EVA: An Effective Tool for Measuring Performance

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Abstract

In a time where corporations measure performance and wealth creation based on accounting principles, this study explored the effectiveness of an economic measure of performance known as Economic Value Added (EVA). This paper examined the importance of corporate governance and EVA, the importance of ethics in the creation of shareholder wealth, the benefits of using EVA as an internal control tool for the decision-making process and evaluating performance, and the profitability of ethics. In addition it compared EVA with other profitability measures, discussed how to successfully implement ethics, and concluded with a summary of the effectiveness of EVA as an internal control tool in corporate governance.
EVA: An Effective Tool For Measuring Performance

In recent years, investors and shareholders have become increasingly concerned with the actual shareholder wealth that is created by a company. Some companies, such as Enron, have shown a complete lack of concern for the shareholder in recent years by making short-term decisions that do not focus on wealth creation. Because companies gain most of their capital through investments of various individuals and other companies, it is the company’s duty to provide an adequate and respectable return on investment to shareholders by making wise long-term decisions. However, most companies are using traditional standards for measuring value that fail to measure the actual creation of shareholder wealth. In light of this, Stern Stewart & Co. (2006) created a standard known as Economic Value Added, which, according to Stewart, is the best standard for measuring the creation of shareholder wealth. This paper first examines the importance of corporate governance and EVA.

The Importance of Corporate Governance and EVA

In a time where acts of corporate fraud and illegal accounting measures have left a seemingly irremovable stain on corporations, corporate governance has never been more important in assuring the creation of shareholder wealth as well as the overall well-being of corporations in general. Corporate governance is one of the major ways a board can protect the investors and stakeholders of a company. Because of this, corporate governance is a central issue in business today and must be understood when considering adopting EVA in a corporation.
Corporate Governance

Corporate governance may be defined as “the relationship between a corporation and its shareholders,” but more explicitly, defined as “the system by which business corporations are directed and controlled” (Cross & Miller, 2007, p. 658). It can be argued that there are four main components of corporate governance: legal and regulatory systems, product and factor markets, external control systems, and internal control systems. Internal control systems include executive compensation, stock options, actions of the board, or anything that seeks to align officers’ desire for personal gain with the similar interests of shareholders (O’Connor, Priem, Coombs, & Gilley, 2006). Corporate governance is important because the owners of the company, comprised mainly of shareholders, are separated from the control of the company, which is carried out through various officers and directors. Because the ownership of a corporation is separate from its control, directors and officers need to be monitored in some way to assure that the shareholders are not being cheated. Directors and officers owe both legal and ethical duties to the corporation and the shareholders (Cross & Miller, 2007). These duties can be broken down to include a duty of care and a duty of loyalty. Ultimately, corporate governance defines the relationship between the ownership (shareholders) and the control (officers and directors) of a corporation. Thus, the main purpose of corporate governance is to monitor the officers and directors. It may involve audited reporting of financial conditions and legal protections for shareholders. These two factors ensure a fair evaluation of the officers and directors and provide punishment for those who take advantage of the shareholders (Cross & Miller, 2007).
Corporate Governance and EVA

In a study of the practical significance of effective corporate governance, researchers found that companies offering greater shareholder rights had higher profits, higher sales growth, and higher firm value among other economic advantages (Gompers, Ishii, & Metrick, 2003). One outstanding way of implementing internal controls is through the adoption of EVA, the performance measure “most directly linked to the creation of shareholder wealth over time” (Stern Stewart & Co., 2006, ¶ 1). The adoption of EVA as a standard for internal controls, in addition to the use of regulations, would make for an effective and motivating tool for corporate governance. EVA is “a measure of residual income, which focuses on the concept that a company must earn an adequate risk-adjusted return on its investment in assets” (Beneda, 2004, ¶ 3). The purpose of EVA is to report more than an earnings per share figure by evaluating the adequacy of profits a corporation has made in comparison to the capital it has employed to reach that position. EVA is helpful because “the primary financial objective of any company should be to maximize the wealth of its shareholders” (Stern Stewart & Co., 2006, ¶ 5).

EVA also seeks to evaluate the return shareholders are receiving compared to what they should receive by accepting the risk involved. Essentially, \( EVA = NOPAT - (\text{Capital} \times \text{Cost of Capital}) \). Another formula for calculating EVA is \( (\text{NOPAT} - \text{WACC}) \times \text{Operating Assets in Place} \). NOPAT is the net operating profit after taxes; WACC is the weighted average cost of capital; and Operating assets in place “represents the amount of capital invested in the company’s existing operating assets” (Beneda, 2004, ¶ 6). In an article on ethics and corporate governance, Adi Godrej, chairman of Godrej Group, notes that corporate governance is about doing what is right for both the company and the
shareholders (The Hindu Business Line, 2003). When asked about EVA, he replied, “When we adopted a remuneration system where employees were remunerated based on the EVAs that would be created, we experienced a profit of 130 per cent in those businesses in the first year” (The Hindu Business Line, ¶9).

