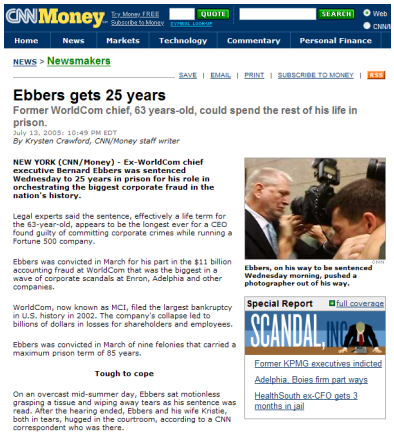
Two Goals of the CEO

- Provide Shareholder Value
- …and stay out of jail



CNN Money

Home | News | Markets | Technology | Commentary | Personal Finance

NEWS > Newsmakers

SAVE | EMAIL | PRINT | SUBSCRIBE TO MONEY | RSS

Ebbers gets 25 years

Former WorldCom chief, 63 years-old, could spend the rest of his life in prison.

July 13, 2005: 10:49 PM EDT
By Krysten Crawford, CNN/Money staff writer

NEW YORK (CNN/Money) - Ex-WorldCom chief executive Bernard Ebbers was sentenced Wednesday to 25 years in prison for his role in orchestrating the biggest corporate fraud in the nation's history.

Legal experts said the sentence, effectively a life term for the 63-year-old, appears to be the longest ever for a CEO found guilty of committing corporate crimes while running a Fortune 500 company.

Ebbers was convicted in March for his part in the $11 billion accounting fraud at WorldCom that was the biggest in a wave of corporate scandals at Enron, Adelphia and other companies.

WorldCom, now known as MCI, filed the largest bankruptcy in U.S. history in 2002. The company's collapse led to billions of dollars in losses for shareholders and employees.

Ebbers was convicted in March of nine felonies that carried a maximum prison term of 85 years.

Tough to cope

On an overcast mid-summer day, Ebbers sat motionless grasping a tissue and wiping away tears as his sentence was read. After the hearing ended, Ebbers and his wife Kristie, both in tears, hugged in the courtroom, according to a CNN correspondent who was there.

Ebbers, on his way to be sentenced Wednesday morning, pushed a photographer out of his way.

Special Report full coverage

SCANDAL, INC.

