



Case Study

Vyaderm Pharmaceuticals

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Case Synopsis

- ❖ CEO introduces Economic Value Added
- ❖ EVA consists of 3 elements: EVA centers, EVA drivers, and an EVA-based incentive program
- ❖ Several stumbling blocks – resistance from senior managers, difficulty of managing large number of EVA centers, and unexpected bonus adjustments
- ❖ Focuses on one business unit
- ❖ Sudden exit of a competitor produces an unexpected one-time ‘windfall’ in earnings
- ❖ Resulting in bonus payout issues(?)



Case Issues?

- ❖ All listed in page 8
- ❖ 2000 EVA for the North American Dermatology division
- ❖ 2000 EVA bonus payout for a manager
- ❖ 2001 EVA and estimated bonus payout for the same manager
- ❖ What would you recommend Mr. Vedrine?



Case Theory

- ❖ EVA is one of the tools that companies use to link their internal profit performance to the expectations of external financial market constituents ...
- ❖ It is a residual income concept ... subtracts shareholders' expected return on capital from company's accounting profit [... also it is a objective measure]
- ❖ Bonus: Emphasis is not on absolute EVA in one year but on **'difference' in EVA** results from year to year
- ❖ Complications: number/type of EVA centers, appropriate accounting adjustments in computing EVA, EVA target, EVA interval, design of EVA bonus bank

| R&D Amortization for EVA Calculation | | all figures in US\$ 000's | | | | Growth Assumed 17% | | |
|--------------------------------------|-------|---------------------------|-------|-------|-------|--------------------|--------|--------|
| | | 1996 | 1997 | 1998 | 1999 | 2000 | 2001E | 2002E |
| R&D as reported in P&L | 10673 | 12487 | 14610 | 17094 | 20000 | 39000 | 27378 | 32032 |
| (5 year amortization) | | | | | | | | |
| 1995 | 2135 | 2135 | 2135 | 2135 | 2135 | | | |
| 1996 | | 2497 | 2497 | 2497 | 2497 | 2497 | | |
| 1997 | | | 2922 | 2922 | 2922 | 2922 | 2922 | |
| 1998 | | | | 3419 | 3419 | 3419 | 3419 | 3419 |
| 1999 | | | | | 4000 | 4000 | 4000 | 4000 |
| 2000 | | | | | | 7800 | 7800 | 7800 |
| 2001 | | | | | | | 5476 | 5476 |
| 2002 | | | | | | | | 6406 |
| | | | | | | | | |
| R&D Amortization Under EVA | 2135 | 4632 | 7554 | 10973 | 14973 | 20638 | 23616 | 27101 |
| Cumulative R&D Expense (P&L) | 10673 | 23160 | 37770 | 54864 | 74864 | 113864 | 141242 | 173274 |
| Less: Cumulative Amortization (E | 2135 | 6767 | 14321 | 25293 | 40266 | 60904 | 84521 | 111622 |
| Capitalized R&D for EVA Calculat | 8538 | 16393 | 23449 | 29571 | 34598 | 52960 | 56721 | 61652 |

| Advertising Amortization Schedule for EVA | | | Growth Assumed 10% | | |
|-------------------------------------------|------|------|--------------------|-------|-------|
| | 1998 | 1999 | 2000 | 2001E | 2002E |
| Advt. as reported in P&L | 41 | 45 | 50 | 55 | 61 |
| (3 year amortization period) | | | | | |
| 1996 | 11 | | | | |
| 1997 | 13 | 13 | | | |
| 1998 | 14 | 14 | 14 | | |
| 1999 | | 15 | 15 | 15 | |
| 2000 | | | 17 | 17 | 17 |
| 2001 | | | | 18 | 18 |
| 2002 | | | | | 20 |
| | | | | | |
| Advt. Amortization Under EVA | 38 | 41 | 45 | 50 | 55 |
| Cumulative Advt. Expense (P&L) | 113 | 158 | 208 | 263 | 324 |
| Less: Cumulative Amortization (E | 73 | 114 | 159 | 209 | 265 |
| Capitalized Advt. for EVA Calcula | 40 | 44 | 49 | 54 | 59 |

| EVA Calculation for Dermatology Division | | Growth Assumed 18% | | |
|-------------------------------------------------|---------------|---------------------------|---------------|---------------|
| all figures in US\$ 000's | 1999 | 2000 | 2001E | 2002E |
| NOPAT | | | | |
| Net Income Before Tax | 20000 | 51000 | 27848 | 32861 |
| R&D Expense | 20000 | 39000 | 27378 | 32032 |
| 1. R&D Adjustment | -14973 | -20638 | -23616 | -27101 |
| Advertising Expense | 45 | 50 | 55 | 61 |
| 2. Advertising Adjustment | -41 | -46 | -50 | -55 |
| 3. Goodwill Amortization | 2500 | 2500 | 2500 | 2500 |
| Net Operating Profit Before Tax | 27531 | 71866 | 34115 | 40298 |
| Current Year Income Tax Payment | 7875 | 18725 | 10622 | 12376 |
| Net Operating Profit After Tax | 19656 | 53141 | 23493 | 27922 |

