

CHAPTER TWO – LITERATURE REVIEW

2.1. Introduction

The **Local Firm** has two major management concerns, which are

- i. To develop a desired characteristic of an alternative management control system, that would minimize agency cost while creating wealth for investors, and
- ii. To retains high performers while motivating them to create wealth for shareholders

The framework of Economics of Organization Architecture by James Brickley, Clifford Smith & Jerold Zimmerman (1999) and the understanding of agency theory have profoundly influenced the selection of EVA as an alternative management control system for the **Local Firm**. Where as the survey and interviews on succession planning from the work of Egon Zehnder International (2002) has given the systematic approach in analyzing and act as a guide in developing the entry-exit path to address the succession issues currently encountered by the **Local Firm** understudied.

2.2. Economics of Organization Architect

James Brickley, Clifford Smith & Jerold Zimmerman (1999) agreed with many other researchers (W. Edwards Deming, 1982; W Burke, 1987; Joseph M. Juran, 1989; J. Vogt & K. Murell, 1990; Thomas G Cummings & Christopher G Worley, 1997, etc) that organization and associated policies of a firm have profound effects on performance and firm value. Their underlying assumption --- the fundamental economic problem facing individual firms (as well

as entire economic systems) is trying to ensure that decision-makers have the relevant information to make good decisions; and these decision-makers have incentive to use information effectively. In short, it is about how individuals make choices and respond to incentives. Hence, the fundamental challenge in designing both firms and economic systems is to maximize the likelihood that decision makers have

- 1) The relevant information to make good decisions, and
- 2) The incentives to use information productively.

Three (3) critical aspects of corporate organization were identified to provide a systematic and consistent approach in analyzing organization problems and improving the effectiveness of organizations architecture. They introduced the term ***“Organizational Architecture”***, i.e.

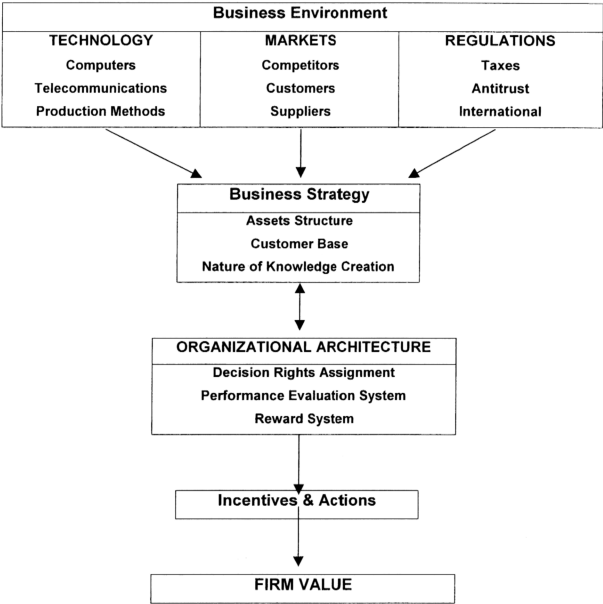
- a) The assignment of decision rights (rights to decide and take actions) among individuals within the firm,
- b) The structure of systems to evaluate performance of both individuals and business units, and
- c) Method of rewarding individuals.

According to James Brickley, Clifford Smith & Jerold Zimmerman (1999), organizational architecture is like a ***“three-legged stool”***; changing one of the three legs without careful consideration of the other two is typically a mistake. Hence it is ***“integrative”*** and the three components are highly interdependent.

It is worth noting that the optimal architecture will be different for different companies. Such structural differences are not random, but vary due to the underlying factors such as ***market conditions, technology, and the***

regulatory environment. They summarized these three key factors as the firm's external business environment as per Figure 2.

Figure 2. Determinants of Organizational Architecture



Sources: James Brickley, Clifford Smith & Jerold Zimmerman, 1999, *The Economic of Organizational Architecture*

For any firm, these three factors are:

- a) The structure of its markets (competitors, customers & suppliers);

- b) The technology, which affects both its products/services, method of production and information communication systems, and
- c) The regulatory constraints on its activities --- are likely to have the greatest influence on the business strategy.