The Importance of Ethics in the Creation of Shareholder Wealth

In a profession where maximizing profits has become more important than maximizing shareholder wealth, corporations have continually lost sight of the importance and value that morals and ethics have in the decision making process. Ethics may be defined as “the branch of philosophy concerned with the evaluation of human conduct” (Kemerling, 2006, Section E). Morals may be defined as “distinction[s] between types of value, judgments, or propositions” (Kemerling, 2006, Section M). Examples of the diminishing value of ethics in business may be seen in various case studies conducted due to specific ethical issues. One valuable case that has been studied and discussed for many years is the Ford Pinto Case, a case that examines the ethics of the cost-benefit analysis. An examination of the Ford Pinto Case, with a specific focus on the cost-benefit analysis, will help raise the awareness of, and bring a greater understanding of, the diminishing value of ethics in the business world today. This section of the paper examines the ethical and moral issues involved in the decisions Ford made and demonstrates that the majority of businesses care more about profits rather than maximizing shareholder wealth. This section will also show the results of the diminishing value of ethics in the business world today. Finally, this section illustrates how the adoption of EVA may increase the value of ethics in the business world, encouraging the
creation of shareholder wealth through ethical and sound means that may be evaluated by the shareholders.

*The Ford Pinto Case*

In the early 1970s, due to an increasing demand for smaller cars, Ford decided to make the Ford Pinto. According to Lee Iacocca, Chief Executive Officer of Ford at the time, stated, “The Pinto was not to weigh an ounce over 2,000 pounds and not cost a cent over $2,000” (Engineering.com, 2006, ¶ 3). To accomplish this task, Ford produced the Pinto in 25 months rather than the normal 43 months. According to Richard De George, author of the book *Business Ethics*, the accelerated production is the reason Ford did not conduct a rear-end impact test until production was complete. When the test was conducted, Ford engineers found that the gas tank could potentially explode if the car was hit from the rear at a speed of 20 miles per hour or greater (De George, 1995). Ford found that it could solve this problem with the installation of a special baffle piece that would cost anywhere from $6.65 to $11 for each piece. Ford decided to do a cost-benefit analysis to see which would cost more: the expenses resulting from the injuries and deaths that would result from crashes or the cost to replace every Ford Pinto with this special baffle piece.

*Cost-Benefit Analysis*

When Ford conducted the cost-benefit analysis, it analyzed what the potential benefits would be if they fixed every Pinto by installing the baffle piece. According to Hoffman & Moore (1990), Ford estimated that there would be 180 burn deaths, 180 serious burn injuries, and 2,100 burned vehicles. Ford also estimated that each death would cost $200,000, each injury would cost $67,000, and each vehicle $700. Ford’s
process of determining that a human life was worth $200,000 may be found by looking at
the findings of the National Highway Traffic Safety Administration (NHTSA) in
Hoffman & Moore’s *Business Ethics*. Using these estimates, it multiplied the number of
each incident by the cost of the incident and added all three figures. Its final estimate
showed Ford would be saving $49.5 million. When Ford conducted its cost analysis, it
estimated that sales would be 11 million cars and 1.5 million light trucks that would need
this baffle piece. It also estimated the highest possible cost per baffle piece at $11 per
piece. Its final estimate of the costs came to $137 million (Hoffman & Moore, 1990).

When looking at the cost-benefit analysis conducted by Ford, the numbers used
should be clarified for today’s reader to understand. The numbers that Ford came up with
were $49.5 million in benefits and $137 million in costs. Because Ford did this analysis
in 1971, these numbers have a significantly different value today, mainly due to inflation.
Using a 4% average per year for inflation over the last 30 years (Wachovia, 2004), the
benefits that were $49.5 million at the time are now worth $195.3 million and the costs
that were $137 million are now worth $540.6 million. Bringing these numbers up to date
helps today’s reader understand how much money Ford was dealing with when it
conducted its cost-benefit analysis.

The results produced from the cost-benefit analysis may be interpreted to say that
it would have cost Ford $137 million to fix the Pintos by installing the baffle piece when
it would have cost $49.5 million to leave the cars alone and deal with the expenses of
injuries and deaths from the crashes. Ford decided that, because it would be cheaper, it
would not install the baffle piece. According to De George, Ford did not tell the
consumer that the car was not as safe as others, nor did it inform consumers that they had the option of purchasing the baffle piece (De George, 1995).

*Whistle Blowing*

The Ford Pinto case illustrates the moral dilemma faced by the engineers of Ford. As a company, Ford has an obligation to not bring harm to anyone. The question is what is the employee obligated to do to prevent the harming of others from what the company does? Were the Ford engineers morally required to say something? These questions raise the issue of whistle blowing, a term referring to “a wide range of activities that are dissimilar from a moral point of view” (DeGeorge, 1995, p. 223). An example of whistle blowing is when someone reports another employee for some offense done, such as sexual harassment or cheating on expense account. The person who does the reporting is said to blow the whistle on the offender. In this case, external, impersonal whistle blowing is the issue and the motivation considered is a moral motivation because the general public could be at harm. If it is said that whistle blowing is permissible in this situation, there is no obligation on the employee.

Because whistle blowing comes with a risk to the employee, the whistle blower must know whether it is permissible to blow the whistle or if it is morally required of him or her. According to De George (1995), for the employee to be morally required to blow the whistle, “The whistle blower must have, or have accessible, documented evidence that would convince a reasonable, impartial observer that one’s view of the situation is correct, and that the company’s product or practice poses a serious and likely danger to the public or to the user of the product” (p. 235). If the evidence is unavailable, then the whistle blower does not have a moral obligation. The engineers knew that the Pinto was
not safe because they conducted a rear-impact test. This shows that the engineers had proper evidence to support the fact that the Pinto would be dangerous to the public and therefore had a moral requirement to blow the whistle. However, if employees had blown the whistle on Ford, they could have lost their jobs. When one engineer was asked if anyone told Iacocca, Ford's CEO at the time, the engineer responded that the person would most certainly have been fired (Engineering.com, 2006). Congress has attempted to alleviate this problem of discrimination against whistle blowers through a section of the Sarbanes-Oxley Act of 2002 (Sarbanes Oxley Online, 2007).

