Corporate Governance and Economic Value Alignment

GERALD H. LANDER* AND ALAN REINSTEIN**

Abstract

As a result of recent problems with corporate reporting and management, renewed interest in Corporate Governance has arisen. We analyze economic value alignment as a form of Corporate Governance, a concept similar to but more encompassing than economic value added and value-based management. We look at some specific ways that various companies and industries have applied economic value added analysis. The results show that the companies that use economic value alignment increase their value significantly over those that do not. The results show that discriminating investors and management should demand that their associated companies use EVA to improve overall financial reporting and to better manage assets. In turn, the SEC and Accounting Standard Setting Bodies should consider the long-term benefits of requiring certain sized companies to report relevant EVA data to key stakeholders. (JEL F49)

Introduction

Due to recent problems with corporate reporting and management, a renewed interest in corporate governance has arisen. We analyze Economic Value Alignment (EVA) as a form of corporate governance, a concept similar to but more encompassing than economic value added and value based management. Corporate governance can be defined as the laws, policies and procedures that ensure that (1) firms run in the interest of owners and (2) scarce resources are allocated, managed and redeployed to maximize productivity and value.

At the board level, governance involves (1) board composition and incentives, (2) transparency and disclosure, (3) proxy contests, hostile takeovers and (4) the glare of media attention and criminal penalties. Management level governance is also important. Questions management needs to answer include (1) What are the best practices in getting managers and employees to think and act like owners? (2) Which management processes, organizational structures and incentive plans produce superior financial returns? and (3) How can top executive leadership and attitudes help create or destroy shareholder value?

Economic Value-Alignment is based on EVA, which in turn is based on profits. It examines an entity’s ability to cover its full costs, including the cost of capital. Unless it covers its cost of capital, it does not create wealth. By measuring the value added over all costs, including the cost of capital, EVA measures, in effect, the productivity of all factors of production. It does not, by itself, tell us why a certain product or a certain service does not add value or what to do about it. But it shows us what we need to find out and whether we need to take remedial action. Expected value added can also be used to find out what works. It shows which product, service, operation, or activity has unusually

*University of South Florida—St. Petersburg and **Wayne State University—U.S.A.
high productivity and adds unusually high value. Economic value-alignment aligns the expected value added concept to the entire management of the business entity.

Shareholder Value

Shareholder value creation has become one of the most widely discussed issues in business today. Organizations whose share prices do not keep pace with market expectations face increasingly impatient and even hostile boards of directors and shareholder activists. Even small deviations from expectations can greatly affect share prices and managerial actions. Yet, while many embrace a dynamic economy and the generation of wealth, many others view maximizing shareholder value as a corporate agenda that is hostile to employees, the environment and communities.

This debate has several dimensions. First is the question of whether the current fascination with shareholder value is appropriate. Philosophically, two distinct positions on this issue arise. On one side, some argue that an organization’s only objective should be to maximize shareholder value. Corporations should not undertake such pursuits as charitable activities or community building events. The shareholders (not management) should decide where to allocate these resources, through the dividends or capital gains they receive. This pure shareholder view resonates most strongly in the USA.

Another view holds that focusing exclusively on shareholder value is not cost-beneficial. This view argues that equal attention must be paid to all stakeholders—employees, customers, the community and shareholders—if a firm can enjoy long-term success. This is the pure stakeholder view that many European countries support.

Between these views is the position of “the shareholder is the first among equals,” probably best characterized by the late Robert Goizueta, CEO of Coca Cola, who was fond of saying, “We work hard to remember that the wonderful things our company is capable of—serving our customers, creating jobs, positively impacting society—happen only as long as we fulfill our vision of creating value for our shareholders.”

A second debate arises at the measurement level. As today’s long-term increased focus on shareholder value creation intensifies, so have the metric wars. Traditional accounting measures such as net income, EPS and ROA have been routinely criticized as misleading, manipulative and ineffectual in disclosing an organization’s value creating performance. In turn, proponents of economic value measures have responded with specific metrics and methodologies that claim to both better measure and motivate the creation of shareholder value.

Wealth Versus Value

Understanding this debate requires distinguishing between the notions of wealth and value. Stock market performance is a direct external measure of wealth. Wealth measures are important and straightforward, but also have limitations. By definition, they are only useful for publicly traded corporations. As market measures, they are influenced by events beyond the control of the firm, such as general economic and industry trends and by bullish/bearish public sentiments. Furthermore, stock market measures seldom provide an adequate measure of senior employee performance below that of CEO and cannot measure the success or failure of individual subsidiaries or business units that are not separately traded.

This is where value comes in. Value is an internal performance measure that derives from internal company reports. Measuring value and the amount of value added in any period is more problematic than measuring wealth because there is more disagreement on what value is. In recent years, firms such as Stern Stewart, Braxton, Holt, Alcar,