The ultimate goals of the firm are reflected in its business strategy, which will affect its optimal organization architecture. As "Form ever follows Function", normally significant changes in corporate business strategies typically call for major changes in decision-making authority, performance measures for evaluating managers and employees, and management incentive compensation systems.

It is noted that in heavily regulated firms, or in smaller firms in fairly stable industries, top management is likely to have more of the relevant information for decision-making. In such cases, centralized decision-making is more likely to be adopted with relatively less emphasis on formal performance evaluation and pay-for-performance systems. Where as, in larger companies particularly those in unregulated industries or facing stiff competition, decision rights are more likely to be decentralized among managers and employees. In such cases, performance evaluation and reward systems must be designed to control agency problems and promote better decision-making.

In short, the principle of Economic Darwinism --- Concept of Survival of the Fittest implies that companies increase their chance of survival by adapting their organization architecture to changes in their particular economic environments. The important implications are, first, existing architectures are not random, there are sound economic explanations for the dominant organization of firms in most industries; second, surviving architecture at any point in time are optimal in a **relative** rather than an **absolute** sense (i.e. they are best among the competition, though not necessarily the best possible). Hence, it is necessary to understand how the firm arrived at its existing architecture, to discover why and

what worth preserving while what need to replace with new forms and content because the costs of organizational changes normally are large.

2.3. Agency Theory

2.3.1. Definition of Agency Cost

In a public listed company, the legal owners of the firm are the numerous shareholders. However, the board and the other officers carry out the day-to-day management. This means that there is a separation of ownership and control. In this sense, the managers who are involved in the daily management of the public listed company are actually the agents of the principal (shareholders).

The main objective of the manager is to maximize the shareholders' wealth. However, being agents of the shareholders, there exist a potential conflict of interest between shareholders and the management team. It is inevitable that there will be instances whereby conflict of interest will happen.

Agency costs represent the difference between the value of an actual firm and the value of a hypothetical firm, which would exist in a more perfect world where management and shareholder incentives are perfectly aligned. A perfect situation is one in which there is no separation of ownership and control.

2.3.2. Why Agency Cost Exists?

The four common reasons that will lead to an inevitable conflict of interest between both parties are:

- a) It is just human nature that we will not give our best when managing the affairs of others. The absence of a sense of ownership will make us not willing to give our best effort. The absence of a sense of ownership is due to the separation of ownership and control. A simple example is, shirking on the job by giving less than our full effort.
- b) Asymmetric information means that the insider manager knows more about the company's performance than the busy shareholders. Thus managers have an advantage in decision-making but many may not take action that will maximize the shareholders' wealth. For example, the manager may promote someone close to him rather than the efficient worker.
- c) Relationship. Managers are also responsible to other stakeholders like staff, suppliers, customers, government and the community. As such, managers may take into account relationship and thus will not sack an inefficient staff.
- d) As a result of modern portfolio theory, nowadays each shareholder only owns a small percentage of the company's shares. As monitoring requires time and cost, there is no incentive for each individual shareholder to monitor the action of managers. Every shareholder expects the other shareholder to do the monitoring so they can benefit from the reduction in agency cost without paying for it. This is the free-rider problem.

2.3.3. Areas of Conflict of Interest

The two areas in which conflict of interest may occur are in the area of investment and financing.

The investment choices managers prefer may not always be in the best interest of the shareholders. There are six ways in which this may happen.