Although the engineers may have had a moral requirement, it is still debated whether or not Ford was unethical in making the decision it did. Technically, Ford's Pinto conformed to all the current safety standards because there was no rear-impact standard set by the NHTSA. The Pinto was completely safe according to the standards set at the time. But did Ford really care about safety? When asked about safety, one engineer replied, "Safety wasn't a popular subject around Ford in those days. Whenever a problem was raised that meant a delay on the Pinto, Lee would chomp on his cigar, look out the window and say 'Read the product objectives and get back to work'" (Engineering.com, 2006, ¶ 9). Although this statement may seem to show that Ford did not really care about safety as it rushed the production of its Pinto, this is still only the opinion of one engineer. But even so, Ford was producing this car in 25 months rather than the usual 43 (De George, 1995). This may have been done for two reasons: to cut the cost of production and to catch up with the foreign automobile market of subcompact cars. Ford was losing sales because of the new subcompact cars that were being produced in the late 1960s and early 1970s. It needed to come up with something quick and cheap to provide
a product that would give it a larger market share in the automobile industry. So the question is raised, was Ford irresponsible in producing this car so quickly?

**Ethics and the Importance of Shareholder Wealth**

Although its car met the current safety standards, Ford, a company that should care about the safety of its customers and maximizing shareholder wealth, should have either replaced each car with a baffle piece or made consumers aware of the problem and offer them the option of purchasing the baffle piece. Ford knew that this car was unsafe, even though it met the safety standards. Because of Ford’s irresponsibility and lack of concern for maximizing shareholder wealth, the amount it had to pay was estimated to be over $50 million while the amount it saved was estimated at around $21 million.

According to Gitman (2006), author of *Principles of Managerial Finance*, a shareholder (or stockholder) is one of many owners of a corporation where stock shows the amount of ownership. To maximize shareholder wealth, Gitman says, “Financial managers should accept only those actions that are expected to increase share price...Because share price represents the owners’ wealth in the firm, maximizing share price will maximize owner wealth” (p. 13). This is different from profits in the sense that good ethical and moral decisions will affect share price, whereas maximizing profits disregards risk. “Because profit maximization does not achieve the objectives of the firm’s owners, it should not be the primary goal of the financial manager” (p. 13). In addition to looking at the share price, it is also important to look at the economic value added to see the actual shareholder wealth created (or lost).

In light of this information, one can see that Ford’s production of the Pinto was irresponsible because it was not the best decision for creating wealth for the owners of
the company. In fact, in an effort to gain a larger market share and maximize profits, Ford actually hurt the owners of the company. Beyond responsibility, how are ethics involved in maximizing shareholder wealth? According to Gitman (2006), an effective ethics program will give the company a positive image, reduce potential lawsuits, and build loyalty among the shareholders. "Such actions, by maintaining and enhancing cash flow and reducing perceived risk, can positively affect the firm's share price" (Gitman, 2006, p. 16). Therefore, it may be concluded that ethical and moral decisions are essential to maximizing shareholder wealth. Because EVA helps align the interests of executives with the interests of shareholders, the use of EVA in the Ford Pinto case may have led Ford executives to make more ethical decisions to help protect the shareholders and the overall growth of the company.

Although Ford may have been irresponsible in the production of the Pinto, was it unethical in using the cost-benefit analysis? Some have said that the cost-benefit analysis used by Ford was a type of utilitarian calculation. However, this was not a utilitarian calculation and moreover, had a utilitarian calculation been used, Ford would have made a better decision. Utilitarianism may be defined as "an action...promoting the greatest happiness for the greatest number of people" (Foreman, 2002, p. 26). If a utilitarian calculation had been used, the Pinto's effect on all people would have been considered. "An adequate moral utilitarian calculation would include the deaths and the injuries, as well as the inconvenience for all the purchasers, and weigh these factors against the dollars saved" (De George, 1995, p. 226). Not only did Ford have a moral requirement to not harm others, it also had a requirement to act in the best interest of the shareholders. This cost-benefit analysis is not a calculation considering all possible effects on all
people; it was a calculation that placed a monetary value on human life to help the company make its decision. Rather than using the cost-benefit analysis and attempting to place a monetary value on human life, Ford would have been better off looking at the wealth that would be created or lost for the shareholders. If Ford’s executives would have done this, they would have realized the possible loss of wealth due to lawsuits and a bad company image. By looking to the interests of the shareholders, Ford’s executives would have made a more ethical decision in order to maintain shareholder wealth creation rather than looking to increase profits.

