Review

The development of a value creating competencies index: The economic value added (EVA) approach

Meiya G. Nthoesane

Centre for Business Management, UNISA, P. O. Box 392, Unisa, 0003, Republic of South Africa.
E-mail: Nthoemg@unisa.ac.za. Tel: +27 12 352 4151, +27 74 11 33 550. Fax: +27 12 429 4798.

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Shareholders always expect business executives to create real economic value and wealth for their organisations, and accordingly, compensate these executives based on the economic value that has been created. Economic value added (EVA) is regarded as the true measure of economic value and has since been utilised as a tool for executives’ compensation. Inherent to compensating executives on EVA, is the underlying assumption that executives were selected on their ability to create value. However, studies fail to indicate where EVA has been utilised in the selection of executives. This renders a disconnection between selection and performance measure. This article put forward the argument that attributes and competency measures are some of the measures that can predict performance. Based on this, conceptualises that attributes and competencies that are linked to EVA be identified in order to develop a competency measure that is based on EVA.

Key words: Attributes, competencies, economic value added, managerial performance, measures of value.

INTRODUCTION

How can shareholders consistently expect executives to create value and wealth for their organisations and compensate executives based on value creation without ensuring that such value creating qualities and competencies are innate to executives? In recent years maximising shareholder value has become the new and widely accepted corporate paradigm. Studies by Stern et al. (1991) and Stewart (1991, 1994) pioneered the development of economic value added (EVA), a financial measurement for real economic value. These studies assert that EVA stands well out in the crowd as the single best measure of value creation for an organisation on a continuous basis. This notion is also supported by Ward and Price (2008). Subsequent to the establishment of EVA, many studies have reported the different uses and adoptions of EVA; these studies are reflected in the work of Sharma and Kumar (2010). It is worth noting that these previous studies acknowledge the link between economic value creation and executive’s performance and further recognises how the executives’ performance is linked to their compensation. Noble as it sounds, these studies have limitations with regard to the role of competencies in the executive’s development process and value creation.

The most fundamental flaw lies in the fact that there seems to be no strategic link between EVA as a performance measure and the capability of executives to create value in organisations. This paper aims to bring to light the proposition that organisations cannot measure what was never assessed. As a result, this paper further aims to bring to the surface the notion that there needs to be an exploration as to why there is a disjuncture between executive performance and executive competency with regard to the utilisation of the EVA metric. The conceptualisation in this paper is that there should be competencies that are inherent towards developing shareholder value.

MEASURES OF VALUE

Researchers including Burksaitiene (2009), Goldberg (1999), Morard and Balu (2009); Yao et al. (2009) and Young and O'Byrne (2000) posit that the primary objective of a business enterprise is to create value for both shareholders and society. However, the concept of shareholder value is not a new one - it had been reported...
As early as in the late 19th century by scholars like Marshall (Nam et al., 2009). As a result, there are many ways in which organisational value can be measured, and these measures of value highlight that organisational value can be measured by determining the excess returns between an organisation’s operating profits and the capital invested to generate such profits, within a specified reporting period. In practice, varying value measures have been utilised to measure shareholder value, and these include, but are not limited to the following:

1. Net income (NI): This is an accounting-based measure and consists of cash flows from operations (CFO) plus accruals and deferrals (ACCRUALS) (Goldberg, 1999):

   \[ NI = CFO + ACCRUALS \]  

2. Return on Investment (ROI): This is the measure that was developed to help manage a vertically integrated entity. The intent of the measure is to evaluate the organisation’s success by comparing its operating income to its invested capital (Brewer et al., 1999). The key limitation of ROI is that if executives are compensated based on this measure, they will make investment decisions biased towards themselves at the expense of the overall organisation’s best interests - the sole aim will be to have high ROI even if the investment proves futile in the long run. It is denoted by the equation:

   \[ ROI = \frac{\text{Operating Income}}{\text{Investment}} \]  