- a) Managers favor growth over wealth maximization, due to greater prestige attached to managing a larger conglomerate and the extra power that they yield. Empire building, through questionable acquisition takes up the company's cash. This cash rightfully belongs to the shareholders.
- b) To become entrenched, managers may also choose to make irreversible investment for which they have a particular expertise, so that they will not become expendable in the future. For this reason, oil firm may have continued to invest in oil exploration in the early 1980s despite the falling oil prices.
- c) Managers also may wish to rely on personal relationships in their business dealings to make it more difficult for potential replacements to complete the deal that they have initiated.
- d) Managers prefer investment with a shorter pay-off period. This can create a tendency for managers to select projects with a short payback period over higher NPV investments that requires longer payback period. This is due to the manner in which performance appraisal is being carried out in most companies. Companies tend to evaluate staff on short-term results.
- e) Managers prefer low risk investment. This is due to the non-diversification of human capital. It is easier for shareholders to diversify their investment risk. Risk diversification by shareholders can be accomplished by holding a well-diversified portfolio by buying shares of other companies. However, it is not easy for employee to switch career due to the unique capabilities and training of the individual. Most professional do not simply have the time to be proficient in two jobs. This problem is even more real for those working in specialized industry. Highly specialized employee may only be able to sell their services to this company, as there is no similar line of career. The direct

consequences of this non-diversifiable of human capital are that bankruptcy has a greater impact on managers than shareholders. Because managers have more to lose from a bad investment, they have a bias towards taking on lower risk investment and thus do not necessarily maximize the shareholders' wealth.

- f) Managers tend to award themselves more perquisites than is necessary to maintain the level of motivation and corporate image. Examples would be large corporate building, expensive decor bigger company car and a list of other benefits. This again is money lost to the shareholders.

With regards to financing, shareholders prefer the use of debt for the following reasons.

- a) Loan agreement will place restrictions on the managers' freedom. In a sense, the providers of debt are assisting the shareholder to monitor the actions of managers and so reduce agency cost.
- b) Debt requires fixed monthly repayment of installment and so reduces the availability of cash. As the amount of cash is less, there are also fewer tendencies to waste shareholders' fund on questionable acquisition.
- c) The use of debt also improves the efficiency of management who must ensure that there are enough cash flows from sales to meet the monthly loan repayment. Dividend payment is at the discretion of the Board.

2.3.4. Solution to Minimize Agency Problem

This agency cost can be minimized through monitoring, constraints, providing incentives and meting out punishment if the objectives are not met.

Collectively these are known as agency costs. It is the extra costs incurred when delegating certain tasks and responsibilities to an agent.

- a) **Monitoring cost:** The cost of monitoring the agent such as audit fee. Another example would be the direct contracting costs. This is the legal fee incurred for drawing up the terms and conditions prior to employment and the issuance of stock option plan.
- b) **Constraints:** Constraints restrict the freedom of the managers to act. It also lay down the rules that managers have to abide by in order not to face certain unfavorable consequences. An example is a loan covenants within the loan agreement. In other words, loan covenants assist the shareholders in monitoring the behavior of the management as the loan providers also have an interest in the survival of the company.
- c) **The discipline of the financial market.** If a company is not performing, the share price will drop. This continuous fall in share price will provide a signal to potential investors not to supply capital to the firm. In this manner, the price mechanism performs the role of resource allocator by not transferring capital to firms that are under performing.
- d) **The threat of take over:** An under-performing firm may reach a point whereby the values of its assets are worth more than its market value of its share. This will put the firm in a vulnerable situation, as it is a good candidate for potential take over. Once a company is taken over, the top management will be the first to be asked to leave. So the manager's position is threaten if they do not perform up to the expectation of the shareholders.
- e) **Punishments:** This includes all the control measures to ensure compliance with the company's policies, procedures, rules and standards. For instance,

the fear and embarrassment of being fired or being replaced if performance is continuously below standards.

- f) Incentive payments: An incentive payment can be paid to the managers to make them think like the owner. For instance, linking bonuses and perks to performance. Another possible strategy is to provide the key managers with stock option plan.

2.3.5. Consideration in Designing Compensation Package

There are some factors for consideration in designing an incentive compensation package such as.

