CHAPTER FOUR -
EVA IN A FOREIGN CORPORATION

4.1. Introduction

A **Foreign Corporation** is defined as a real estate service group having offices throughout Asia Pacific. Each of these offices started off as a partnership or family owned professional firm. In the early 1990s, a public listed corporation subsequently acquired these firms. The owner-operators were retained as minority shareholders and continued their service as operators in the same firm. In mid 1990s, these owner-operators divested further their shares to an institution from America. Majority of them retired, but some of them have been retained as independent consultants to these firms. In short, the **Foreign Corporation** had experienced the separation of control and ownership since early 1990s.

The **Foreign Corporation** has similar background and is affiliated to the **Local Firm.** Brokerage service is its core business complemented by valuation and management services. The **Foreign Corporation** is one of the prominent real estate service providers in the Asia Pacific region having its corporate headquarter based in Hong Kong. The corporate office in Hong Kong is a driver firm for the Asia Pacific region. Benchmarking and best practices are some of its core values, and it is the first real estate service organization to introduce and implement EVA in mid-1990s.

The interviewees in this **Foreign Corporation** were selected from two of its offices namely Hong Kong and Singapore. Three individuals were pre-identified from its marketing team. Two individuals represented by its financial controller or managing director formed the support group for the interviews. The rationale of having both the marketing and supporting group is: incentive compensation for marketing staff is directly correlated with performance, while the support group is better informed on the implementation of EVA. They have no knowledge of them being selected as the interviewees for this study. Hence non-structure questions were probe to them during conversation to solicit for feedback on EVA implementation. Moreover, to ensure confidentiality of the interviewees, they were anonymous in this study. The probing and observations were conducted during two working visits to Hong Kong and Singapore respectively in year 2001 and 2002.

Non-structure questions posted to the support group were focused on what was implemented, how it was implemented, and if EVA met the four objectives mentioned in Chapter 3. While the marketing group was posted with questions related to EVA as performance metrics and incentive compensation particularly in meeting objective 2 and 3 of Chapter 3.

4.2. EVA Implementation

EVA was introduced and directed for implementation in the **Foreign Corporation** by its corporate holding company since early 1996. It was implemented by geographical phases i.e. initiated from Australia, Hong Kong, Greater China, India, Korea and finally South East Asian countries.

EVA was introduced as one of the performance metrics in the various business units and aligned with its incentive compensation payment. The interviewees confirmed that EVA was implemented to evaluate the performance of each company and business unit. It was conducted in-house by its corporate holding company and training was provided to the respective companies' financial controller. Chief Executive Officer, Managing Directors, and/or Chief Operating Officers of the **Foreign Corporation** were required to attend briefing and workshop prior to its implementation. Apparently, it was a directive that all companies must implement the system.

From the understanding given by its financial controllers, implementation of EVA does not follow entirely of Stern Steward's framework based on their four main EVA applications. Stern Steward's application at phase one is to develop and institute EVA as a measure and as a management system. Responses from the support group concurred that, it is their priority to develop EVA as the performance metrics in each business units but they reserved comments on EVA as a management system.

The three essential financial variables of EVA formula i.e. cash flow generated by its business unit (NOPAT), capital invested to generate those cash-flow (TC) and the cost of capital (C%) are defined and established by its in-house consultants. It was briefly mentioned that for ease of operation, they adopted the cost of borrowed funds based on the overdraft rate. Therefore, the cost of capital fluctuated according to the market interest rate. EVA was also used as a guide for decision on capital expenditure and investment. No elaboration of how it works could be obtained from the financial staff because they deemed such information was sensitive and confidential.

The second phase, using EVA for motivation, is concerned with tailoring the special incentive plans that make staff behave and act as owners. All the interviewees concurred that performance metrics was defined and established based on EVA for each business units. Most of the key elements in Stern Stewart's EVA bonus plan are implemented such as Pay for increasing EVA, No thresholds or caps, A target bonus and Performance targets set by formula except bonus bank. Bonus bank was highly recommended by Stern Steward as the key that makes manager think and act like the owners of the portions of the business they influence most directly is monies held at risk that are lost if improvements in performance are not sustained (Al Ehrbal, 1995).