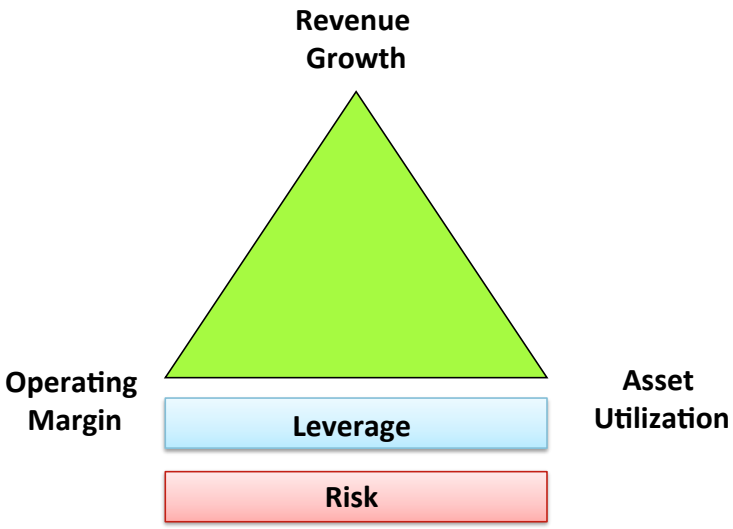
Former KPMG executives indicted

Adelphia: Boies firm part ways

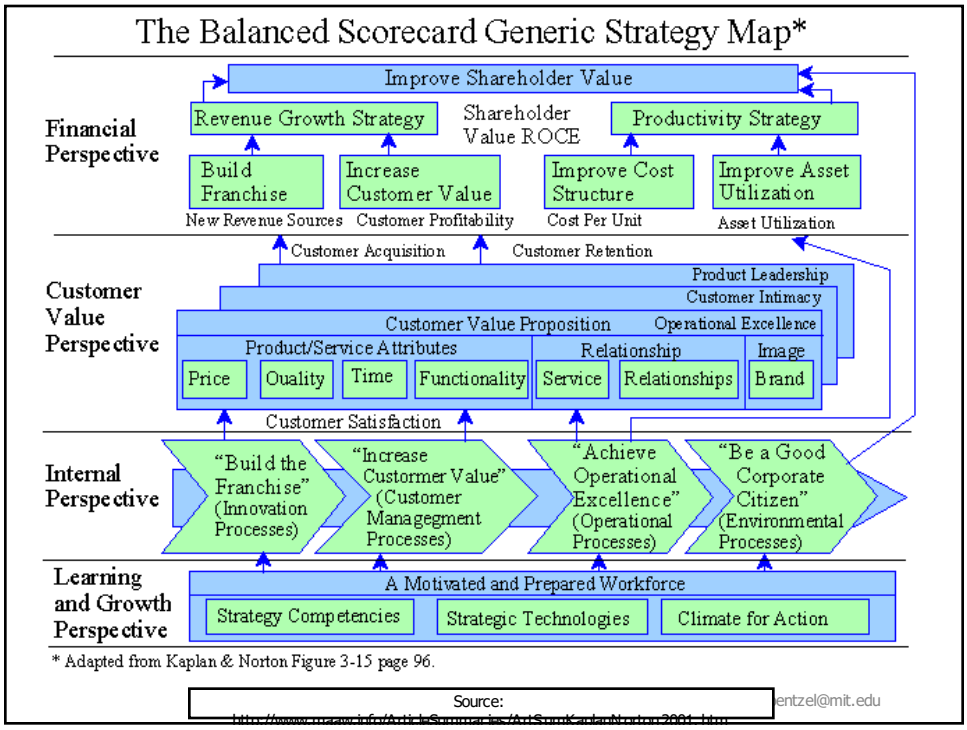
HealthSouth ex-CFO gets 3 months in jail