- The incentives are tied to a reliable target such as price per share or growth in EVA.
- Timing of the reward is important. It must not be too far into the future as most CEO will not be around for that long to enjoy the benefits. On the other hand, too short a time frame can also encourage short-term actions at the expense of long-term sound decision-making.
- Managers must not be penalized for factors outside their control. For example, if an economic downturn cause share price to fall, then the manager should not be penalized.
- The compensation strategy must be easy to monitor and not easily manipulated by the manager. Therefore, tying profit to the compensation of manger is not suitable as profit can be easily manipulated through window dressing.
- Finally, the percentage of shareholding must be substantial. Otherwise there will be no reduction of agency cost. This is because if the manager

only owns 5% of the company's shares, then for every dollar that is taken out from the company, the manager still gains 95 cent.

2.4. Succession Planning

A number of interviews with some corporate leaders have shown that when the top job is in transition, companies become vulnerable especially if the successor is unsuitable or the delay in appointing the suitable successor (The Focus Volume VI/1). Even though most organizations are aware that delivering exceptional care, support and development to firms' top performers is critical to the long-term success of firms that have weathered the recent recession (*US Technology Practice Group, 2001-2, The Focus*). Nonetheless, most companies deal with this task on ad hoc basis. It rarely forms part of any mid- or long-term strategy. The interviews revealed that most firms would politely shelve the succession issues during good times as it is considered an insult to the current CEO. But when it is handled during bad times, most companies would end up with failure and have bad experiences. Therefore, Egon Zehnder International decided to publish a special issue on succession planning to illustrate the pitfalls and pointing out remedies.

Among the pitfalls of a CEO succession highlighted in Egon's work are some classic warning signals such as the lack of credible internal candidates, continued poor performance of the firm, the departure of promising management talent, a sudden void due to ill-health or other personal issues, mechanical time-based succession tables that are neither performance oriented nor related to changing company needs. Normally the handover process most often fails because the underlying issues are addressed too late, lack of interest from the senior to acknowledge succession-related issues and most importantly it was dealt ad hoc whence it comes.

Egon strongly believe that by identifying and removing these sources of error at an early stage, and by systematically following a few basic rules, companies can vastly improve the chances that a change of corporate leadership will not only succeed but also become an opportunity to revitalize the enterprise as a whole (The Focus, Volume VI/1, pp34-36). They have recommended some basic rules such as: -

- a) Involvement of the Senior Supervisory team be it Board of Governors or Advisory Council to treat succession planning as part of its long term strategies and set-up supervisory measures for recruitment, evaluation, development, retention and dismissal of senior executives.
- b) Succession planning must be driven by CEO with full commitment to make sure that suitable processes, structures and management mechanisms are in place to support effective transition.
- c) Key competencies for the top job must be identified and assessed against the changing market needs.
- d) Developing an open and inclusive culture of communication to discuss the processes and criteria for selection of successor(s), expectations, suitability and needs of all those involved in the executive succession process. By openly making information available is a crucial element in building and maintaining the relationship of trust within the company.
- e) Companies must continuously benchmark its pool of successors against the market standard. It is important to build up a cadre of potential candidates and "under-performers" must be excluded with objectivity.
- f) It is a painful process for the incumbent to let-go, hence it is important to build-in the exit path at the beginning to minimize the trauma face by the incumbent while ensure the smooth transition.

In short, the key words in succession planning is human resource management that emphasized on developing and retaining high performer candidates as part of a company long term strategies.

2.5. Economic Value Added (EVA)

EVA is based on the simple concept of residual income. Residual income is zero if a firm's operating return is just equal to the required return at a specific level of risk. The required return is the capital charged for both debt and equity. EVA is a measure of true profits. Stern Steward defined EVA as Net Operating Profit After Taxes (NOPAT) minus the appropriate capital charged for both debt and equity. The formula is $EVA = NOPAT - C\% (TC)$. $C\%$ is the required percentage of capital cost and TC is total capital employed (inclusive both debt and equity). In short, it is a real monetary metric.