Although the use of the cost-benefit analysis has been criticized, using it as a form of assigning monetary value to human lives was the requirement of the law concerning lawsuits at the time (Hoffman & Moore, 1990). So, Hoffman asks, is the NHTSA as responsible as Ford since they allowed them to make the Pinto? If the NHTSA had the test results of the Pinto and knew that it was unsafe, then the answer would be yes. But if the NHTSA was unaware of the test results and only saw that the Pinto passed all current regulations, then the answer would be no. The National Highway Traffic Safety Administration should be completely aware of all cars’ safety ratings, including the Ford Pinto’s rear-impact test results. The NHTSA should have been aware of the Pinto’s safety concerns and should not have allowed Ford to produce it until these safety violations had been dealt with properly. Therefore, the NHTSA still bears some responsibility concerning the Ford Pinto case. Regardless, this case shows that the cost-benefit analysis was not helpful in this situation for the Ford Company or the NHTSA as it disregarded the potential harm to the overall consumer base.
Consequentialism vs. Deontology

What kind of ethical issues are involved in the decision to continue making the Pinto, even though Ford knew the car was unsafe? The main issue at hand is that the Pinto met the current safety regulations for subcompact cars but was a completely unsafe car due to the placement of the gas tank. What was the ethical reasoning for Ford to continue making this car anyway? In general, there are two approaches to ethics: consequentialism, a results oriented approach in which the end justifies the means, and deontology, a rules oriented approach in which the means are self-justifying (Foreman, 2002). The Pinto case shows that Ford used a consequentialistic approach to ethics when it should have used a deontological approach. Using the consequentialistic approach, Ford had a few results in mind. It wanted a larger market share of the subcompact car market, it wanted to maximize profits by keeping costs low, and it was willing to use the cost-benefit analysis to do this. It estimated that producing the Pinto without the baffle piece would benefit them more financially as it kept the cost of the car down. Therefore, because Ford wanted to save money and gain this market share, it was willing to produce the Pinto quickly and irresponsibly, ignoring safety of the consumer and the long term effects on the wealth of the shareholder.

Because this case involved human lives, Ford would have been better off if it had used a deontological approach with a few rules in mind. Ford should have been primarily concerned with maximizing shareholder wealth by way of a concern for the safety of its consumers and by maintaining a good public image rather than saving money. If Ford had been concerned about the shareholder’s wealth, it would have considered the long term effects of making a subcompact car that was not safe for its consumers (Gitman,
2006). It is obvious that the means would be self-justifying in using the deontological approach. In essence, Ford should have been more concerned with the principle than with the results. The principle is simple: decisions should be made in the best interest of the shareholder. The implementation of EVA in this case would encourage a deontological approach since EVA focuses on the shareholder wealth created (or lost). Although it may have seemed to have cost Ford more to install the baffle piece on every Pinto, it was the right thing to do concerning its consumers and shareholders. Even though Ford estimated it would cost it less financially to leave the Pintos alone, that estimate proved to be wrong in the end (DeGeorge, 1995). So Ford did not even attain the results it hoped to achieve by following a consequentialistic approach. So it is not only important for companies to use ethics in business, but it is imperative that businesses use the right kind of ethics. To use the right kind of ethics, companies should add EVA as a tool for evaluation and decision making.

So is the value of ethics diminishing in the business world today? A few specific examples would show that the answer is yes. One example is a 2002 lawsuit filed against American Express by over 4,000 women saying that American Express discriminated based on gender and age. Another example is a 2004 agreement made by KPMG, an auditing firm, which cost it $115 million for failing to accurately audit another company. Another obvious example of the diminishing value of ethics is the Enron Corporation, whose executives told employee-shareholders that the stock price would go up, yet sold their own shares and eventually took the company into bankruptcy (Gitman, 2006). According to information found by Gitman, companies with accounting misdeeds have decreased shareholder wealth from $1.8 trillion to $527 billion due to their misdeeds.
Because companies care more about maximizing profits rather than maximizing shareholder wealth, the SEC has been forced to take steps such as the Sarbanes-Oxley Act to protect the investor.

These major corporate failures in recent years, due to accounting misdeeds, have shown the absence of ethical decision-making. The SEC and Congress have already taken the right steps concerning unethical financial reporting by adopting the Sarbanes-Oxley Act to help protect the investor. They have done so because they realize that a majority of companies do not consider maximizing shareholder wealth to be their primary goal. It seems that one way to increase the value of ethics is to illustrate the poor results and punishment that come from a diminished view of ethics in the decision-making process. It is also important for companies to realize that the primary goal of the business should be to maximize shareholder wealth. If a company adopts EVA as an additional tool, the interests of the executives will be aligned with those of the shareholders. According to Stern Stewart & Co. (2006), a sustained increase in EVA will bring a continual increase in the market value of the company.

After examining the Ford Pinto case and looking at numerous examples of accounting misdeeds, it is apparent that the business world has a diminishing view of the value of ethics. The examination of the Ford Pinto Case, with a specific focus on the cost-benefit analysis, has helped raise the awareness, and brought a greater understanding, of the diminishing value of ethics in the business world today. It is also evident that Ford did not break the law in the decisions it made, but that it was irresponsible and unethical. The examples discussed illustrate that the value of ethics seems to be diminishing in today’s business world and that the results of this have been negative. Essentially, the
Ford Pinto case illustrates that the primary goal of companies should be increasing shareholder wealth, but it often is not. It is evident that the use of EVA would encourage stronger ethics as managers would be focused on the long-term creation of shareholder wealth.

