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# Liberty Business Review

Volume 1

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A New Concept

*Dr. Bruce Bell*

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*Kristen S. MacNevin*

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Leverage Buyout

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*Dr. Bruce Bell*



**LIBERTY**

**UNIVERSITY**

**Lynchburg, VA**

# Liberty Business Review

Liberty Business Review  
Lynchburg, Virginia

## Liberty Business Review: A New Concept

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*Liberty Business Review: A New Concept*

Bruce K. Bell, Dean  
School of Business and Government  
Liberty University

The *Liberty Business Review* is a new concept in peer-reviewed business journals. With this inaugural issue of the publication, we hope to fill a void in the ever-expanding field of business journals.

First, the *Liberty Business Review* is unique in its primary medium as an online journal. While copies may be made available in hard copy, the journal is designed to be accessible to the wid-

est possible audience in an easy to retrieve online format. Because knowledge should be available to everyone, the editorial staff of this journal wish to provide the articles contained in this publication to all interested parties without cost.

Second, this journal will contain academically mature articles by students and faculty at Liberty University and throughout the country. While this initial issue contains just four articles that have been reviewed by the editorial board and other academicians at Liberty, future issues will contain articles by scholars in Business and Economics at Liberty and other outstanding universities. Moreover, scholarly articles that are

presented for publication from non-academics will be considered as they contribute to the literature.

Third, the articles will be of broad interest to a widely diverse audience, and consequently they will examine issues of scholarly importance in those fields. At the same time, however, the articles will promote a Christian worldview and will highlight the integration of that worldview into the academic disciplines. Consequently, future articles may well analyze best practices in the teaching of Business within a Christian setting. The test for publication will always be academic rigor and scholarly interest.

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**"The purpose of the *Liberty Business Review* is to examine issues of Business and Economics from a Christian perspective and with a commitment to scholarly excellence."**

The purpose of the *Liberty Business Review* is to examine issues of Business and Economics from a Christian perspective and with a commitment to scholarly excellence. As future issues are published, articles will be solicited from students and faculty at Liberty University and from other colleges and universities around the

country. It is the hope and expectation of the editorial board that this journal will be a powerful vehicle contributing to the theory and practice of principled business in this country and around the globe.

The four articles contained in this inaugural issue are as follows:

First, Kristen S. MacNevin examines ethics in the Accounting profession, examining specifically recent corporate scandals and positing the influence of post-modern culture in the workplace.

Second, Timothy J. McCollum explores the

# A New Concept Continued from page 1

value system of the U.S. Marine Corps and suggests the Corps' process of inculcating values as a model that might be adopted by civilian organizations.

Third, Huong T. Nguyen analyzes foreign currency exposure and foreign exchange risk management in multinational companies, emphasizing the importance of managing risk, minimizing possible loss, and protecting profits.

Finally, Kyle Phelps presents a historical view of leveraged buyouts in the 1980s, adding that the growth of global business ventures demands a more comprehensive financial model—Economic Value Added—as a more

appropriate and more effective corporate governance system for contemporary organizations.

Our hope is that the reader of this issue will be enlightened, engaged, and edified by these student papers and will join us in anticipating the next volume of the *Liberty Business Review*.

## Accounting Ethics by Kristen S. MacNevin

**Accounting Ethics: A Consideration of the Modern Ethical Environment with Relation to Current Accounting and Business Ethics**

### Abstract

The rise and fall of the Enron Corporation set off a long-burning fire under the American social conscience. Clearly unethical behavior had occurred within Enron and within other

members of corporate America. As a result it is necessary to investigate how such behavior occurred. The nature of accounting is key. In order for ethical principles to apply to such industries, it must be shown that they can be considered moral or ethically responsible institutions. Secondly, an adequate discussion of what business ethics is commonly defined as must be provided before the ethics or lack

thereof of accountants may be examined. Third, the role of those same ethical standards must be explained within a business context. Fourth, recent societal preventative measures for unethical practice should be examined. Fifth, and finally, the contribution of philosophical trends and the current philosophical mood of society must be investigated in order to delve into the mindsets of those who

**“Accountants and business persons are not inherently more likely to choose immorality over ethical behavior than any other segment of society.”**

perpetrate such acts as society seeks to condemn. Such investigation will show that the downfall of the financial greats should not have been as unexpected as it appears to have been, rather the infiltration of postmodern thinking into all aspects of daily life should have been the first and most obvious

warning sign of future events.