The idea behind EVA is that shareholders must earn a return that compensates them for the risk taken. Therefore, if EVA is zero, shareholders have earned a return that exactly compensates the risk (Gary D. Burkette & Timothy P. Hedley, 1997; Esa Makelainen, 1998; Joel M. Stern, G. Bennett Steward & Donald Chew, 1999; Pamela Peterson, 2000; Joel M. Stern, John S. Shiely & Irwin Ross, 2001; S. David Young & Stephen F. O 'Byrne, 2001). Conventional accounting standards have no charge for common equity. In other words, the funds provided by shareholders are deemed to be free. Accounting theorist justify this by suggesting that all net profit is attributable to shareholders and they alone as owners can ascertain what is a necessary or required rate of return.

2.5.1. Background of EVA (Economic Value Added)

EVA is not entirely new. EVA is a variation of residue income after adjustments to how one calculates income and capital. It is also known as Economic Profit, which was established long ago. Alfred Marshall (1890) originally suggested that a firm must do more than generate net income as defined by Generally Accepted Accounting Principles (GAAP). To survive in the long term, firms must generate sufficient profit to cover the cost of all invested

capital. Economic Profit performance measurement applies the actual cost of capital --- including both debt and equity--- used by the business to determine if a company is actually generating economic value (Gary D. Burkette & Timothy P Hedley, 1997; Pamela Peterson, 2000).

This idea of Economic Profit re-presented by Church in 1917 and by Scovell in 1927 (Esa Makelainen, 1998) was discussed in management accounting literature in the 1960s. In the late 1960s and early 1970s, the cost of capital is referred to as the "minimum acceptable return" or the "minimum revenue required". Profit is defined as earnings in excess of the cost of capital.

Since mid-1980s, EVA has gained popularity as compared to conventional accounting treatment on cost of capital. Most of this change can be credited to Stern Steward & Co's (thereafter referred as **Stern Steward**) marketing efforts to develop a product that has its foundation in economic and financial theory. Most Residue Income or Economic Profit concepts are often called EVA, even though they may not include even the main elements as defined by Stern Steward.

One of the main elements associated with EVA was the concept of Market Value Added (MVA) which has a theoretical link to market valuation. EVA is a measure that tells what has happened to the wealth of shareholders. MVA is the difference between the company's market value and book value expressed as $MVA = MVe - BVe$.

- MVe is the Company's Total Market Value and if the assumption that the book and market value of debt are equal, it is therefore refers to as Market Value of Equity.
- BVe is the Company's Total Capital Invested and similarly assuming that the book value and market value of debt are equal, it

is therefore referred to as the Book Value of Equity such as reserves, retained earnings, provisions, items that are not debt, etc.

MVA is positive when the total market value of a company is more than the amount of capital invested, and it will sell on the stock markets with a premium. On the other hand, if MVA is negative that means the total market value is less than capital invested, the company has destroyed the shareholders' value and it will sell at a discount on the stock markets. Stern Stewart explains that whether a company succeeds in creating MVA or not depends on its rate of return. There is a connection between EVA and MVA as defined by Stern Stewart as $MVA = PV \text{ of Future EVA}$. In short, MVA is equal to the present value of all future EVA. Increase in EVA will increase the company MVA. This relationship has implications on the valuation of a company.

Esa expressed this relationship from the perspective of yield and market value of a bond (1998). If the yield of a bond exceeds current market interest (i.e. cost of capital) then the bond will sell at a premium (there is positive EVA so the bond will sell at positive MVA), and vice versa.

2.5.2. Pro & Cons of EVA

Many companies started to introduce EVA in the 1990s and there are some empirical studies. Various results are presented. Some studies supported EVA's superior position as a Performance Measure and Incentive Compensation Method while others do not. Currently, most researchers agree on the usefulness of EVA as a performance measurement and incentive tool but the superiority to explain shareholder value change is still debatable even though few have used EVA as a tool for assessing changes in shareholders' value.

