calculate value creation for separate entities within their own responsibilities, related to their activities. The participated centralized companies are still fairly flat. However, with value-based management it does decentralize certain responsibilities as appears from the figure above. Targets are set lower into the organization in line with the value-based strategy. Companies became more businesslike upon value-based management, instead of consensus seeking. Decision rights lie at decentralized level. Business units have autonomy in making decisions without approval from the Board of Management (unless it concerns amounts above a certain level). Communication is based on dialogues. Previously, communication was predominantly top-down, where lower entities were only executing corporate directives. Strategy development is based on value creation and involves lower hierarchical levels. Resources are managed and assigned to the most value-adding activities, based on strategic plans and budgets. This counts for financial resources, but also for human resources. Resources and capabilities are therefore applied to those activities that show the most value creating potential. This implies that activities are divested in case they do not fit the business model or create insufficient value. The resources that are released or received are subsequently allocated to value creating activities. Budgeting still is an important instrument, but rooted in value creation and plans that follow from dialogues. Value drivers and non-financials have impact on the amounts, strongly related with strategy. In order to be able to respond quicker to changing circumstances in the company's environment and have managers enact proactively and entrepreneurial. In most cases, performance measurement has extended financial measures with (nonfinancial) value drivers. These are based on accountability and controllability. At some companies performance measurement also includes personal development, for instance by encouraging taking risks or personal objectives.

Surprisingly, the results by testing the hypothesis "Value-based management improves automotive companies' performance" do not confirm the significant improvements through value-based management in all aspects as assumed, especially not at strategy development and the power of decision. These results, in general, fail to support hypothesis "Value-based management improves automotive companies' performance". However, the result shows that the most of the interviewed companies dedicate that the implementation of value-based management resulted in an efficient allocation of capital, and thereby to an increase of company value. Interesting is that external factors as the demands of lenders and the capital market may be relevant for high rates of return, but are not decisive to the implementation of value-based strategy. It is conspicuous that value-based management control system has no positive effect to the power of decision, strategy development and management style. It seems that there came little support from the top management. Nevertheless, especially the internal communication is equitably top-down. Planning system is still an important part in a company. Value drivers and non-financials have impact on the amounts, strongly related with strategy. To respond quicker to changing circumstances in the company's environment and have managers enact proactively and entrepreneurial, in most cases, performance measurement has extended financial measures with (nonfinancial) value drivers. These are based on accountability and controllability.

5. Conclusion

Value-based management is a quest for prosperity and profit for both the employees and of course for the shareholders. Although putting a value-based management system in place is a long and complex process, successful efforts share a number of common features.

This paper focused on the effects of the implementation of value-based management particular reference to German automotive companies. A general review was conducted of different improvement of automotive companies' performance through value-based management. Using in-depth interviews to study the investment evaluation practice in German automotive companies produced some methodological findings. According the literature value-based management has a positive impact on almost all areas of an organization, especially in management and decision-making. Therefore the decision was to test the hypothesis "Value-based management improves automotive companies' performance". However, unexpectly the results do not confirm the significant improvements through value-based management in all aspects as assumed, especially not at strategy development and the power of decision. The result help to diagnose the problems of value-based management implementation in failing to achieve the right balance between all actors of agency conflict.

Although, there are some limitations to the current study, this paper has shown avenues for future research. This study can be used as a basis for future studies. A quantitative survey could be prepared and carried out, involving a larger number of companies focusing on the persistence for the last five post-adoption years. Many questions could be rephrased and reformulated, and many important ones added. Finally, research on impact of the value-based management could be worth conducting.

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