The key to success is a good education!

### Introduction

The mercurial rise and fall of the Enron Corporation set off a long-burning fire under the American social conscience.

The shockwaves extended down Wall Street and around the world, prompting scores of companies to voluntarily restate and correct their earnings statements. From every crevasse and corner voices rose demanding increased accountability, demanding tighter regulation, demanding that the unethical be brought to justice. Despite

Clearly, in such estimation, those at fault should be punished. However, perhaps it is more instructive to investigate how such a widespread behavioral trend was spawned in the first place. The base upon which social and business ethics rest, and the social conscience under whose watch the fall of Enron occurred, are inherently flawed, having been undermined by a move to embrace relativism and positivism during the last several decades. Under such secular and naturalistic contexts there can be no legitimate form of ethics or any resultant method for genuine accountability.

Fundamental to the issue at hand is the nature of accounting and business. In order for ethical principles to apply to such industries, it must be shown that they are inherently moral or ethically responsible institutions. Secondly, an adequate discussion of what business ethics is must be provided before we can truly investigate why the current situation does not conform to those standards. Third, the role of those same ethical standards must be explained within a business context. Fourth, recent societal preventative measures for unethical practice should be examined. Fifth, and finally, the contribution of philosophical trends and the current philosophical mood of

society must be investigated in order to delve into the mindsets of those who perpetrate such acts as society seeks to condemn. Such investigation will show that the downfall of the financial greats should not have been as unexpected as it appears to have been. The downward trend is a study in contradictions that has been a long time in the making. However, at the very beginning it is important to make the following distinction: despite the fact that most of society views business as a whole, including executives as inherently dishonest (Carroll, 1996), accountants and businesspersons are not inherently more likely to choose immorality over ethical behavior than

**“Under such secular and naturalistic contexts there can be no legitimate form of ethics or any resultant method for genuine accountability.”**

any other segment of society (De Vries, 2002).

**Brief Observations on the Business Climate**

In light of the current scandal-ridden business environment, it may be helpful to bring the following to mind:

as long as there has been a business community with people to operate and act within it, there has been unethical behavior (Schlender, 1982). The shock and dismay that we as a society feel in the wake of the collapse of Enron, Arthur Andersen, WorldCom and others brings to light a surge of indignity that seems misleadingly unfamiliar.

***Failure of Business Ethics in the Last Half Century***

It only takes a few moments to make a backward glance at the events of the subsequent decades and see that what society calls unethical behavior is not new to the American business community. In a current business ethics textbook, Archie Carroll (1996) recounts several instances of ethical

**“Of the top 500 corporations, over twenty percent, 115 in total, had either been criminally convicted or settled a civil case dealing with other forms of intentional wrongdoing.”**

missteps during the last half century. During the 1960s price fixing in the electronic equipment industry drew public ire followed by the savings and loan scandals of the 1980s and 1990s. Such a brief reflection fails to encompass the rampant scandal culture that has since



...they shall mount up with wings as eagles. Isa. 40:31

emerged, adding political and social scandals to the unwritten list of ethical misjudgments.

A study conducted by *US News & World Report* in 1982 revealed some shocking statistics about high-level corporate America. Of the top 500

corporations, over twenty percent, 115 in total, had either been criminally convicted or settled a civil case dealing with other forms of intentional wrongdoing. To add to the gravity of the situation, the top 25 companies of the initial 500 had worse courtroom statistics than the aggregate (Carroll, 1996).