The third phase firmly implants EVA as a mind-set through training and communication within the organization and market at large (Al Ehrbal, 1998). Seminars and forums were organized directed to the financial controllers and respective companies' CEO and/or Managing Director prior to implementing of EVA. From the feedback of the support group, they knew that they are expected to be the change agents to communicate and train the rest to embrace increasing EVA as the company's main mission --- creating wealth is the end and increasing EVA is the mean. But they have failed to create the ripple effects across the organization because no significant commitments and efforts were shown in developing EVA training programme for the staff. The marketing group concurred with the view because there was hardly any training session organized to the staff at large on EVA and its implementation. From the responses of the interviews, generally its EVA implementation embraced the four phases with a different magnitude.

4.3. Findings and Illustration

According to the support group, they adopted both financial and non-financial metrics, which covered various aspects such as asset management, productivity, customer service, behavioural and financial. EVA is one of their many financial performance metrics for decision-making. Conventional financial metrics such as operating income, net profit, cash flow from operation (CFO), earnings per share (EPS), etc were used. Three (3) out of the four (4) interviewees from the support group preferred conventional financial metrics as compared to EVA. Further probing indicates that they found conventional accounting measures were more practical due to some genuine technical problems in implementing these new metrics. Moreover they were quite reluctance to buy-in yet another management fad. Such response concurred with the survey of CIMA members conducted by Graham Francis and Clare Minchington (2000).

Confidentially, one financial year data was obtained from one of the offices to demonstrate how to calculate EVA and the most commonly used conventional accounting metrics from a common set of data. The data used here has been disguised to protect confidentiality. All figures have been converted linearly, so that meanings of the figures and the respective relations between the figures are still unchanged even though they do not relate to any real numbers. This example not only shows how all the metrics are calculated but also provides an opportunity to compare and contrast the key features of these metrics.

The balance sheet and income statement have been reproduced as per Table 4 –Selected Financial Data From One of the Foreign Corporation's Offices. Most of the commonly used accounting measures are available directly from the balance sheet and income statement and require no further calculation such as operating income, net profit and cash flow from operation (CFO). EVA is not directly revealed in the financial statements, but can be calculated from data provided either in the financial statements, or in the notes to the financial statements. Some adjustments may be required such as Information & Research, marketing outlays like Advertisement & Promotion in the income statement will be amortized over a period of 3 years rather than expense off. Equity equivalents such as deferred income tax reserve and depreciated items represent economic book value have been added to the company's capital.

Table 4.Selected Financial Data From One of The Foreign Corporation's Offices.