Using EVA as an Internal Control Tool for the Decision-Making Process and Evaluating Performance

When considering the major issues currently facing corporations, the need for an effective internal control tool may be seen when looking at stock options, executive compensation, and the regulatory responses of the government. Because the central objective of the board is to align the interests of officers with the interests of shareholders, most boards have used incentive systems such as stock options in order to motivate officers to do what is best for the company and its shareholders. Executive compensation is also a major concern since many companies' shareholders feel executives are paid too high for the quality job they are doing. In response to these issues, the government has instituted its own changes in order to fix the problems. These changes are also highly important as they have greatly affected the way companies work and how they are held accountable.

Stock Options

One major issue at the heart of corporate governance is the alignment of the interests of officers to those of the shareholders. One main way companies have attempted to solve this problem is by offering employees various forms of stock options. According to the National Center for Employee Ownership, a stock option is “a right issued by a corporation to an individual or an entity to buy a given amount of shares of
company stock at a stated price within a specified period of time” (Johanson, 2005, ¶ 12). Essentially, the officer or employee is receiving a financial stake in the corporation. It follows that if the market price of the stock increases, the employee may exercise his or her stock option and realize a gain. It should be noted that the officers might receive various restrictions on their options concerning when and how they may exercise them.

The theory is that the employee (or officer) that receives the stock options should have incentive to conduct business in a way that will be profitable to the company as well as the shareholders. For the majority of officers that have received stock options, this is the case. However, many officers have seen options as another way to abuse shareholders by either committing accounting fraud (also known as cooking the books) to raise the share price or backdating the options they received to a time when the market price of the stock was much lower. Recent corporate news reveals the disastrous potential of making a company look more profitable than it is: ultimate collapse and failure of the company with little or no compensation for the shareholders. Enron, the widely infamous name associated with accounting fraud, developed a complex network of subsidiaries where it could move debt until it finally went bankrupt and shareholders were left with nothing.

Of all the corporate executive scandals that have occurred in recent years, few have been as highly publicized as the recent stock-options fraud scandals. In August, KB Homes announced an internal investigation due to *The Wall Street Journal* (2006) inquiring about the suspicious timing pattern of grants. It was not long after this announcement that KB Homes’ CEO Bruce Karatz and two other executives, one of whom was the chief legal officer, would be leaving the company due to backdated option grants. Though it may seem odd for a homebuilding company executive to be caught in
this situation, Karatz has quite a high profile with a large amount of compensation coming from options. In 2006, his total compensation was over $150 million, with the majority of this amount coming from options exercises. Since 1992, he has made over $180 million just from exercising options. The problem is that Karatz and one of the other backdating executives were the ones that originally selected the dates for the options without permission from the board. Another problem is that a majority of Karatz’s option grants between 1998 (when the backdating began) and 2001 seemed to be dated on the lowest closing price for the year low, quarterly low, or monthly low. One example includes the 500,000 options he received in 2000 (dated at a monthly low) that were sold for a profit of around $54 million. According to the article, Karatz will soon give up $13 million of excess profit from the backdating to KB Homes. How much Karatz will walk away with, however, depends on the terms of his departure. If he retires, he will retain some of his options. One interesting result from the investigation is KB Homes’ creation of a new “non-executive chairman” position that it is already seeking to fill (The Wall Street Journal, 2006). According to the Fortune 500, KB homes finished 2005 with profits of $842.4 million and its profits were 8.9% of its revenues. Although KB Homes experienced a decrease in stock price, the main injury induced was a large decrease in shareholder confidence (CNN-Money, 2006).

Executive Compensation

The situation with Karatz illustrates the tremendous problems that have accompanied the benefits of offering officers and directors options as an incentive to increase the value of a corporation. According to The Wall Street Journal article (2006), more than 50 executives and directors have lost their jobs because of stock options
scandals and over 130 companies are currently under federal investigation on the matter. Furthermore, the situation shows a failure in the system of internal controls regarding the use of executive compensation as an attempt to align the interests of directors and officers with the interests of the shareholders. Some executives have compensation packages in the hundreds of millions. William McGuire, CEO of UnitedHealth, has a total compensation package valued at $1 billion (Kirkland, 2006). Phil Purcell, CEO of Morgan Stanley, received $66 million in 2004 despite a decline in stock price of 25% over the last five years. In some of these cases, executives have not been paid according to their results. But basing executive compensation on performance is not necessarily the answer either. According to Shawn Tully, *Fortune Magazine* writer (2006), CEOs, who typically receive a bonus based on an increase in earnings per share, may achieve results through short cuts such as “lavishing tons of ‘free’ shareholder capital-chiefly retained earnings-on plants and products that yield low returns, or by borrowing money and earning a bit more than the 5% or 6% interest rate” (Tully, 2006, p. 90).

An adequate solution to these problems is the implementation of more sound regulation in the financial sectors of corporations. From the various examples given, it is apparent that there should be a little more regulation on companies with regards to how they issue stock options, the amount of access the recipients have to those options, and the reporting requirements involved in the issuance of stock options. With these in place, corporations would save themselves a lot of time and a lot of trouble, as corporations are increasingly moving toward shareholder democracy. Another possible solution to these problems is to employ EVA as an evaluation tool to regulate executive compensation and stock options.
Regulations

In response to corporate scandals, Congress passed the Sarbanes-Oxley Act (SOX) in 2002 requiring more corporate accountability from executives. The act addressed corporate governance by providing for certification requirements, which place more responsibility on the executives of the company. Under section 906, CEOs and CFOs must certify that the reports they file with the SEC are in full compliance and are a fair representation of the financial conditions of the company. The act also provides protection for employees that report securities violations by their employers, allows for blackout periods where an issuer’s ability to purchase or sell securities is temporarily suspended, and provides enhanced penalties for violations of the various securities acts (Cross & Miller, 2007). Because this act was passed only a few years ago, its impacts will not be clearly seen for a few more years. One thing that will hopefully result from the act is a decrease in corporate scandals such as Enron.