Logically, recent troubles would cause one to wonder how unethical behavior could have become so commonplace, so rife in American accounting and commercial circles. These business communities, by their nature, are created to serve the public interest, either in providing a product or a service necessary to daily life. A Certified Public Accountant, for example, is granted special certification by each state's government, presumably as an agent of the public. With that certification comes a corner on the accounting market as well as a responsibility to maintain public trust (Williams, 2002). However, the events of the last several years have begun to call that level of responsibility into question. W. Michael Blumenthal attempts to explain the rise in corporate irresponsibility stating that "[p]eople in business have not suddenly become immoral. What has changed is the contexts in which corporate decisions are made, the demands that are being made on business, and the nature of what is considered proper corporate conduct" (as cited in Carroll, 1996, p. 109). Jack Behrman (1981), in his study of business ethics describes a similar struggle, ascribing the rising tension to the conflicting needs of the quantitative plans and qualitative ethics that managers are increasingly forced to integrate. Many factors must be considered to give an accurate assessment of the development leading to the current study in contradictions. The natural first step, it would seem, would be to conduct some form of empirical study to discern whether or not business ethics had indeed declined in a measurable way. However, as ethics are qualitative by nature, an honest quantitative study of their decline or rise would be scientifically impossible (Carroll, 1996). Thankfully, qualitative research methods can be employed to discern trends within the field, even if not through use of a more rigorous scientific method.

### **Media Involvement**

With such a scandal ridden past, it seems appropriate to wonder why the current situation seems to draw seemingly more public dismay than its predecessors. One hypothesis is that the increase of public involvement is due to an increase in public awareness. With the proliferation of information sharing technology, news media have been able to disseminate the current state of business ethical affairs to a

much wider audience of consumers (Carroll, 1996). With increased saturation it naturally follows that there would be increased public outcry.

### **The Influence of Stock Price**

Much of the unethical behavior of the last several years has been a result of management focus on stock price and stock valuation above other concerns. In some cases, Sunbeam Corporation, for example, initial massive cost cuts led to increased stock prices, but in the end, decreased the long-term value and potential life of the company (Seglin, 2002). Additionally, many indicators point to the demise of Enron stemming from an overwhelming emphasis on stock price. According to Jeffrey Seglin (2002), with sixty percent of Enron's employees as stockholders, the emphasis on stock value was so high that displays in company elevators kept employees aware of the real-time price of their investments.

### **Accounting and Business as Moral Institutions**

In recent years a trend has begun to emerge, seeking to compartmentalize aspects of life, relegating morality and moral judgment to private life, and creating a sterile, mechanized business environment. However, the proponents of this dichotomy are often some of the first to decry a CFO caught in embezzlement as being unethical. How can that be possible? If accounting and business are, in and of themselves, nothing more than systems designed for achieving some specific end, then how can any moral value be ascribed to actions contrary to a specific procedure? Paul Williams (2002) makes an observation on the shift in the nature of accounting over the past several decades. Instead of being seen as a steward of the public interest and trust, the accountant is now seen primarily as a provider of accurate and timely information, and so long as he or she follows a prescribed formula, the information will be acceptable to those holding them accountable. Behrman (1981) makes the observation that the trend to mechanize is typical of American society by saying, "Western man believes that we can achieve what is right by intellectual and technical effort" (p. 61). This false sense of purpose has created a

minefield of decisions for accounting and business professionals. The Financial Accounting Standards Board, also known as the FASB, devises standards for the reporting and preparing of financial information under the framework that "[s]tandards are clearly not viewed as moral directives, but as solutions derived by an application of some knowledge system believed to be a technology" (Williams, 2002, p. 13). Williams continues to build his case by creating a scenario in which a person uses a recipe to create a pie. Instead of using flour in following the recipe, the cook uses cement. Now, clearly the cook did not follow the recipe, but does that give rise to a charge of the cook being unethical? Certainly not, perhaps it would be more accurate to say that they are careless, or thoughtless, but not unethical. According to Williams (2002), to declare that someone is unethical for failing to comply with a standard presupposes that the standard had some inherent moral authority. He further proves his argument:

Unless accounting rules, standards, and procedures are regarded as moral directives or norms, it is incoherent to label as unethical someone who does not comply with them.

But to speak of accounting as merely a body of technical knowledge that, when applied, is capable of producing moral directives exposes accounting to accusations of intellectual incoherence. Moral directives cannot be justified solely on technical grounds. (2002, p. 2)

Therefore, it is logical to assume that there is a measure of moral fiber under-girding the fabric of the accounting system. However, since a sense of morality cannot coherently be derived from a solely technical directive, it follows that, as John Kaler (1999) explains, "there has to be some sort of prior knowledge of the nature of morality...it is only by having that knowledge that we can be in a position to judge what is and is not a correct resolution of an ethical problem" (p. 210). Despite the attempts to reduce accounting and business to mechanical procedures, the moral underpinnings and responsibilities still remain, binding those who call themselves professionals to their standards.