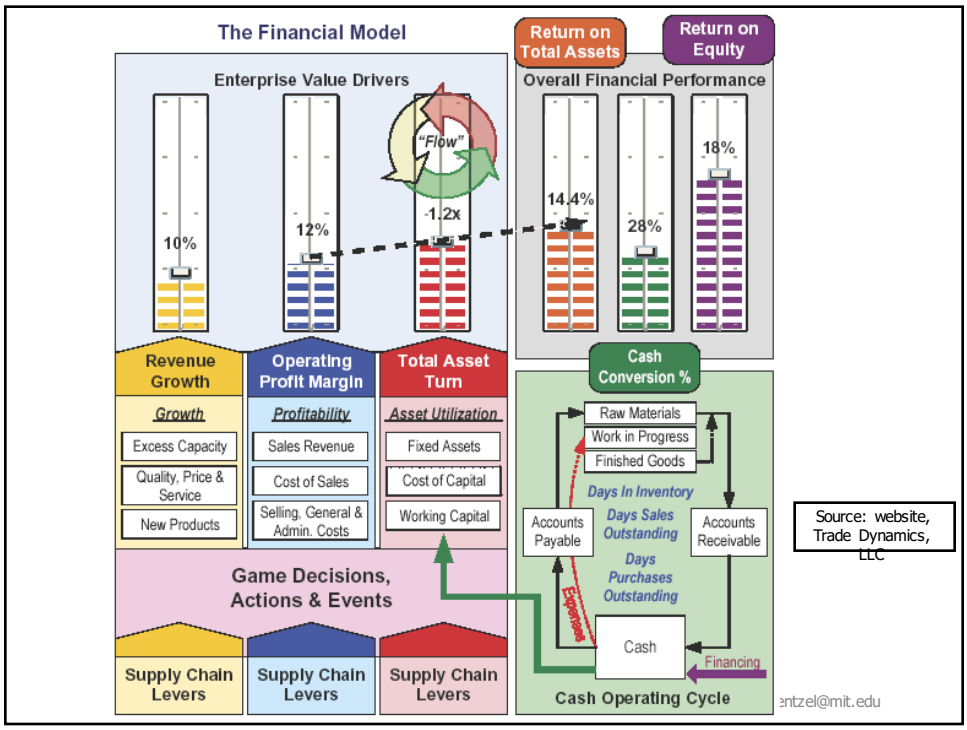
Jarrod Goentzel goentzel@mit.edu

Drivers of shareholder value

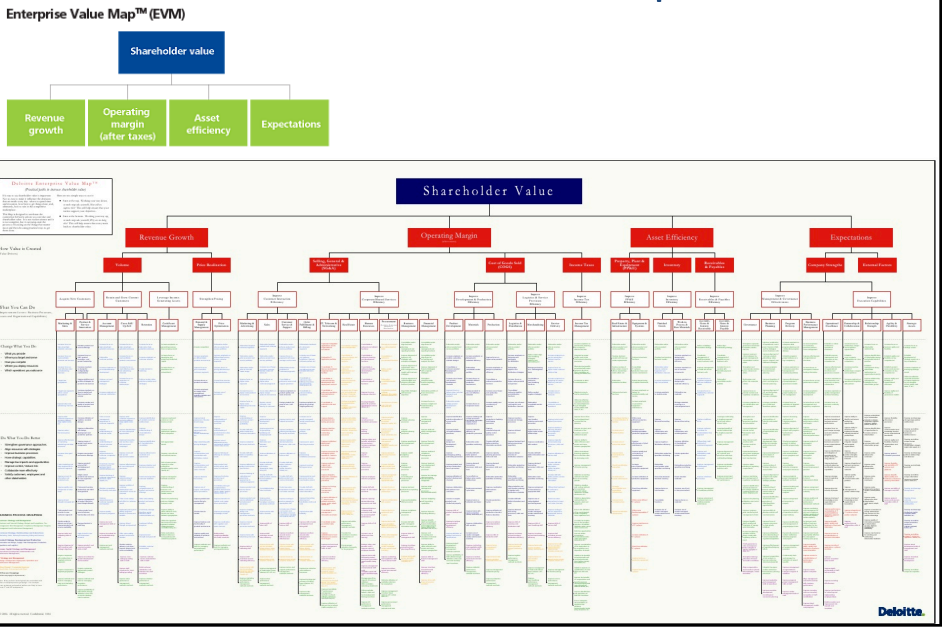


Jarrod Goentzel goentzel@mit.edu

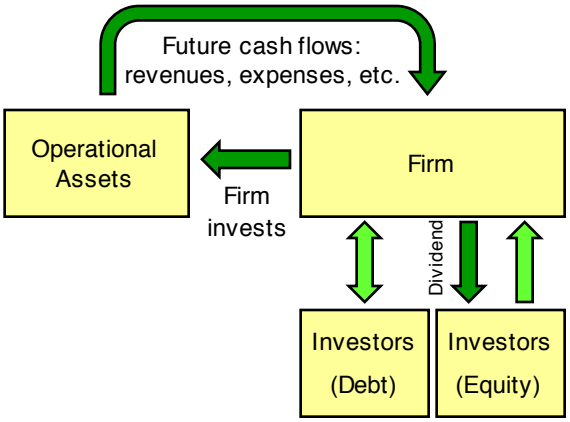

The Balanced Scorecard Generic Strategy Map*
Improve Shareholder Value
Financial Perspective
Revenue Growth Strategy
Shareholder Value ROCE
Productivity Strategy
Build Franchise
Increase Customer Value
Improve Cost Structure
Improve Asset Utilization
New Revenue Sources
Customer Profitability
Cost Per Unit
Asset Utilization
Customer Acquisition
Customer Retention
Customer Value Perspective
Product Leadership
Customer Intimacy
Customer Value Proposition
Operational Excellence
Product/Service Attributes
Relationship
Image
Price
Quality
Time
Functionality
Service
Relationships
Brand
Customer Satisfaction
Internal Perspective
"Build the Franchise" (Innovation Processes)
"Increase Custormer Value" (Customer Managegment Processes)
"Achieve Operational Excellence" (Operational Processes)
"Be a Good Corporate Citizen" (Environmental Processes)
Learning and Growth Perspective
A Motivated and Prepared Workforce
Strategy Competencies
Strategic Technologies
Climate for Action
* Adapted from Kaplan & Norton Figure 3-15 page 96.
Source:
entzel@mit.edu


The Financial Model
Return on Total Assets
Return on Equity
Enterprise Value Drivers
Overall Financial Performance
"Flow"
10%
12%
1.2x
14.4%
28%
18%
Revenue Growth
Operating Profit Margin
Total Asset Turn
Cash Conversion %
Growth
Profitability
Asset Utilization
Excess Capacity
Quality, Price & Service
New Products
Sales Revenue
Cost of Sales
Selling, General & Admin. Costs
Fixed Assets
Cost of Capital
Working Capital
Raw Materials
Work in Progress
Finished Goods
Days In Inventory
Accounts Payable
Days Sales Outstanding
Accounts Receivable
Days Purchases Outstanding
Expenses
Cash
Financing
Cash Operating Cycle
Game Decisions, Actions & Events
Supply Chain Levers
Supply Chain Levers
Supply Chain Levers
Source: website, Trade Dynamics, LLC
entzel@mit.edu

Deloitte Enterprise Value Map



Finance and supply chain work together to create shareholder value



Operations / supply chain: use funds to generate returns

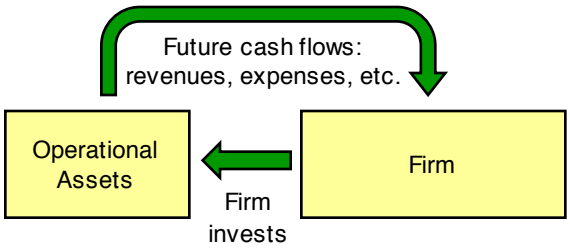
Finance: allocate funds

Finance: acquire funds

Jarrod Goentzel goentzel@mit.edu

Investment evaluation

1. Estimate the relevant cash flows
2. Calculate a figure of merit for the investment
3. Compare the figure of merit to an acceptance criterion



Jarrod Goentzel goentzel@mit.edu

What is a relevant cash flow?