This study briefly discussed the empirical studies from two (2) perspectives i.e. The Pros and Cons of EVA. The supporters of EVA are Stern

Steward with other independent researchers such as Stephen F. O'Bryne, James Brickley, Clifford Smith & Jerold Zimmerman, Kleiman, Gary D. Burkette & Timothy P. Hedley (East Tennessee State University), Keith Kefgen & Rosemary Mahoney (HVS Executive Search), Gary S Tjaden (Georgia Institute of Technology). Contrary, Gary C. Biddle, Robert M Bowen (University of Washington), Wallace (University of California at Irvine), David Keys, Mumin Azamhuzjaev, James Mackey, etc. are against EVA.

Stern Steward & Co as the promoter of EVA has consistently updated its research on the effectiveness of EVA. In 1993, 1995 and 1996, various researches based on broad data and systematic method covering the period 1985-1993, have concluded that EVA provides a better predictor for market value than other earning measures such as net income, earning per share, internal rate of return, etc. Esa Makelainen (1998), Andrew Wileman (1999), Kyeong-Pyo Ryu (2000), Graham Francis & Clare Minchington (2000) and Pamela Paterson (2000) supported the superiority of EVA as performance measures because empirical studies confirmed that even when earning is growing, shareholders value could be destroyed and eventually the market value. Pamela (2000) in her study in 1995 and 1996 has contested the linear correlation between EVA and MVA. Her findings showed that it is possible to have a positive MVA and a negative EVA as well as a negative MVA and a positive EVA. No causal explanation was given in her study.

Stern Stewards & Co also conducted a comparative study on the performance of companies between EVA adopter and non-adopter at different time period over the 60 months ending December 1998. The study concluded that the degree of superior performance increases 12.12% annually or 77.2% over 5 years period for EVA adopters who outperformed their competitors who are non-EVA adopters (Kyeong-Pyo Ryu, 2000). Several corporate figures such as Venkata Ramani (Vice President at Harris Trust & Saving Bank), Joseph Willett (Senior Vice President & Chief Financial Officer of Merrill Lynch & Co.

Inc), Susan Malley (Chief Investment Officer of Citicorp Investment Services) acknowledged that companies that adopted EVA in financial management and incentive compensation generally outperformed their competitors.

First, EVA is tailored to eliminate economic distortions in GAAP. EVA looks beyond mere accounting numbers and focuses on real economic results. Second, EVA explicitly charged operating profits for the opportunity cost of invested capital to assess how decisions affect the balance sheet as well as the income statement and accurately weigh the trade-off between the two. Third, Stern Steward specified that bonus plans are to be de-coupled from budgetary targets. By holding back some monies in the bonus bank, which is forfeitable if improvement is unsustainable, managers are strongly motivated to achieve the very best results possible. Fourth, EVA permeates all aspects of managing and planning as it provides a singular focus to align and speed decision-making, as well as communication and encourage teamwork (Kyeong-Pyo Ryu, 2000).

On the other hand, Gary C Biddle, Robert M. Bowen and James S. Wallace contended their disagreement on EVA based on two claims i.e.

- a) Does EVA better explain stock returns and firm value?
- b) Does EVA better motivate managers to increase shareholders' wealth?

Their findings showed that earnings generally beat EVA. Because most market participants found earnings are more relevant than EVA when correlated to stock returns. James Dodd and Shimin Chen (1996) concurred that the association of EVA and stock return is far from perfect. EVA accounted for approximately 20.2% of the variation in stock return as compare to 24.5% by using Return on Assets.

On the second claims, even though their research evidences concurred that firm using residual income-based incentives generally support a pre-condition to motivate managers to take actions consistent with shareholder

wealth creation. But they do not believe that EVA is the best internal measure (David Keys, Mumin Azamhuzjaev and James Mackey, 1999).

2.5.3. EVA as Performance Control System

To implement EVA properly is to keep it simple and accountable. EVA must become the focal point for managing business. Increasing EVA must be embraced as the company's main financial mission with public commitment i.e. creating wealth is the end and increasing EVA is the means.