### **Business Ethics Defined**

There are many levels on which to examine business ethics. The first level is to discuss to whom the ethical standards primarily relate. Carroll (1996) defines ethical responsibility as that which “embod [ies] the range of norms, standards, and expectations that reflect a concern for what consumers, employees, shareholders and the community regard as fair, just or in keeping with the respect for or protection of stakeholders’ moral rights” (p. 35). For these ethical responsibilities to be worth any consideration there must be some basis for their assertions. In general terms, ethical behavior is based upon a set of moral norms and directives, usually those embraced by society as a whole or by societal sub-groups, that prescribe ways of behavior. For instance, specific prohibited forms of behavior may include lying, cheating, and murder (Seglin, 2002). These moral norms as well as many others are frequently derived from a society’s religious structure, be it liberal or conservative, with the mandates of the religion framing and regulating all aspects of social behavior (Kaler, 1999). In one form of interpretation, “business ethics is no more and no less than the prevailing moral code of the society as applied to business activities” (Camenisch, 1982, p. 195). The resultant failure of the business community appears to derive itself, at least in part, from the seemingly arbitrary and self-protecting nature in which the ethical standards are derived. If ethics are based on little more than just whatever society feels to be right at any given time, how can those ethics ever be enforceable? If the ethical framework has no more justification than to serve one’s interests or to protect a way of life, then those ethics should be called into question. There must be some transcendent authority for absolute claims to be justifiable.

### **The Role of Ethics in Accounting and Business**

The structure of American society is such as to place different expectations upon each of its operating sectors. According to Carroll the primary purpose that the business sector plays is one of economic utility (1996). That means that whatever the stated goal or mission of the enterprise, the ultimate purpose is to create economic activity, economic gain, and to engage in economic transactions. As a result of its

high impact in the economic aspect of society, business has a responsibility to represent its actions fairly to and consider its stakeholders, those who have a “vested interest in the firm” (Carroll, 1996, p. 23). Carroll continues, explaining that the business or firm has an “implied level of ethical performance suggested by a consideration of the great ethical principles of moral philosophy” (1996, p. 36). So, the economic function is not one that stands as a primary end in and of itself. Companies have a duty to provide information to those stakeholders that is understandable, timely, and relevant, and the accountants bear the responsibility of ensuring that these purposes are met (Behrman, 1981). However, the stakeholders, as important as they are, are not the only users of information who must be considered.

Occasionally, conflicts of interest will develop between the organization and the organization’s shareholders, forcing the company’s management and accountants to find a way of allowing both groups to co-exist in harmony with whatever decision is made (Carroll, 1996). The economic success of a firm is only as good as it is tempered by an overriding concern for treating all stakeholders in a way that is fair and ethically responsible. However, frequently managers will interpret a responsibility to stakeholders as meaning that a particular financial goal must be met. If an earnings projection is not achieved, the manager feels that they did not fulfill their duty to the stakeholders. That is not necessarily the case, though. Frequently a financial professional will have to make a decision that is ethically sound, but will not produce a particularly desirable economic result. Jeffrey Seglin (2002) explains that “[w]hile it’s nice to think that making ethical choices always results in a better bottom line, that’s not necessarily the case. Sometimes a leader must make an ethical decision even when he or she knows it might result in a short-term hit to the company’s bottom line” (p. 78). In the case where ethics and economics clash, unfortunately, it is often economics that win such struggles.

### **Current Measures of Encouraging Socially Ethical Behavior**

Due to the overriding concern for the treatment of stakeholders in business and accounting matters, society has created several solutions for creating an environment conducive to ethical behavior.