1.0.	Sources of Income	Financial Year 1 (USD)	Financial Year 1 (USD)
1.a.	Brokerage Services	1,950,000.00	1,950,000.00
1.b.	Valuation/Financial Services	600,000.00	600,000.00
1.c	Management Services	800,000.00	800,000.00
(1)	**Net Revenue**	**3,350,000.00**	**3,350,000.00**
2.0.	**Less Operating Expenses**	**w/o Adjustment**	**with Adjustment**
2.1.	Payroll & Remuneration	1,287,000.00	1,287,000.00
2.2.	Statutory Contribution	325,000.00	325,000.00
2.3.	Commission	754,000.00	754,000.00
2.4.	Medical & Insurance	54,000.00	54,000.00
2.5.	Staff Training & Expenses	53,300.00	53,300.00
2.6.	Advertisement & Promotion*	200,000.00	66,666.67
2.7.	Bank Charges	13,000.00	13,000.00
2.8.	Entertainment	35,000.00	35,000.00
2.9.	OE & Printing Supplies	54,600.00	54,600.00
2.10.	Professional Services	38,000.00	38,000.00
2.11.	Rental & Utilities	555,000.00	555,000.00
2.12.	Telecommunication Charges	132,000.00	132,000.00
2.13.	Traveling & outstation	255,000.00	255,000.00
2.14.	Information & Research*	30,000.00	10,000.00
2.15.	Depreciation	97,500.00	97,500.00
	Total Expenses	**3,883,400.00**	**3,730,066.67**
(2)	**Operating Income**	**(533,400.00)**	**(380,066.67)**
(3)	**Interest Income**	**Nil**	**Nil**
(4)	**Interest Expense**	**Nil**	**Nil**
(5)	**Income Taxes**	**Nil**	**Nil**
(6)	**Cash & Short Term Investment**	**2,233,400.00**	**2,233,400.00**
(7)	**Fixed Assets (Net Book Value)**	**611,000.00**	**611,000.00**
(8)	**Short Term Debts**	**2,385,500.00**	**2,385,500.00**
(9)	**Long Term Debts**	**Nil**	**Nil**
(10)	**Capital Paid At Par**	**1,300,000.00**	**1,300,000.00**
(11)	**Shareholders Equity**	**601,900.00**	**601,900.00**
(12)	**Earning Per Share (EPS)**	**5.57**	**5.57**
(13)	**NOPAT = (Operating Income + Interest Income) X (1- Effective Tax Rate)**	**(533,400.00)**	**(380,066.67)**
(14)	**Cost of Capital = Capital Paid at par and adopted the interest rate of 1% per month equivalent to 12% per annum**	**156,000.00**	**156,000.00**
(15)	**EVA = (NOPAT + Changes in Long Term Liabilities + Interest Portion of Operating Lease)- Capital charges (adjusted invested capital X WACC)**	**(689,400.00)**	**(536,066.67)**

Note: * Expenses which can be adjusted following the principle of asset depreciation over 3 years.

NOPAT, Cost of Capital and EVA are not directly revealed in the financial statements, but they can be calculated from data provided. NOPAT without adjustment appeared to record a loss of USD 533,400.00 as compared to USD 380,066.67, which capitalized the expenses for Advertisement & Promotion and Research & Information over a three-year period. The difference is quite substantial. But the **Foreign Corporation** does not adopt the adjustment method because it does not comply with their tax-reporting requirement.

In item (13) of Table 4, interest income is included in NOPAT because cash balances are included in invested capital. If management is to be charged for the use of cash, any returns should also be included in NOPAT. From Table 4, no interest income was generated nor taxes are payable as it is a losing concern. There is a possible explanation for no interest income as normally invested capital is managed centrally by a corporate treasurer where as the data was obtained from one of the Foreign Corporation's offices.

Calculation of Cost of Capital is important in determining EVA. Market interest rate was adopted by the **Foreign Corporation** as its rate of required return for its capital. However to ease illustration, the calculation of cost of capital will be based on the proposed rate of Stern Steward i.e. 1% per month or 12% per annum. Since it is only one-year data, the capital was based on the initial paid out i.e. USD 1,300,000.00 instead of shareholders' equity of USD 601,900.00 to reflect the real cost of capital involved over time. When it is added to NOPAT, EVA has recorded a negative USD 689,400.00 as compared the EPS of USD 5.57. In shorts, EPS does not reflect the true picture of a company financial standing because it tells nothing about the cost of generating those income. Thus EVA is a better performance indicator. It was fully agreed by the support group of both offices.

EVA as an integrated management control tool was less effective in offices or business units as compare to corporate office where central decisions on treasurers and investments are made. The result of EVA at business units is less significant compared to those conventional metrics like profit and operating income that are well accepted and easy to understand by most of the staff.

4.4. Analysis of Findings

The feedback from the interviews was analyzed from the notes by grouping the answers to the four central questions/issues i.e.

a) Does EVA provide a completely integrated management control system?
b) Does EVA act as self-regulating internal corporate governance tool?
c) Does EVA based incentive compensation scheme attract, retain and motivate staff towards higher performances?
d) Does EVA provide a common language that is simple and communicative within the organization and to the market at large?