3. Residual Income (RI): Residual income is defined as the net operating income (net income plus after tax cost of debt; NOI) less the cost of all the capital employed in the business. This cost of capital is the opportunity cost of investing capital in a particular organisation instead of alternative investments of the same risk magnitude and profile. The shortfall of RI lies in the fact that it is based on historical information and is based on accounting standards. Furthermore, the residual income approach cannot be used to compare the performance of firms with divisions of different sizes:

   \[ RI = NOI - k \times \text{CAPITAL} \]  

4. Return on Net Assets (RONA): Is the indication of the ability of the organisation to generate profits relative to the amount of capital employed (Desai and Ferri, 2006). However, even though RONA reflects the amount of capital used to generate profits, this measure does not incorporate the rate required by investors providing such capital. This relationship is reflected in Figure 1, for a
hypothetical ABC (Pty) Ltd organisation.
5. Economic value added (EVA): EVA is the variant of the residual income measure. The proponents of EVA argue that by making market related adjustments to the financial statements; it makes EVA a superior and more convincing measure of value than its predecessor, residual income. EVA is the cash generated from the operations during the specified accounting period less the amount needed to replenish capital, less the opportunity cost of holding the capital used by the business during that period (Goldberg, 1999).

This paper accepts EVA as the convincing measure of shareholder value, in that as a performance measure it pays attention to both the internal company processes that drive efficiency to produce profits, and equally importantly, puts the emphasis on minimising the cost associated with financing the capital that will produce the said profits. Furthermore, EVA encapsulates most of the value drivers identified by Fiordelisi and Molyneux (2010); these authors conclude that there are factors that are significant drivers of economic profits and shareholder value, viz., income diversification, cost and revenue efficiency, financial leverage, firm assets size and a decrease in market risk exposure. This relationship is reflected in Figure 2.

**ECONOMIC VALUE ADDED (EVA)**

In support of EVA, many studies and researchers claim it to be the best available financial metric for measuring value (Brewer et al., 1999; Fatemi et al., 2003; Fiordelisi et al., 2009; Fiordelisi and Molyneux, 2010; Kryzanowski and Mohnsi, 2010; Lee and Kim, 2009; Nam et al., 2009; Stern et al., 1991; Yao et al., 2009; Young and O'Byrne, 2000; Young, 2010). The argument being that EVA differs from other metrics because it incorporates both the enterprise profits and the capital costs for such profits. Furthermore, the utilisation of EVA ensures that executives do not under-utilise the available capital that could have earned a return in excess of the organisation’s cost of capital. The fundamental feature of EVA is that it incorporates the charge for the utilisation of both debt capital and equity capital. It differs from accounting earnings in that accounting earnings only deduct the after tax cost of debt; this fundamentally distorts the real economic profits because the cost of equity capital is not included. However, if the enterprise was to be fully financed with debt, the argument of accounting earnings could hold, but it is known that this form of financing is not desirable because the company will be over leveraged and much needed value will be eroded.

EVA is defined as the difference between after-tax operating profits and the cost of invested capital, and is calculated as follows:

\[
EVA = \text{NOPAT} - \text{IC} \times \text{WACC} \tag{4}
\]

Where:
- NOPAT = Net operating profit after tax
- IC = Total capital invested
- WACC = Weighted average cost of capital
In the calculation of NOPAT, all non-operating items like interest and dividends on securities invested outside the business and non-operating expenses are not considered. The total capital invested is the sum of all shareholders’ funds and loans. In determining WACC, the cost of debt is taken as the after tax cost, and the cost of equity is determined on the basis of the capital asset pricing model (CAPM), and is given by the following formula:

\[
Ke = Rf + \beta_i \left(Rm - Rf\right)
\]

(5)

Where:
- \(Rf\) = Risk Free Return
- \(\beta_i\) = Market Risk Coefficient of Particular Security
- \(Rm\) = Expected Market Rate of Return

Sharma and Kumar (2010) acknowledge the relevance and importance of EVA and the fact that EVA focuses on both the profits and the cost of generating such profits. This supposedly makes EVA an integral business measure that is used both internally and externally to measure performance, both of the organisation and that of executives because it is consistent with the organisational goal of creating value for shareholders.