### ***The Legal System***

The first mode of fostering ethical behavior is through the imposition of laws. As soon as word of the first accounting scandal hit the newsstand and airwaves, the cry rang out for increased regulation for the accounting industry. Many desired to add more laws to the current system, and others, disenchanted with the privately regulated nature of the profession, called for a system administered entirely by the government, cutting out professional regulating bodies like the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). The most prominent result of such recent outcries is the Sarbanes-Oxley Act that seeks to corral corporate executives and ensure properly reported financial statements. The rallying cry gained tremendous popularity, as it has happened every time that a scandal has hit the front page, and if the law was the answer, then it would follow that there would have been no further transgressions. Unfortunately, there have been and there probably always will be further scandals. The partial reason for this is that many of those in the business community believe that to have information is to also wield a form of power, meaning that the person “who has the information is able to make better decisions in a market than he who does not” (Behrman, 1981, p. 97). In certain cases, it would be to the distinct advantage of a business to either withhold or twist a bit of information to its own benefit, and therefore, a business will look for a legal loophole or a way to skirt the law. However, a desire to not disclose all information may not be necessarily rooted in a desire to deceive, it may simply be that the company does not want to disclose too much information to the wrong parties (Behrman, 1981). For instance, a business may not want to disclose detailed financial information that would allow competitors to find a way to differentiate themselves and take away market share.

It is important to note, though, the nature of the law with relation to society as a whole. For the most part, what is accepted

and adopted as law can be said to be representative of what society as a whole believes to be ethical behavior. In Carroll's (1996) words the law "reflects society's codified ethics" (p. 113). Granted, not every person agrees with the tenets embodied by the law, but it is safe to say that a majority of persons must subscribe to the belief behind the law for it to be upheld in such a society. Now, the premise that to obey the law is the sum total of ethical behavior is an attractive view, and not entirely un-expected given the primacy of law in our society. An accountant may be able to justify any number of dishonest or questionable practices based on an assumption that if it is not specifically prohibited then it must be ethically permissible. What they fail to realize is that the law is not to be definition of or high water mark for ethical behavior, but rather to be the starting place, a floor if you will, from which all else rises. Seglin (2002) makes the observation that group consensus is not a justification for unethical behavior and that "just because an action is legal does not automatically make it ethical" (p. 76). Ethics must be a higher standard of behavior to which one adheres. Carroll (1996) explains that the law cannot encompass all possible situations in which a decision might be made, and therefore cannot be the highest standard that we base our decisions upon. There must be a standard that is overarching, one that is more dynamic than

**"Sadly, only twenty-three percent of those students surveyed felt that there was any relationship between ethics and producing correct financial statements."**

the specificity of codified law. This is not to say that the law is inadequate, because the law serves its purpose, but it is to say that the law is not and should not be the ultimate authority.

### *Collegiate Ethics Education*

A second way that American society has sought to combat unethical business practices is to institute what some deem to be comprehensive ethics courses into collegiate business and accounting curricula. The theory is that if students are presented with specific situations in a classroom environment and then given the

tools with which to ascertain an ethical solution that this will facilitate the development of a more ethical accounting profession and business environment as a whole. A study conducted by Zogby International and sponsored by the National Association of Scholars shines some light on the ethical state of the college students that these courses seek to influence. Senior college students were asked a battery of questions and the results ranked what the group as a whole deemed the highest ethical responsibility of business to be. The highest-ranking ethical action was to preserve diversity and equal opportunity within a workforce. Sadly, only twenty-three percent of those students surveyed felt that there was any relationship between ethics and producing correct financial statements. These same students reported that, according to seventy three percent of respondents, their professors teach a relativistic culturally differing view of morality and ethical behavior where there are no absolutes (Lamer, 2002). It is within this context that ethical instruction takes place for America's future business leaders. Many classrooms emphasize that students must be ethical in their business practices, and that the way to do so is to attend to financial and social concerns. At the same time, the same classrooms teach the same students that there is no objective truth and that truth is different for each person. Robert Sirico, president of the Acton Institute for Study of Religion and Liberty weighs in on the issue of business ethics discourse saying that:

it is lacking in an important respect: it deals with the ethics of a corporation as if they were a special mode of behavior rather than an extension of personal and individual ethics. In fact, the subject of individual ethics is so dicey in these days of relativism and positivism that the subject of personal morality is not likely to come up at all in discussions of business ethics. (2002, par. 5)