In contrast to KB Homes’ dramatic picture of corporate governance failure, Citigroup is a perfect picture of a very profitable company that continues to grow in spite of the large amount of regulations it must follow. Citigroup, the largest commercial bank and eighth largest company overall, was the second most profitable Fortune 500 company at the end of 2005 with $24,589 million in profits. Of the top three most profitable companies, two were commercial banks. Citigroup’s profits were 18.8% of revenues, placing it in the top 40 companies ranked by profits as a percentage of revenues. Of this list, commercial banking is the most represented industry comprising 12 of the top 40 companies by profits as a percentage of revenues (CNN-Money, 2006). Although the profits are not a direct indication of Citigroup’s dominance of corporate governance
compared to KB Homes’ dominance, it is an indicator that a company can be highly profitable in the midst of many regulations.

Considering Citigroup’s dominance, as well as many other commercial banks such as Bank of America, the major factor to consider is the profitability of commercial banks despite the high number of regulations they are under. Out of the 50 most profitable industries, commercial banks ranked third with overall profits equaling 18.3% of revenues. One possible explanation for the higher profits of Citigroup is that banking is more profitable than homebuilding. Still, commercial banks must comply with over 30 federal regulations (The Federal Reserve Board, 2006). These regulations leave very little or no room for large corporate scandals such as accounting fraud and backdating options. This is also because banking is such a highly watched industry where many investors seek a safe return. In an industry where regulations abound and the government pays very close attention to all activities, commercial banks have continually been highly profitable. Although many corporations are afraid of the impact of regulations on business decisions, commercial banks have proved that fear to be a small problem. The main point that Citigroup and commercial banks prove is that the financial sectors of publicly traded companies can, and very well should, be more regulated, as companies would be able to raise ethical standards and maintain profit levels.

EVA as an Evaluation Tool

With the government having done its part by implementing more financial regulations, companies can help solve the problem by implementing EVA as an evaluation tool to regulate executive compensation and stock options. Because the board of directors grants options and compensation packages, it is the board that should
implement EVA as an evaluation tool for granting stock options and other forms of executive compensation such as bonuses. Because EVA evaluates officers according to the wealth they create beyond the capital they have used, the adoption of EVA by the board of directors would be highly beneficial to increasing shareholder wealth and a decrease in corporate scandals such as those previously mentioned. According to Fortune Magazine writer Shawn Tully (2006), it is “essential to deduct a charge for equity capital from accounting earnings to see how much money CEOs are really making for shareholders” (p. 90). He believes that bonuses should be based on the returns of new capital a CEO generates every year because these returns drive share prices. His suggestion: CEOs should get a target bonus for generating a return equal to the target cost of capital (or an EVA of 0), while CEOs that generate a return above that which is expected would get a part of the profit which is above the expected amount. To show that companies are beginning to adopt EVA, he notes that executives at DuPont get bonuses when earnings exceed a 6% return on capital.

Implementing EVA

The primary problem with options is that the exercise price is the market price and is fixed for a period of ten years, leaving the CEO a large potential to benefit if the stock price rises at all. This means the CEO can gain a substantial profit while still earning less than a decent return for the shareholder. With most boards cutting option grants when share price increases and increasing option grants when share price decreases, CEOs are often overpaid for underperforming while underpaid for excellence (Tully, 2006). One way EVA can be used to encourage stronger performance and increasing shareholder wealth is granting a fixed number of shares that have an exercise
price that is a certain percentage above the current market price. Although it may be difficult to put a reasonable markup on these options, Charles Schwab has already implemented this with its CEO, Chuck Schwab. According to Tully, Charles Schwab gave the CEO three separate grants of 800,000 options each that were valued at 12%, 25%, and 40% above the share price at the time they were granted. According to the CEO himself, “It’s right that the shareholders who put up the capital get a 12% preferred return before I benefit” (Tully, 2006, p. 92). With incentives such as these, the only way for the executive to truly profit is by generating returns that are above the required return for shareholders rather than just slowly increasing the stock price over time. Another way boards have begun to change is through a lengthening in the period of years executives must wait to exercise various options and grants. Exxon Mobil’s upper management must wait five years to sell half of their restricted stock grants and cannot sell the other half for another ten years or until retirement (whichever is later). Another change boards have made is forcing CEOs to hold stock valued at five to eight times their salary, keeping a lot of their value in the company and its share price. The main benefit of these changes is that they force executives to focus on long-term wealth creation rather than short-term share price increases. Although some executives will still try to find shortcuts and other ways of increasing their wealth, these changes, in addition to the regulations added by the Sarbanes-Oxley Act of 2002, will help improve returns at companies and reduce the number of scandals due to backdating options and accounting fraud.
EVA and Other Profitability Measures

When considering the adoption of EVA, its relation to earnings and stock price is a very important factor. Even more important is a comparison of EVA to the profitability measures that are currently in use.