Contrary to the claim by many scholars that EVA is directly linked to firm value creation, a study by Nappi-Choulet et al., (2009) concludes that there is a negative association between firm performance and EVA. Although this study is probably trying to bring new thinking as to how we conceptualise and accept the notion of a positive relationship between value creation and EVA, it however, highlights what can be regarded as a fundamental limitation while measuring a proxy for performance. The proxy utilised was based on accounting standards, which were reported at historical costs; these lacked the market related adjustments that EVA implements to justify its claim of real economic profits.

In addition, Mittal et al. (2008), in a study that used codes of ethics and corporate social responsibility (CSR) as a proxy for company performance, found no convincing relationship with EVA. Further, Kim (2006) also found that EVA has a very little explanatory power in measuring shareholder value; however, the study that was repeated later by Lee and Kim (2009) concluded that indeed EVA is a superior measure of firm performance and value. In this context it is accepted that EVA does provide a superior measure of shareholder value creation and accordingly, the ability to create value should form a fundamental competency for executive appointment.

**ECONOMIC VALUE ADDED (EVA) AS A MEASURE OF EXECUTIVE PERFORMANCE**

The logic of using EVA as a tool for executive performance and compensation has been argued on the basis that when executive’s compensation and performance are linked to EVA, they then start thinking and acting like owners of the company (Goldberg, 1999). The objective of performance and compensation plan is to encourage executives to take decisions that will add value to the organisation. EVA motivates executives to act in the best interests of the organisation, because if they add value to the company, such acts will be rewarded and be reflected in their bonuses. Accordingly, the EVA system punishes mediocre performance; if executives make decisions that destroy value; in the same manner bonuses are lost. Goldberg (1999) further identifies the benefits of EVA compensation and bonus plans over conventional plans as follows:

1. Executives are rewarded for continuous improvement rather than just levels of EVA.
2. No need to reset or re-negotiate the plan.
3. Bonuses are tied to a performance measurement that is highly correlated to shareholder value.
4. Executives win (or are penalised) when shareholders win (lose).
5. Compensation plans drive budget; budget does not drive bonus plans.

Clearly, this system is beneficial for the long-term profitability and sustainability of an organisation. Prolific work has been done by Desai and Ferri (2006); Murphy (2007) and Rodgers (2007) in illustrating the nature of EVA and how it can be utilised as both a performance indicator and a tool for executive compensation. Additionally, EVA has been widely promoted and preferred as a performance measure and as a tool for assessing chief executive officer (CEO) performance (Coles et al., 2001; Ghani et al., 2005). It therefore, appears that EVA aims to create a connection and harmony between the decisions of both shareholders and executives. This is done in the form of creating synergy and alignment between investment decisions and performance measures by executives and shareholders respectively; an argument supported by Goldberg (1999).

However, it appears that there is a weakness in this thinking. The flaw lies in the fact that there seems to be no strategic link between EVA as a performance measure and the capability of executives to create value in organisations. Hence, this paper argues that one cannot measure what was never assessed. The underlying fundamental assumption (even though not clearly articulated) of using EVA as a performance measure and a tool for compensation is that executives do possess the competencies and capabilities essential to create shareholder value, hence measured by EVA-influenced performance measurement tools. Clearly, this assumption lacks substance, because until the ability to create value can actually be assessed, executives that are assessed based on EVA for their performance are not fairly treated. It is for this reason that this paper puts
forward an argument for the need to develop a bridge in this gap (Figure 3) by identifying those competencies that could at least be used as a proxy for creating shareholder value, in order to be able to develop a value creating index that is influenced by EVA components. Only then can it be justified that executive performance be measured by EVA and that EVA can be utilised as a compensation tool.