EVA implementation framework covered all four main EVA applications beginning with the letter "M" through three overlapping phases. The first two applications are fused into one phase, i.e. to develop and institute EVA as a performance measure and as a management system. The second phase is to use EVA for motivation, by tailoring the special incentive plans that make staff into owners. The third phase i.e. the fourth application is to implant EVA as a mind-set through training and communication within the organization and market at large (Al Ehrbal, 1998).

EVA formula as stated earlier is $\text{NOPAT} - [\text{C\% (TC)}]$. In short, the EVA formula combined the three essential financial characteristics of an organization:

- Cash flow generated by the organization = NOPAT
- The capital invested to generate those cash flow = TC
- The weighted average cost of capital (WACC) of the investment = C%

It is important that all the three individual terms (or components) of EVA to be defined as operational tool. It is also important for making EVA concept simpler in order to facilitate the communication and learning process of the operating people. Even though, Stern Stewart has identified more than 160

potential adjustments in GAAP earnings and balance sheets, but it is not wise to do all of these adjustments because of its marginal effects. Therefore, Stern Stewart advised clients to make only five to fifteen adjustments (www.eva.com/evaabout/foorm.shtml). 5 key questions used as the guideline to decide on the adjustments are:

- Will the operating manager understand the change?
- Will it influence their decisions?
- How big difference does it make with this company?
- Can the necessary data be obtained?
- How much does it cost? (Esa Makelainen, 1998)

NOPAT refers to Net Operating Profit After Tax, which is equivalent to the accounting term of Earnings Before Interest After Tax. It is derived from NOP by subtracting calculated taxes from NOP, hence

$$\text{NOPAT} = \text{NOP} \times (1 - \text{Tax rate})$$

These calculated taxes do not correspond with the actual taxes payable. Interest on debt is the tax shield that will reduce the actual taxes payable.

Capital as defined by Stern Stewart is both debt and equity. In other words, it is total assets less non-interest bearing current liabilities at the beginning of the period (year) plus cumulative goodwill write-offs and extraordinary items if any.

Cost of capital or rate of return is NOPAT divided by capital, therefore the definition of capital and NOPAT affect the rate of return.

The whole meaning of EVA is to establish a capital cost based on risk-adjusted opportunity cost so as to achieve efficiency use of capital. Even though the solvency ratio has impacts on the WACC (Weighted Average Cost of Capital), however to balance the precision and simplicity, since most managers are familiar with the cost of borrowed funds (interest), therefore it is the cost of

equity that needs to be established. Stern Stewart recommended 1% a month or 12% per annum for easy adoption. In Australia, historically investors have required a 6% premium to risk-free investment such as long-term government bonds. With bond yielding about 5% that means the typical cost of equity for Australian companies is close to 11%. For businesses that are more volatile, the cost of equity is even higher (www.brw.au/stories/19991126/4275.htm). In 1999, the average cost of capital of the Stern Stewart top 200 companies was 18.1%, though it ranged across the sectors from 14.6% for Mining & minerals companies to 20% for furniture & Appliances companies (www.fm.co.za/topco2000/topevabox.htm).

2.5.4. EVA as the Incentive Compensation

At the second phase of EVA implementation, it focuses on *motivation*. It is an incentive system that makes manager think and act like the owners of the portions of the business they influence most directly. The key is not shares or legal title, but rather monies held at risk that are lost if improvements in performance are not sustained (Al Ehrbal, 1995).

The use of bonus bank, with a portion of exceptional bonuses held hostage and subject to loss if performance falls, causes managers to focus on projects that create enduring value. The other essential feature of these bonus plans is that targets for EVA improvement are automatically reset by a formula, which eliminates the game-man-ship created by annual negotiations. These features work together to create two characteristics of EVA bonus plan that are crucial to the effectiveness of a corporate governance mechanism:

- a) Managers know that the only way they can make themselves better off is by creating more wealth for shareholders.
- b) They also know that they will share in any wealth they do create.