Answers and responses are classified into two categories i.e. "Yes" and "No". Most of the answers are not a straight "yes" or "no", but very likely or implicitly towards "yes" will be classified as "yes" and vice versa.

These findings were analyzed according to similarity and/or differences on central issues expressed by the two group of interviewees from Hong Kong and Singapore office.

4.4.1. EVA as A Management Control system

The perception of EVA as a Management Control System was difference between the two groups of interviewees. Table 4.1. provides a breakdown of the interviewees' responses on EVA as a Management Control System.

Table 4.1. Responses on EVA as A Management Control System

	Hong Kong Office		Singapore Office	
	Yes	No	Yes	No
The Support Group	2	-	2	
The Marketing Team		3		3
Total No. of Interviewees	2 (40%)	3 (60%)	2(40%)	3 (60%)

Marketing staff interviewed from both offices were ambiguous on this issue, they showed lack of interest and knowledge on how their units' business plan were been evaluated, how the budget allocation was determined, etc. But support group from both offices shared common understanding that annual business plan and resources allocation were evaluated and determined based on each business unit's performance. In fact, they understood fairly well the three ways of managing EVA i.e.

- Increase the return of current assets or improve its operating profit,
- Identify new businesses that have returns exceeding the cost of that new capital, and
- Dispose assets or divest activities that earn returns less than its cost of capital.

However, most of them in the support group have recommendation power but no decision-making authority. Although, EVA complemented other performance metrics for decision-making but this marginal gain does not justify the additional effort as perceived by most of them. A supplementary interview with one of the executives from the corporate holdings company found EVA is worth pursuing as it allows manager to have greater control on performance by identifying which business units generate return for its capital and which do not. At the time of writing, the corporate holdings company of the **Foreign Corporation** had decided to divest its interest in the entire region in exchange for one of its key business units in Hong Kong to its American counterpart. This was the outcome of using EVA as its performance metrics.

With regards to EVA as compensation system, various questions were directed to the two groups of interviewees from the two offices. For example: What is the corporate compensation objective? What is the corporate compensation policy and pay structure? What kind of incentive system? How does your reward system relate to performance? Are you excited with the compensation policy? What would happen if you failed to meet your performance target?

The support group commented that its corporate compensation objective is based on Pay For Performance. In addition to their conventional productivity and behavioural metrics, EVA was introduced and link to its incentive payment. Response on how does it works was quite evasive as they were not interested to discuss the process. Again, it may be due to confidentiality of information. Comparatively, responses of marketing staff from both offices agreed that pay for performance is its corporate reward objective. The marketing staff from Hong Kong office were particularly not excited about the incentive component as compared to those interviewees from Singapore office. It appears that EVA as an integrated management control system may not be applicable to the business unit and at individual level.

4.4.2. EVA as An Internal Corporate Governance

The underlying assumption that EVA act as internal corporate governance mechanism is derived from Stern Steward's belief that the visibility of linkages between reward and performance will change the behaviour of employees to think and act like the owners. Unstructured and open-ended questions related to this perception are probed to the interviewees. Among these questions are:

- How does your performance achieved affect your annual bonus?
- Who determine your performance quota?
- What is the basis of your performance quota?
- If you fail to meet your performance quota, what would happen?
- Since the introduction of EVA as the new performance metric, what have you experience?

Table 4.2. provides a breakdown of the interviewees' responses on EVA as an internal corporate governance tool.

Table 4.2. Responses on EVA as Internal Corporate Governance

	Hong Kong Office		Singapore Office	
	Yes	No	Yes	No
The Support Group	2	-	2	
The Marketing Team		3		3
Total No. of Interviewees	2 (40%)	3 (60%)	2(40%)	3 (60%)

Generally, the support group from both offices perceived that EVA allows them to identify the performance level of each business unit. No EVA improvement, no incentive will be paid to the business units and individuals concerned. It reduced individual bias due to relationship in evaluating performance of business units or individuals. Thus, objective rewarding is visible and accountable.