So students are given prescribed circumstances in accounting and business decision-making and then asked how they would respond in the given situation. Of course, the students must first abide by the laws set up by federal and state authorities, and standards set by governing bodies such as the FASB and SEC, but the trouble comes when the student must consider a situation to which specific statutes do not

speak. What method the student uses depends largely on the philosophical bent of the school and professor. Overall, the utilitarian approach of the maximum good for the maximum number is the approach that textbooks and scholars advocate in such circumstances. Charles Colson (2002), a respected author and lecturer in the subject of ethics, critiqued the teaching of business ethics explaining that schools such as Harvard and other academic elites would have a difficult time teaching a reasonable model of ethics as they are committed to philosophical relativism. He continues to explain the impact of this dilemma on the current situation saying: "Enron's collapse exposes the glaring failure of the academy. Ethics historically rests on absolute truth, which these institutions have systematically assaulted for four decades" (par. 8). Additionally, it seems that the teaching of ethical theory frequently has a misleading focus on performance. Don Soderquest, former Chief Operating Officer of WalMart, stated in an interview with World magazine that he "worries that most books on business ethics mistakenly focus on behavior...It's not what you do, but what you believe. Behavior will always be governed by what you believe" (Lamer, 2002, p. 15). The focus of ethical education on the performance of the person who must act is not entirely unjustified, but should not be the first priority. A greater emphasis must be made on laying a reliable foundation for making such actions. If the actions are the focus, and the foundation is not laid then by default the structure with which the student is presented to solve moral dilemmas is weak and doomed to ultimately fail.

The focus on ethical education as a means to produce ethical actions is also problematic due to the approach being taken. Ethical theory, in and of itself, is interpreted as being a method by which decision-making can be reliably undertaken and proper results occur when the methods are applied. Such a statement is, by nature, devoid of any true meaning, reducing ethics to no more than a recipe for success. As a result, John Kaler (1999) disputes such an undertaking asserting that teaching such methods to business students with the intent to influence their future business dealings is to "invite not just confusion but non-cognitivism: the view that in ethics there are no right answers and so argument is redundant" (p. 208). Surely



this is congruent with the current societal mantra of universal tolerance. It seems self-defeating to teach students that there is no ultimate authority and that there is no higher or absolute truth and then to expect them to adhere to absolute standards within the business community. Even the argument for the use of cultural norms and utilitarian justice fall short in creating a reasonable permutation between the business world, which by necessity must rely on absolute standards to ensure equal and fair treatment of all, and the personal decision making structures of those populating the business community, which are increasingly based upon relativistic thinking. Teaching students ethical principles that they should apply to business decisions is not an inherently bad idea, however, the tools which are being given to the students to solve the problems are what seem to be lacking. Perhaps, as Robert Sirico (2002) suggested, it would be more productive to return to a form of ethics instruction that emphasizes universal virtues and absolute morality, than to continue to cloud the true goal by attempting to educate by using simply case studies on current controversial topics. Unfortunately, with society's current trend to marginalize Judeo-Christian ethics, such a paradigm shift would require significant amounts of influence. Charles Colson (2002) explained the situation well when he said that the collapse of Enron signaled the failure of ethics education. The fact that such education provides no basis for rational decision-making apart from subjective humanism is a compelling explanation. It is irrational to teach relativism and positivism, emphasizing the idea that individual interpretation is the highest form of enlightenment, and expect that these same persons will act in any way other than a subjective self-serving manner. All of the education or indoctrination in the world cannot change the human heart against its will, and attempts to teach two such conflicting worldviews will naturally lead to the confusion that cultivated the business scandals.

### ***“Whistle-blowing”***

In addition to the law and ethical education, society, in particular the business world, instituted internal measures to help ensure that unethical behavior does not go unpunished. The common term for this practice is “whistle-

blowing.” What is implied by whistle-blowing is that when an employee views what they know or deem to be unethical or unlawful practices taking place, they are bound to a standard that compels them to report the wrongdoing to their superiors or to an outside governing board. Unfortunately, what was set up to empower workers to maintain an ethical environment has two disadvantages, first the wrongdoing is not remedied, and second, the whistleblower suffers personal repercussions from their honesty. Joseph McCafferty (2002) discusses this dilemma in an article published in *CFO* magazine. He comments that those who are known as whistleblowers often end up being treated as trouble makers, losing their jobs with little hope of finding new ones or suffering undesirable social stigmatism. Such ethical behavior is rarely rewarded. Frequently co-workers within the company will view whistle-blowing activity as a signal of disloyalty. It seems natural, given such repercussions, that many people would rather turn a blind eye to problems than to confront them. With such undesirable obstacles in the way of those who would shine a light on wrongdoing, the only reason, it seems, to come forward would be to maintain ones own personal integrity.