1. Cash Flow Principle:

   only cash flows where *money moves* in or out of the firm are relevant

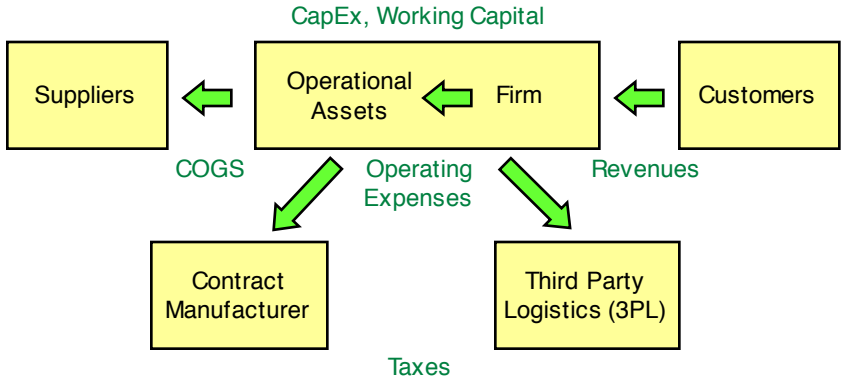
2. With-Without Principle:

   only cash flows that are different (incremental) *with* the investment than *without* the investment are relevant to the decision

Jarrod Goentzel goentzel@mit.edu

Projected, relevant cash flows in the SC

Use incremental financial statements to capture the projected, relevant cash flows and calculate FCFs



Jarrod Goentzel goentzel@mit.edu

Incremental Income Statement

Revenue
Cost of goods sold (COGS)
GROSS INCOME
Operating expenses
OPERATING INCOME (EBITDA)
Depreciation & amortization
OPERATING INCOME (EBIT)
Interest expense
Other non-operating expenses/income
Income taxes
Extraordinary items
NET INCOME

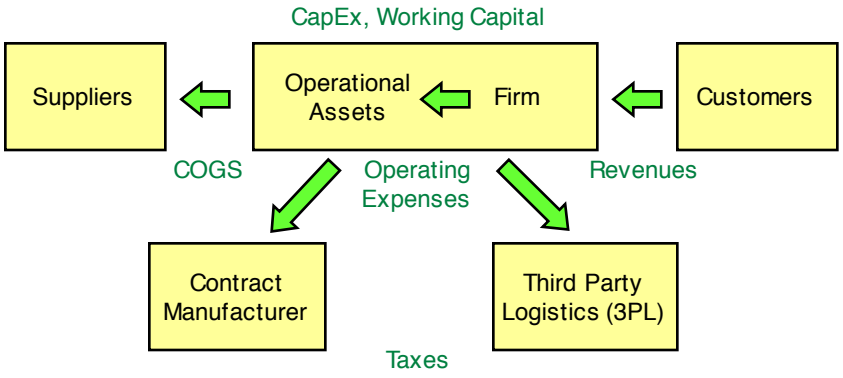
Revenue
Cost of goods sold (COGS)
GROSS INCOME
Operating expenses
OPERATING INCOME (EBITDA)
Depreciation & amortization
OPERATING INCOME (EBIT)
Income taxes
Net Operating Profit After Taxes (NOPAT)

$$NOPAT_t = EBIT_t - TaxRate \times EBIT_t$$
$$= (1 - TaxRate) \times EBIT_t$$

Relevant cash flows from the Income Statement:
$NOPAT_t + DA_t$

Jarrod Goentzel goentzel@mit.edu

Incremental Balance Sheet



Relevant cash flows from the Balance Sheet:

$CapEx_t$, $\Delta NetWorkingCapital_t$

Jarrod Goentzel goentzel@mit.edu

Free cash flows

$$FCF_t = NOPAT_t + DA_t - CapEx_t - \Delta NetWorkingCapital_t$$

$$FCF_t = \left[(1 - TaxRate) \times EBIT_t\right] + DA_t - CapEx_t - \Delta NetWorkingCapital_t$$