Taxes = 35% of (PBT + Goodwill Amortization)

**EVA Calculation for Dermatology Division****Growth Assumed 18%**

all figures in US\$ 000's

1999**2000****2001E****2002E****Capital****Net Operating Assets****110000****135000****153164****180734****1. Capitalized R&D****34598****52960****56721****61653****2. Capitalized Advertising****44****48****53****59****3. Accumulated Goodwill Amortization****7500****10000****12500****15000****Capital****152142****198008****222438****257446****Capital Charge (11%)****-16736****-21781****-24468****-28319****Economic Value Added****2920****31360****-975****-397**

| EVA Bonus Calculation for Division Manager | | | | |
|---------------------------------------------------|------------------|-------------------|-------------------|-------------------|
| | 1999 | 2000 | 2001E | 2002E |
| | Old Model | EVA Year 1 | EVA Year 2 | EVA Year 3 |
| Economic Value Added | 2920 | 31360 | -976 | -397 |
| EVA Improvement Goal | | 2150 | 2150 | 2150 |
| EVA Target | | 5070 | 33510 | 1174 |
| Interval | | 12000 | 12000 | 12000 |
| Actual EVA Improvement | | 28440 | -32336 | 579 |
| EVA Performance (%) | | 319.1% | -187.4% | 86.9% |
| North American Managers Bonus | | | | |
| Basic Salary | | 200000 | 200000 | 200000 |
| Target EVA Bonus (60% of Basic) | | 120000 | 120000 | 120000 |
| Starting Bank Balance | | 0 | 131450 | -93410 |
| 1. Calculated Bonus | | 382900 | -224860 | 104290 |
| New Bank Balance | | 382900 | -93410 | 10880 |
| Payout 100% of available Target | | 120000 | 0 | 10880 |
| Plus 50% Remaining Bank Balance | | 131450 | 0 | 0 |
| 2. Total Bonus Payout | | 251450 | 0 | 10880 |
| Ending Bank Balance | | 131450 | -93410 | 0 |



Discussion

- ❖ Why Mr. Vedrine has chosen to implement an EVA system?
- ❖ It introduces balance sheet accountability to managers
- ❖ The cumulative bonus bank feature is a feature to support long-term focus
- ❖ Should give full bonus for FY 2000
- ❖ OR, propose modification of the EVA program
- ❖ Motivation effects of the windfall in 2000 and negative EVA in the foreseeable future



Organizational Design Issues

- ❖ EVA center feasible only if each center has its own balance sheet (... often ... lower levels do not have)
- ❖ Artificially constructing balance sheet runs into problems of asset allocation of shared resources, transfer pricing, and currency fluctuations
- ❖ So reduce from 15 to 4
- ❖ Responsive measures: measures over which they have day-to-day control
- ❖ So, Mr. Verdines goal of single global EVA center is questionable

| EVA Bonus Calculation for Division Manager | | Experimenting | | |
|---------------------------------------------------|-------------|----------------------|---------------|---------------|
| | 1999 | 2000 | 2001E | 2002E |
| Economic Value Added | 2920 | 31360 | -976 | -397 |
| EVA Improvement Goal | | 2150 | 2150 | 2150 |
| EVA Target | | 5070 | 33510 | 1174 |
| Interval | | 25000 | 25000 | 25000 |
| Actual EVA Improvement | | 28440 | -32336 | 579 |
| EVA Performance (%) | | 205.2% | -37.9% | 93.7% |
| North American Managers Bonus | | | | |
| Basic Salary | | 200000 | 200000 | 200000 |
| Target EVA Bonus (60% of Basic) | | 120000 | 120000 | 120000 |
| Starting Bank Balance | | 0 | 63096 | 0 |
| 1. Calculated Bonus | | 246192 | -45533 | 112459 |
| New Bank Balance | | 246192 | 17563 | 112459 |
| Payout 100% of available Target | | 120000 | 17563 | 112459 |
| Plus 50% Remaining Bank Balance | | 63096 | 0 | 0 |
| 2. Total Bonus Payout | | 183096 | 17563 | 112459 |
| Ending Bank Balance | | 63096 | 0 | 0 |