There are additional impediments to a potential whistleblower. Many companies instill a fierce loyalty within their employees, and such a potentially misguided sense of loyalty could cloud the judgment of a person who was a witness to misbehavior. Fear of causing a reaction that could lead to the demise of the company and eventually cost them and their co-workers their jobs, many employees would rather not speak out (Seglin 2002). So, it would appear that the institution of whistle-blowing, while a good idea in theory, does not serve the purposes that it was created for. The prime culprit seems to be the failure of ethical standards and a lack of personal integrity on the part of those whom it depends.

### **The Failure of Postmodern Society**

Given three of the attempts that society has taken to foster ethical behavior and ethical practices within the business community, it seems that they fall short of accomplishing their goals. While all are valiant attempts,

with good intentions at their core, all ultimately fail due to one overriding factor: rampant post-modernistic thinking. James Sire (1997), a philosopher, makes the observation that “the effects of postmodern perspectives can be seen almost everywhere in Western culture” (p. 185). The business and accounting communities, although based in absolute truth at the start, are no exception, having been permeated by relativistic thinking over the years. As goes philosophy, so goes society.

### ***Postmodernism: A Brief Definition***

Postmodernism, as a worldview, can be very complex and difficult to understand. There are many facets to postmodern thought. First and foremost, there is no objective truth. Nothing can be known for sure to be true, and naturally, if that is the case, then nothing can be said to be false either. Truth is a non-entity. Reality is simply what a person defines it to be (Sire, 1997). Since the nature of existence is relative, the things that we call values must also be relative as well. In fact, the postmodern view asserts that values are a construct of society and of culture (Takala, 2002). Whatever suits society at a given point in time is what will be deemed to be ethical. Whatever does not suit society will be deemed unethical. There is no other underlying reason for it. It becomes simply a matter of what is useful and beneficial to those who hold the power. The natural extension of this line of thinking is that a value or ethical frame will change when it no longer is useful or would cause an undesirable result to those who would use it (Kaler, 1999). Therefore logic and reason are not useful methods within the postmodern framework, because postmodernism in its most basic sense is the end of reason and logic as we know it (Takala, 2002). It is important, however, to note that not all aspects of postmodernism are negative. The postmodern movement began as an effort to correct what were deemed to be the problems and excesses that arose in the modern era, and as such, were a positive attempt to correct past inadequacies. Additionally, the troubles reflected in Enron and the other corporate giants can be traced back as far as modernism and the Industrial Revolution. Postmodernism, however, did much to exacerbate these underlying issues.

### ***The speech act and knowable truth.***

Discourse, or the manner of speech, is a very critical part of some postmodern schools of thought. The manner of speech and the words that are selected hold special meaning for truth and reality for the postmodernist. In essence, discourse creates reality. For instance, when a person speaks, they have motives behind performing their speech act. They may wish to persuade, to trick, or to simply inform, but there is always a motivation behind speaking. When a person speaks, he creates an impression or a reality not only for himself, but also for the person on the receiving end of the speech act. All of this is true, of course speaking has motives behind it, and there are always different ends to which a speech act might work. The difference lies in the way that the actual speech act is classified. The postmodern speech act is nothing more than glorified story telling, where a story is only as true as those who are told it believe. In the business environment, the "truth is what we can get our colleagues... to agree to. If we can get them to use our language then...our story is as true as any story will ever get" (Sire, 1997, p. 180). However, the creation of reality by speech should not be confused with any actual identification of an objective observed reality, rather quite the opposite is the case. Postmodernism at its core will decry the notion that there is any relation between the reality created by discourse and anything that is actually extant in any objective sense (Sire, 1997). So, if there is no connection between the words and concepts that a person hopes to convey through speech and reality, then there is no knowable objective source of truth. If there is no knowable objective source of truth, then what is correct, good, and true will be defined by whoever holds the most power at a given time, making all of knowledge futile and relative. One could

**"...knowledge is a figment of our own personal imagination, where truth is relative and all is to be tolerated."**

never know that there was any sure thing. A person could not know that they even existed, as that could be no more than simply a construct created to serve a certain purpose. Behrman (1981) explains that in postmodernism "no one value is primary over all others. As you can see, some of these values bounce against each other. They conflict" (p. 55).