**How competencies creates economic value**

There has been much confusion in the literature regarding the terms competency, competence and to a certain extent competent. Competencies should and are not to be seen as a job or a task, rather as that which enables people to perform the work – that is, a class of attributes that can be used to characterise individuals and their behaviours (Mitchelmore and Rowley, 2010) and as a capability or ability (Boyatzis, 2008). Competences, on the other hand, involve the evaluation of performance in a specific domain or activity, and linking the two is an act of being competent. This relationship in the context of EVA and executive performance can be illustrated in the EVA application model in Figure 4. This illustration provides clarity as to how these related terms are distinguished in this paper. Furthermore, Hersey et al. (2001); Mitchelmore and Rowley (2010) and Sudsakorn and Fredric (2009) assert that competencies can be described in terms of personal traits, skills, knowledge and experience of the executive that lead to superior managerial performance. Within this context, an executive who can portray a certain class of competencies that are regarded as value-creating should be competent in creating economic value for the organisation; a competence that is measured by EVA informed performance
measurement instruments.

Studies have shown that there is a relationship between the competencies and an organisation's superior performance (Bertoncelj et al., 2009; Dreyfus, 2008; Kagaari and Munene, 2007; Qiao and Wang, 2009; Resnick et al., 2010; Sudasakorn and Fredric, 2009) hence it is conceptualised here that there should be competencies that are related to creating shareholder value. This renders support to the view that certain competencies will lead to superior performance; hence to create value, one needs to have an understanding of which competencies are important in an attempt to achieve this superior performance.

Boyatzis (2008) identified three critical steps in constructing competencies of superior importance. These are the action - a set of alternative behaviours; the intent - which calls for measurement methods that allow for assessment of both the presence of the behaviour and the inference of the intent; and finally measurability - the ability to measure these competencies. This assertion is compatible with the notion that competencies can be essential in ensuring the creation of economic value in organisations in three simple ways:

1. Action: This is defined as a set of behaviours and refers to the skills, knowledge and experience that an executive should possess.
2. Intent: The underlying intent that is, the ability to create shareholder value.
3. Measurability: Developing a measuring tool or an index that can measure these competencies in executives.

Research highlights that one of the interesting distinctive features of competencies is that they can be developed in adulthood (Boyatzis, 2008); this is critical in that it provides a platform for continuous leadership development - an essential factor in developing leaders for creating value for their organisations. This is also illustrated in the personal development loop in Figure 4. Furthermore, Greaver (1999) asserts that competencies are a source of organisation's future competitive advantage and critical ingredients of organisation's core competencies; a much needed contributor to sustainability, profitability and value.

Importance of competencies and attributes

For a performance measure to be effective, its components need to be linked to the competencies and attributes that were identified as requirements during the selection process of an executive. This is important because authors like Wise (1975) find that there is a positive relationship between personal attributes and job performance. Similarly, Glass (1985) claims that personal attributes are considered as key in assessing the possible success (which in the context of a company can be equivalent to performance) in a presidential candidate, while Hemingway and Maclagan (2004) highlight that personal values play a meaningful role in how managers implement organisational policies to achieve the creation of value. Lieb (2003) affirms that attributes play a key role when recruiters are searching for appropriate executives.

To this end it is becoming clear that the role of executive competencies in organisational value creation cannot be overlooked. In support of this, Heffernan and Flood (2000) illustrate that organisations that adopt certain competencies become more superior performers than their counterparts. It is therefore essential to conduct competency assessment right at the selection phase of an executive so as to ensure a proper alignment of these competencies with the desired performance.

