Wealth creation and managerial pay: MVA and EVA as determinants of executive compensation

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Abstract

Designing effective compensation contracts has become increasingly complex due to the globalization of the executive work force and the multitude of incentive schemes. We examine the relationships between managerial pay and firm performance among domestic and global firms using economic value added (EVA) and market value added (MVA) to assess wealth creation. Our work suggests that top managers in domestic- and globally focused firms are not only incented to increase EVA, but also rewarded for past additions to MVA. The results of our research suggest that managers of highly globalized firms tend to be paid at higher levels, reflecting the increased complexity of managing global firms.

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1. Introduction

Previous studies have proposed that optimal executive compensation contracts perfectly align the interests of the executives with those of the firm’s shareholders (Grossman & Hart, 1983; Harris & Raviv, 1979). In theory, such contracts act as incentive mechanisms for executives to engage in behaviors that maximize the firm’s value and reward executives for such behavior (Fama, 1980; Jensen & Meckling, 1976). Whether executive compensation contracts meet this test of optimality, ex ante or ex post, is an empirical question subject to ongoing investigation (Tosi, Werner, Katz, & Gomez-Mejia, 2000).
Several studies have examined the relationships between measures of firm performance and top manager pay. For example, Murphy (1985) found a statistically significant relationship between the level of pay and performance, while Mehran (1995) found firm performance is positively related to management’s ownership stake and to the percentage of its equity-based compensation. However, Jensen and Murphy (1990) did not find a significant relationship between changes in firm value and changes in executive compensation. Miller (1995) showed no support for a linear relationship between pay and performance, but found strong support for a convex relationship. Hadlock and Lumer (1997) found that pay–performance sensitivities have significantly increased over time for small firms, but not for large firms.

More recently, in a study examining the role of boards in setting managerial pay, Porac, Wade, and Pollock (1999) found evidence that boards make comparisons within and between industries in which the firm competes to support their top management compensation decisions. The authors conclude that boards of directors tend to “anchor their comparability judgments” by examining other firms’ performance. This suggests that top manager performance is assessed based on relative measures and with an eye toward the industry environment affecting the firm.

Unfortunately, most of the studies exploring the nature of the relationship between managerial pay and performance have used accounting-based measures of performance (such as return on equity [ROE] or return on assets [ROA]). Such measures may bear little resemblance with the economic return earned by the firm since accounting-based measures do not account for the risk incurred by the firm’s managers in their search for growth and profitability (Shiely, 1996). For example, earnings growth which may follow a decision to increase the size of the firm does not automatically lead to a per-share growth in firm value because the former may be achieved at excessive capital costs (Copeland, Koller, & Murrin, 1995). In addition, even studies using measures of performance based on market returns fail to adjust returns for the level of risk exposure (Harris & Raviv, 1979). Thus, the exact relationship between pay and performance can be somewhat different than what the empirical results suggest because the impact of risk is not adequately accounted for in commonly employed measures of performance (Lehn & Makhija, 1996; Stewart, 1991).

Our study is designed to further clarify the nature of the pay–performance relationship by adding risk to the equation. Specifically, we seek to investigate the relationship between top management compensation and two measures of risk-adjusted firm performance: economic value added (EVA) and market value added (MVA). EVA and MVA are measures developed and trademarked by the Stern Stewart and Co. First suggested by Stewart (1991), EVA can be thought of as a proxy for the measurement of economic returns. It is the firm’s residual profitability in excess of capital costs. A firm’s EVA is positive when after-tax operating profits exceed the dollar cost of capital (COC). MVA is a closely related measure in that it is the present value of all expected future EVA and can be thought of as the net present value of the firm.

Variations of these measures have been proposed, and used, by others (Copeland et al., 1995; Rappaport, 1986). However, EVA and MVA have received wider attention both in the corporate world and in scholarly research (see for example, Hodak, 1994; Lehn & Makhija, 1996; Spinner, 1995; Tully, 1993; Uyemura, Kantor, & Pettit, 1996). Included among these are studies that have attempted to document the presence (or lack thereof) of
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