Incremental Income Statement	Year 0	Year 1	Year 2	Year 3
Revenue				
- COGS				
= Gross Income				
- Operating Expenses				
= Operating Income (EBITDA)				
- Depreciation & Amortization				
= Operating Income (EBIT)				
- Income Tax				
= Net Operating Profit After Taxes (NOPAT)				
Adjustments				
+ Depreciation (not a cash flow)				
- Net Capital Expenditures				
- Net Working Capital Investment				
Free Cash Flow				

Net Present Value – NPV

- Figure of Merit: The discounted sum of all cash flows including the initial outlay (time 0)
- Acceptance Criterion: Invest if NPV > 0
  + Theoretically sound and widely used
  - Difficult to determine the correct discount or interest rate

Jarrod Goentzel goentzel@mit.edu

Example: White Nile

- White Nile, an online retailer, is considering a new warehouse for better home delivery service
- What are the relevant cash flows?
  - New warehouse and equipment (Cap Ex) 5,000,000
  - More sales from the better service (Revenue) 6,000,000
  - Warehouse labor (Operating Expense) 400,000
  - Lower transportation cost (Operating Expense) -200,000
  - More inventory (Working Capital) 600,000
  - COGS (gross margin is 25%) 4,500,000
  - Depreciation (10 years, straight line) 500,000
  - Salvage (book value after 3 years) 3,500,000
  - Income tax (30% of net income) TBC

Assume no inflation

Jarrod Goentzel goentzel@mit.edu

Incremental Income Statement	Year 0	Year 1	Year 2	Year 3
Revenue	$ -	$ 6,000	$ 6,000	$ 6,000
increased sales from better service		*$ 6,000*	*$ 6,000*	*$ 6,000*
- COGS	$ -	$ 4,500	$ 4,500	$ 4,500
increased COGS from those sales		*$ 4,500*	*$ 4,500*	*$ 4,500*
= Gross Income	$ -	$ 1,500	$ 1,500	$ 1,500
- Operating Expenses	$ -	$ 200	$ 200	$ 200
lower transportation cost		*$ (200)*	*$ (200)*	*$ (200)*
warehouse operations		*$ 400*	*$ 400*	*$ 400*
= Operating Income (EBITDA)	$ -	$ 1,300	$ 1,300	$ 1,300
- Depreciation & Amortization	$ -	$ 500	$ 500	$ 500
warehouse & equip depreciation line item (positive values)		*$ 500*	*$ 500*	*$ 500*
= Operating Income (EBIT)	$ -	$ 800	$ 800	$ 800
- Income Tax	$ -	$ 240	$ 240	$ 240
= Net Operating Profit After Taxes (NOPAT)	$ -	$ 560	$ 560	$ 560
Adjustments				
+ Depreciation (not a cash flow)		$ 500	$ 500	$ 500
- Net Capital Expenditures	$ 5,000	$ -	$ -	$ (3,500)
new warehouse & equipment	*$ 5,000*			
salvage warehouse & equipment				*$ (3,500)*
- Net Working Capital Investment	$ 600	$ -	$ -	$ (600)
+ Net Increase in Accounts Receivable				
+ Net Increase in Inventory	*$ 600*			*$ (600)*
- Net Increase in Accounts Payable				
Free Cash Flow	**$ (5,600)**	**$ 1,060**	**$ 1,060**	**$ 5,160**

Free cash flows for investment decisions

Why consolidate various line item cash flows from your investment/project into FCFs?

- An incremental Income Statement confounds various cash flows in a consistent way, e.g. revenue growth and margin growth
- It applies Income Tax once in an effective way
- Business professionals are accustomed to reading Income Statements
- Investor value is driven by free cash flows

Jarrod Goentzel goentzel@mit.edu

Supply chain cash flows

- It is important to describe your supply chain design in terms of cash flows
- The evaluation of your supply chain initiative (for internal budgets, by external investors) is based on the future free cash flows it creates
- It is challenging but critical to determine which cash flows are relevant
  - Cash must flow
  - Cash flows must be incremental (with or without)
- Consolidate the projected, relevant cash flows into free cash flows
  - FCFs effectively confound various line items in magnitude and timing
  - FCFs align with investor value creation and business professional practice
- Don't forget the balance sheet
  - Capital expenditures are infrequent but high magnitude
  - Net changes in working capital requirements from the previous period define critical cash flows in our supply chain designs (they often make or break it)
- This lesson does not make you an expert, but it enables you to
  - engage with accounting and finance colleagues to confirm your numbers
  - define the basis for investment/budget decisions

Jarrod Goentzel goentzel@mit.edu