The marketing staff from the two offices acknowledged that incentive payment was tied to EVA improvement, but in particular marketing staff from Hong Kong office viewed EVA is just another measure because the incentive has no significant impact on them. But they commented that the Foreign Corporation is trimming cost by cutting down on their fringe benefits and reimbursable claims such as entertainment, travelling expenses and hotel accommodation. Generally, it is difficult to achieve the behavioural change for them to think and act like the owners as expected.

Further analysis revealed that the high fixed pay portion was the obstacle. Most of the marketing staff in Hong Kong is paid an expatriate remuneration package. Relatively the fixed pay portion for marketing staff in Singapore is much lower as they are on local staff remuneration package. For example, a senior marketing executive's annual remuneration in Hong Kong could easily drawn HK$1 million as compared to S$ 85,000.00 in Singapore. Their performance targets were set by formula of three to five times based on the fixed pay portion. Incentive commission is payable upon achieving their various performance quota with no thresholds or caps. Calculation of the performance target based on the minimum factor of three times for a senior marketing executive in Hong Kong office is HK$ 3 million and in Singapore office is S$255,000.00. It is achievable prior to the 1997 economy crisis; but such quota of performance became too difficult to achieve when the market conditions deteriorate beyond their control. Therefore, the incentive pay for increasing EVA is no longer significant or effective. Moreover, there were no monies held at risk that are lost if they failed to sustain EVA improvement. The time frame of contract of service for marketing staff is an obstacle in using EVA as an internal control mechanism. It is because they normally engaged for a period of a year or two and renewal at the end of the tenure subject to management discretion. .

4.4.3. EVA as Motivator

Table 4.3. provides a breakdown of the interviewees' responses on EVA as a Motivator. Generally both groups from both offices do not perceived EVA as an effective motivator.

Table 4.3. Responses on EVA as a Motivator

	Hong Kong Office		Singapore Office	
	Yes	No	Yes	No
The Support Group		2		2
The Marketing Team		3		3
Total No. of Interviewees		5 (100%)		5 (100%)

The compensation-scheme of the **Foreign Corporation** does rewards the 'doer' more highly; but without monies held at risk are lost for failing to sustain improvements in performance is equivalent to having a carrot without a stick. The performance targets are unreachable after the financial crisis as competition intensify and eat into the company's market share. With a yearly renewable contract of service, it is difficult to motivate them to strive for sustainable performance improvement.

Both support group and marketing staff in the two offices shared the same perception that EVA is not effective as a motivator. However, the marketing staff normally disliked EVA as a performance evaluation metric. Contrary, the support group treated EVA as one of the measures for them to account for their decision and management action. Therefore, it explained the high ratio of staff turnover. The percentage of staff leaving the organization is approximately 50%-60% for marketing staff and 20% -30% for supporting staff. The average length of service is less than 2 years.

The **Foreign Corporation's** policy is to attract and hire the very best people with its high pay package. At the same time, it has continuously losing these high performers. According to the survey of UNCTA that professional service firms must attract and hire the calibre individuals, make them still better through career-long training with on-the-job experience and motivate them to continue their professional relationship with the firm (UNCTA, 1993). It is because human asset is one of the critical success factors for a firm.

The support group confirmed that the **Foreign Corporation's** objective is to hire the very best people or calibre individuals from the ranks of experience industry practitioners to fresh graduates. The major challenge is to retain talented, entrepreneurial and highly skill professional staff. Monetary compensation, benefits and perks are packaged to retain these high performers. But they acknowledged that compared to large corporations such as developers, public listed companies, multinational corporations, their compensation package is least competitive and equitable. However, they continue to loss their greatest assets – talented, entrepreneurial and highly skill professional staff to these large corporations.