It provides a single focus for operation management, capital budgeting, planning, performance measurement and incentive compensation. It also promotes a culture of high performance and sense of ownership by management, in which managers take the initiative to create value. The essential goals of the EVA bonus system are to balance the four basic compensation objectives i.e. align management and shareholder interest, to provide sufficient leverage while limit the retention risk and finally keep shareholders cost at reasonable level.

2.5.4.1. Key Elements in EVA Bonus System

The key elements in Stern Stewart's EVA bonus plan are

- Pay for increasing EVA
- No thresholds or caps
- A target bonus
- A bonus bank
- Performance targets set by formula instead of negotiation

Pay for increasing EVA is a precondition of making managers think and act like owners. The objective of every manager is to increase EVA.

No thresholds or caps as managers get an unlimited share of EVA improvement, but bonuses can also be negative if EVA is decreasing.

A target bonus is a competitive bonus based on peer company compensation practices. According to Al Ehrbal (1998), an EVA target bonus is larger than a conventional target bonus as it has more leverage due to the flexible base and it should be higher because the potential for negative bonuses makes EVA plans inherently riskier.

A bonus bank's objectives are to filter large bonus swings and to defer the impact until it can be ascertained that bonuses are associated with permanent changes in shareholder wealth.

Performance targets are set by formula instead of negotiation. Managers earn their target bonus when EVA increase is equal to expected improvement. The annual amount of expected improvement typically is preset for periods of five years or so instead of being negotiated annually. Moreover, the base to which expected improvement is added automatically to reset up or down each year in line with actual experience.

2.5.5. Managing EVA

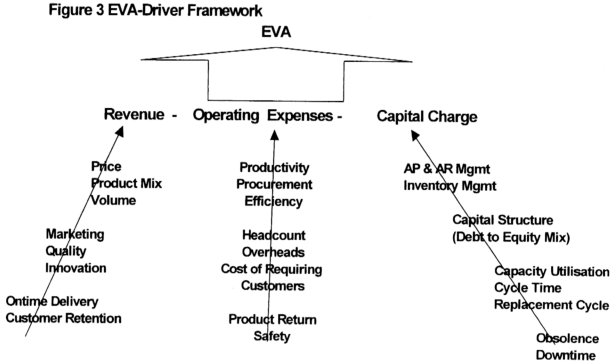
EVA holds out three principal ways of increasing shareholder value:

- First, increase the return derived from the assets already tied up in the business. Run the income statement more efficiently without investing any more capital on the balance sheet.
- Second, invest additional capital and aggressively build the business so long as the return earned exceeds the cost of that new capital.
- Third, stop investing in, and find ways to release capital from, activities that earn substandard returns. This means everything from turning working capital faster and speeding up cycle times to consolidating operations and selling assets worth more to others.

At the measurement phase, a part from figuring out how to measure the EVA for the total company, it is necessary to break the company down into EVA-Driver in order to understand what drives EVA up.

An EVA-Driver Framework is a set of diagnostic tools to analyze operational decisions in terms of tradeoff between income statement and balance

sheet effects, evaluate and identify areas that can be improved. In short, it is a critical self-examination to drive operating efficiencies on the one hand and maximize asset utilization on the other.



Sources: www.sfi.com.sg/eva1.html

As illustrated in Figure 3, the EVA-Driver Framework de-segregates NOPAT and the Cost of Capital into a set of performance measures, which can be tailored for difference businesses and managed within a business unit (www.sfi.com.sg/eva1.html). By questioning each step of a process or business approach to the lowest level of detail, the EVA-Driver Framework allows a manager to focus on those elements of operating profit and/or capital usage which he or she directly manages --- elements which directly impact the creation or erosion of EVA.

There are two sets of EVA-Driver trees under the EVA-Driver framework, i.e.

- a) Financial Driver Tree displays all the essential financial information.
- b) Operating Driver Tree displays essential operating information in order to demonstrate how key measures of operating performance impact overall business performance. Its objective is to assist managers to focus on Key Operating Drivers and Key Performance Indicators that create value and also within the influence of the management.