The value of competencies is captured by scholars like O'Leary (2010) and West and Crawford (2010) who argue that competency assessments improve productivity, profitability and project performance. In addition, McPhee and Kerr (1985) affirm that these assessments assist in identifying and predicting performance, and are pivotal in identifying predictors of achievement and future performance. Further support is from Laffan (2009); Brownell (2005) and Kanaga (2007) who affirm that competencies recognition and assessment is a valuable means in predicting leadership success and responding to future leadership requirements and is instrumental in identifying ‘focused’ executives.

Categories of competencies

DeFillippi and Arthur (1994) suggest that three career competencies exist namely: knowing-why competencies, knowing-how competencies and knowing-whom competencies. These are explained in details as highlighted:

1. Know-why competencies aim to answer the question ‘Why?’ as they relate to career motivation, personal meaning and identification. These provide executives with the drive, sense of purpose and identification with the world of work, and they relate to career clarity, confidence and insight (Cappellen and Janssens, 2008).

Authors further sub-categorised this into:

i. Work-life balance
ii. Professional identification
iii. The centre of decision making
iv. Career progression
v. A search for challenge

These competencies provide meaning and should be the ones that add value, even to executive’s careers/lives.

2. Know-how competencies refer to career relevant skills and job related knowledge competencies, and are
reflected in an individual’s job description (DeFillippi and Arthur, 1994), which contribute to both the organisation’s and the individual’s knowledge base (Cappellen and Janssens, 2008). In addition, the latter sub-categorised this competency class as:

i. Operational/work (Sudsakorn and Fredric, 2009) skills
ii. General business understanding

This is important in that it provides the operational and technical ability on how to create value. It brings together all elements of being able to create value from income generation to efficiency, to risk management and decision making.

3. Know-whom competencies reflect career relevant networks and refer to how people contribute to inter-firm communication (DeFillippi and Arthur, 1994). Additionally, Cappellen and Janssens (2008) highlight that these competencies no longer refer to business networks only, but increasingly reflect communities of practice located outside organisational boundaries and sub-categorised them into:

i. Professional networks
ii. Personal networks

It may appear that most of the emphasis should be placed on the know-how competencies because they are concerned with ‘action’, the ability to ‘do’ and this should be core to this debate. Even so, this does not totally exclude other competencies because the act of creating economic value can also be derived from the knowing-why and knowing whom competencies. Chandler and Jansen (1992) expand the concept of know-how competencies by linking this to three executive roles; viz. entrepreneurial, managerial and technical roles that executives must competently enact in order to achieve success in the organisation.

BUSINESS QUO VADIS?

Previous studies affirm that executive competencies have been shown to be related to superior organisational performance. Accordingly, other studies have shown and argued that competency models and competency testing are some of the valuable tools available to organisations when selecting executives. Reports such as that of the ANOVA communications group (2008) assert that ‘personality testing’ and ‘ability testing’, contribute to 38 and 54% respectively of job performance predictors. Studies by Robie et al. (2008) and Tyler and Newcombe (2006) confirmed that personality traits assessment is related to managerial and work performance.

These observations put to front the idea that there should be competencies that are inherent to creating organisational economic value. It can be argued that there are four broad areas of competencies that underscore the creation of real economic value:

1. Revenue optimisation.
2. Minimisation of operational costs, or managerial efficiency.
3. Cheap cost of capital, or risk management.
4. Profit optimisation.

It appears that this conception supports the argument by Fiordelisi and Molyneux (2010) who identify the drivers of economic profits and shareholder value as income diversification, cost and revenue efficiency, financial leverage, firm assets size, and decrease in market risk exposure. Moreover, this conception also shows the need for strategic and technical competencies in creating value; effectively concurring with the view of Chandler and Jansen (1992) who provides a link between the know-how competencies and the three executive roles, namely entrepreneurial, managerial and technical.

To this end, further research in bridging the gap between executive performance and executive value creation abilities needs consideration. In this way, the expectation of executives to create economic value will receive the necessary justification.

REFERENCES