EVA and Earnings

In a recent study, Chen and Dodd (2001) compared EVA with Operating Income and Residual Income to see how they related to value and which one was the best choice. In this study, the authors noted some companies have stated that the adoption of EVA has led to a dramatic increase in the stock price. Of these companies, Coca Cola stated that its stock increased over 200% from 1987, the year it adopted EVA, and 1993. But when considering the support for this, the study indicates that there is not enough information to support that EVA is a dominant form of valuation. This study also indicates that while the improvement of EVA is associated with higher stock price, the strength of that association is much weaker than proponents of EVA claim it to be. The study indicates, “Simple accounting earnings are of significant incremental information value in addition to EVA measures and that EVA is empirically comparable to residual income, a relatively old managerial accounting concept” (Chen & Dodd, 2001, ¶ 6). The study continues by showing one important difference between EVA and earnings: EVA includes the total cost of both debt and equity capital where accounting includes only debt capital interest expenses. The study concludes, “Since accounting earnings ignore equity capital, they are incomplete measures of economic reality” (¶ 16).

The study by Chen and Dodd (2001) examined some of the claims of EVA by addressing EVA’s supposed advantage of eliminating distortions of Generally Accepted
Accounting Principles. The example used in the study is that some may argue that research and development expenditures should be capitalized since it will bring future benefits to the company. According to Generally Accepted Accounting Principles, research and development must be expensed in the period incurred. According to the study, this could distort both the capital and accounting earnings of the company. When looking at EVA’s claim of superiority over accounting earnings, the study states, “Even with all the theoretical advantages and anecdotal evidence, the superiority of EVA over accounting earnings is still an empirical question” (Chen & Dodd, 2001, ¶ 19). The study also notes that, “Operating income measures provide more information in explaining the variation of stock return than residual income measures, which in turn contain more information than EVA measures” (Chen & Dodd, 2001, ¶ 33). When looking at the advantages and disadvantages of all three measures studied, Chen and Dodd note that residual income contains significant information that operating income does not. The study concludes by stating that “including both the cost of debt and equity in a profitability measure seems to be a promising practice in terms of increasing value relevance. This provides support for one of the EVA advantages heavily acclaimed in the business press” (Chen & Dodd, 2001, ¶ 45).

EVA as an Additional Tool

The study conducted by Chen and Dodd (2001) showed that EVA is not dominant in relation to stock price and return, but is extremely important because it includes both the cost of debt and equity in terms of measuring value. The information contained in the study also leads to the conclusion of using EVA as an additional tool rather than a replacement tool because it adds some benefits but does not necessarily have superiority
over other measures such as accounting earnings. It is important to note that one reason EVA is not superior is that it is still rooted in traditional accounting data. In another study conducted by three professors from west coast universities, research indicated that “although for some firms EVA may be an effective tool for internal decision making, performance measurement and incentive compensation, it does not dominate earnings in its association with stock market returns for the sample firms and period studied” (Biddle, Bowen, & Wallace, 1997, p. 333).

The Profitability of Ethics

Although most agree that ethics are important in the business world, many companies are slow to adopt a code of ethics or spend money on ethics programs because they believe ethics hurt profit margins. In a recent study conducted by the United Kingdom’s Institute of Business Ethics, it was found that ethical companies outperformed those that made no ethical claims in three out of four financial measures. The study had a sample of 350 firms and was conducted between 1997 and 2001. In this study, the IBE concluded that “there is strong indicative evidence that large UK companies with codes of business ethics/conduct produced an above-average performance when measured against a similar group without codes” (Caulkin, 2003, ¶6). In this study, the IBE tried to improve on a similar past study by selecting companies that had a published code of ethics in place for a minimum of five years. However, since having a code of ethics does not necessarily lead to ethical behavior, the IBE studied how the companies measured up in Management Today’s annual most admired companies list (Caulkin, 2003). In addition to this, the IBE looked at the company’s socio-ethical risk management, an area that includes aspects such as human rights and corporate governance. Concerning the
importance of ethics, the IBE found that 19 of 24 companies that have consistently been featured in Management Today’s table in the past five years have codes of ethics and are rated higher than those without codes.

The financial measures that were considered in the study were market value added (MVA), EVA, return on capital employed (ROCE), and price/earnings ratio. Market value added is a measure of the difference between investor cash inflows and cash outflows (Caulkin, 2003). The results of the study on the financial measures showed the companies with a code of ethics did much better with EVA and MVA than those companies without a code of ethics, noting that the difference continues to grow. So not only would the adoption of EVA increase the ethical standards of a company, ethical standards will in turn increase the EVA of that company. The study also produced evidence that the p/e ratios of companies with a code of ethics were much more stable than the p/e ratios of those companies without a code of ethics. Finally, the study failed to draw a clear conclusion on the fourth measure, return on capital employed. The same article about the IBE study notes that ethics may not be the reason for the profit, but that larger, more successful companies are more willing to adopt ethics programs. How ethics is impacting profits at companies remains to be seen in future studies, but the article refers to an IBE quote when it says “that ‘having a code of business ethics might...be said to be one hallmark of a well-managed company,’ rather than a waste of shareholders’ money” (Caulkin, 2003, ¶ 16). So the U.K. study and the U.S. study both conclude that exceptional company performance is related to a set of ethical values and ethical behaviors that are seen in the company throughout an extended period of time. Another article on the study also indicates that EVA should be used in addition to other
tools rather than as a replacement. Verschoor (2003), DePaul professor and researcher of the U.S. study, says that even though EVA is most important to the management, he believes that Stern Stewart’s market value added tool is the best option since it views the company from an investor perspective. Following this, he shows his support for both EVA and MVA by saying, “EVA can help management make better business decisions, and MVA can help motivate better investment decisions” (Verschoor, 2003, ¶ 8).