The major attractions for the marketing staff to join the **Foreign Corporation** are high pay, prominent name and international exposure. On the other hand, they did not perceive that it would be their life-long career with the firm due to the nature of yearly renewal contract. But working in the Foreign Corporation is a good training ground for them to quantum leap to those large corporations. Majority of them are well aware that if they fail to meet their individual performance quota, their contract of service may not be renewed. Sense of belonging was lacking among most of them since they are on annually renewal contract. It is also difficult to instil the value of loyalty and trust among them because as they perceived their stay with the organization is a transit. Because relationship building and experience acquired during their service with the **Foreign Corporation** are their personal assets. These assets will land them with other openings if their contracts are not renewed.

4.4.4. EVA as A Common Language

According to Stern Stewards, to implement EVA properly is to keep it simple and accountable. EVA must become the focal point for managing business. Increasing EVA is the company's main mission. EVA allows all key management decisions to be clearly monitored, and communicated in and out of the organization. Based on this understanding, various questions were probed to the interviewees. Among these questions are:

- What does EVA mean to you?
- Are you aware of the objectives of EVA implementation?
- Why were those objectives chosen?
- What you can do to achieve them?
- How do you communicate with your team /subordinate on improving EVA? .

Table 4.4. provides a breakdown of the interviewees' responses on EVA as a Common Language. Generally both groups from both offices do not perceived EVA act as an effective common language among them.

Table 4.4. Responses on EVA as a Common Language

	Hong Kong Office		Singapore Office	
	Yes	No	Yes	No
The Support Group		2		2
The Marketing Team		3		3
Total No. of Interviewees		5 (100%)		5 (100%)

It is surprise to find that both groups do not appreciate the underlying idea of EVA i.e. Shareholders must earn a return that compensates the risk they taken. Most of them treat EVA is just another management fad like all other performance metrics, which eventually will remain as just one of the metrics.

Between the two groups of interviewees, the support group appreciate the reasons for choosing EVA as one of its performance metrics and the managing of EVA drivers, where as marketing staff just know EVA superficially as a performance metrics to evaluate and compensate them. Monthly performance report on EVA was circulated to individual staff, division heads and director-in-charge but the interpretation of EVA data was least discussed nor brainstormed. In short, EVA is not an effective communication language in and out of the organization.

4.5. Summary of Findings

From the above analysis, it is clear that the experience of EVA implementation of the **Foreign Corporation** was far away from meeting its expectation of a desired management control system and the EVA benefits as promoted by Stern Steward. Further analysis revealed that it was its implementation mistakes that failed EVA. EVA was introduced and implemented by the Corporate Holding Company of the **Foreign Corporation**. It is obvious that the top management of the **Foreign Corporation** has not buy-in. Hence the lack of commitment was felt among the top management. Moreover, EVA implementation has added extra work to the support group while enforced further the line of accountability for the marketing group to meet performance target. Many of them have implicitly expressed their unwillingness to accept the change. If resistance is not eliminated, Bennett Stewart (1995) believes that employees will begin to withdraw or form territories that will affect the success of the implementation stage.

In addition, the finding also concurred that the **Foreign Corporation** did not make EVA a way of life because it perceives that all need to be done is perform the calculation. They also try to implement EVA too fast. It is against the underlying value of making EVA work. A company must learn to adopt the policies, procedures, and methods that drive the impacts of the concept. The challenges of implementation must be overcome by clear communication, demonstrated buy-in from upper management and training but training gets short shrift in the **Foreign Corporation.** Without all these efforts and commitments, it is difficult to ensure a uniform corporate focus to help drive the company's operations and strategy.

Last but not the least, even though incentive was tied to improvement of EVA, but without the element of bonus bank that some monies will held at risk had failed to ensure that staff will focus on creating value for shareholders. In short, EVA better explains the financial position of a company as compared to conventional accounting metrics. But it is not necessary better motivates managers to increase shareholders' wealth for the **Foreign Corporation**.