Successfully Implementing Ethics

The problem with companies having a code of ethics is whether or not those codes are actually being implemented. Although Enron had a code of ethics, it obviously was not following them. There are many companies that have a code of ethics, but do not have successful ethical guidelines. The Ford Pinto case also showed a lack of higher ethical standards (and too much concern for profit maximization). By now it is apparent that one major problem in corporations is a lack of ethical standards.

In a recent article, McDowell (2006), senior consultant at Deloitte Consulting LLP, presented three steps that companies should take to implement successful ethical guidelines. First, a company should provide ethical leadership behavior. Because leaders set the tone for a company, upper management should set the tone for an ethics program. To establish the tone at the top, all upper management and executives must be aligned with the company’s vision, climate, and ethics program. It is also important to provide a leadership style that integrates all employees of the company and communicates the policies and standards of the company clearly. The leadership of the company should reinforce the ethics and values of the company in various meetings and events involving the company to show its commitment. Second, the company should reinforce ethical
practices through the corporate processes. This is seen most often in the policies and procedures of the company. It may be helpful for the company to use ethics in the processes of compensation, evaluation, and promotion by rewarding ethical behavior. It will also be helpful for the company to hire people who understand the company's vision and ethical values.

Another suggestion is to integrate ethics into the company's various training programs. According to McDowell, "Employees who understand the common traits that lead to deep ethical problems in business are much less likely to act unethically" (McDowell, 2006, p. 17). The training for employees in ethics would be more effective if it included strategies for dealing with possible scenarios so that the employees are prepared and in the right frame of mind. Incorporating ethics into the company's various training programs will help ethics become an essential part of the company's personality and vision. Third, a confidential means of communication should be created so that employees are encouraged to act in an ethical manner. Many companies solve this problem by creating whistleblower hotlines that enable all concerns to be reported and given to the most appropriate party to handle the situation. According to McDowell, the company should indicate what behaviors and concerns should be reported, as well as what behaviors should be encouraged in the workplace.

Although most companies believe in the importance of ethics in the business world, many do not see the benefits of spending corporate money on an ethics program. According to McDowell (2006), "If leadership is aligned with an ethical culture and behaves with integrity, the result, based on our research and experience, will be increased ethical behavior and higher commitment from employees" (McDowell, 2006, p. 19).
company desires more committed employees that are concerned for the long-term benefit of the company, it should “create an infrastructure that makes it easy- rather than exceptional- for people to do the right thing” (McDowell, 2006, p. 19).

Conclusion

In a time where corporations measure performance and wealth creation with measurements based on accounting principles, the use of EVA can be effective and very beneficial. Because acts of corporate fraud and illegal accounting measures have left a seemingly irremovable stain on corporations, corporate governance has never been more important in assuring the creation of shareholder wealth as well as the overall well-being of corporations in general. This paper has examined the importance of corporate governance and EVA and found that many companies are having problems due to a lack of effective corporate governance. This paper also considered the importance of ethics in the creation of shareholder wealth by looking at the Ford Pinto Case. Moreover, this paper explored the use of EVA as an internal control tool for the decision making process and evaluating performance. From the examples given in the paper, it is clear that shareholder value is not only important, but it is being challenged daily and is in need of more internal control. By examining stock options and executive compensation, it is clear that the Sarbanes-Oxley Act of 2002 was justified and should help. However, it remains true that regulations alone are not the answer. Through an examination of EVA as an evaluation tool and the various options for implementing it, it is true that EVA can and should be implemented as an internal control to align the interests of officers and directors with the interests of shareholders. Using EVA will give executives incentive to increase shareholder wealth over the long run if implemented in ways similar to the
examples in this paper. By comparing EVA with other profitability measures, this study found that EVA should be added as an additional tool rather than a replacement tool.

This paper also looked at the profitability of ethics in the business world and found that ethics can be profitable to companies through wealth creation and increased employee commitment. Because many companies struggle to have an effective ethics program, this paper examined how to successfully implement ethics and found that most companies simply need to provide ethical leadership, reinforce ethical practices through corporate processes, and create a confidential means of communication. The adoption of EVA as an internal control tool by the board of directors of corporations, combined with the financial regulations imposed by the Sarbanes-Oxley Act, will increase returns at companies, create shareholder wealth, and reduce the number of corporate scandals due to backdating of options and accounting fraud.

EVA has been adopted by many major companies such as Coca Cola, Credit Suisse First Boston, Equifax, and the United States Postal Service. When asked why they adopted EVA, most of these companies said it just makes more sense to evaluate individuals based on the concept of cost of capital. For these companies, their employees understand that they are charged for the money they use and that they must exceed this cost of capital in order to create real shareholder wealth. With over 300 companies worldwide and 81 U.S. companies operating using EVA, Stern Stewart & Co. (2006) is continually seeing more and more companies adopt EVA as an evaluation and decision making tool. As long as shareholders and stakeholders remain the primary concern in corporations, more and more companies may be expected to adopt EVA in the years to come.
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