In such an environment decision-making becomes purely arbitrary, and there is no standard to hold a decision against to ascertain whether it is indeed right or wrong, as these concepts do not exist apart from linguistic construct.

### ***Pluralism.***

Along with relativism fostered by postmodern thought is a concept referred to as pluralism. Pluralism arose in American culture as a natural outgrowth of a society in the throes of philosophical redefinition. According to Carroll (1996), pluralism occurs when power is distributed among a large amount of groups within a society. Examples of such groups would include special interest groups, lobbyists, not-for-profit organizations and the like. Each of these groups has their own vested interest and they seek to influence members of government, business, and society, to work towards their goals and purposes. Carroll (1996) cites that there are tens of thousands of such groups, all pursuing cross-purposes within the same societal group. When conflicting purposes collide it makes for confusion as to what is the correct interest to pursue, but within current American society, our culture of tolerance demands that there is no labeling of right or wrong purposes. So continues the permeation of relativism into all aspects of society, even business. By its nature, pluralism creates dissent within a society because of its "emphasis on autonomous groups, each pursuing its own objectives" and there is no way to bring all the competing interests into any sort of common purpose or agreement (Carroll, 1996, p. 7-8).

### ***Development of the Post-modern Culture***

Now that postmodernism has a brief description it may be instructive to investigate how society found itself to be in such a state. It seems fairly safe to say that American, and even Western, society has not always held to such relativistic, pluralistic beliefs. One only needs to look back into the history books to see that culture and society was once very

different. James Sire (1997) describes the progression of society from its original absolutist roots to the current state in his book *The Universe Next Door*. Society has gone through three stages: the pre-modern, a stage in which knowledge was absolute and was derived from knowledge of a higher being; the modern, a stage where knowledge and truth came from the strength of human reason; and the post-modern, a stage in which knowledge is a construct, a figment of our own personal imagination, where truth is relative and all is to be tolerated. There are two areas in which Sire explains the philosophical development: justice and ethics.

### ***Justice***

Sire (1997) traces the shift in the concept of societal justice in this way. In the pre-modern society, justice is administered based on certain mandates and rules handed down by an all knowing and just God. With the shift to modernism, the concept of justice became focused around a use of what was deemed to be universal concepts of reasonability and logic to derive a concept of justice. There no longer was reliance upon a higher authority, man became that higher authority, and man's reason became the source and author of knowledge. Along comes postmodernism with the concepts of relativism and the skepticism of knowledge. Due to the absence of pre-modern religious mandates and modern universal reason, the postmodern framework has no basis for justice. In fact justice is simply whatever a person deems it to be. There is no rule which any person must follow. In fact, to be consistent with postmodernism, to force or coerce a person to follow any rule would be to silence their personal narrative and to cause violence to their person.

### ***Ethics***

Ethics follows a similar pattern of evolution. During the pre-modern period, ethics was a concept derived, again, from a higher power. Doctrines of right and fairness were based on the nature of God and His attributes. The things that were revealed of God were that which the ethical framework of society was based around. With the change from God-centered philosophy to man-centered philosophy during the modern period, ethics were derived from shared human

experiences and what seemed reasonable to the human mind at the time. If the human mind could conceive it and logically prove it, then ethics could also be so reasoned. Postmodernism changed the concept of ethics dramatically. Ethics were no longer derived from any objective source, be it from God, or from any universal mode of human reasoning. Ethics became entirely subjective, meaning a different thing to every person, simply a different way of speaking (Sire, 1997). Sire sums up the movement:

The move from *being* to *knowing*, from the primacy of God who creates and reveals

the primacy of the self that knows on its own was fatal. It both set the agenda for modern philosophy...and sparked, as well, the recoil of postmodern philosophy...as

humanistic optimism flirted with despair. (1997, p. 177)

### ***Effects of Postmodernism on Accounting and Business***

The postmodern mindset has created a dichotomy within society, where business must conform to absolute standards in order to function, but the persons who are the fuel and power behind the business community subscribe to personal beliefs that are one hundred percent opposed to the premise of the business environment. One could suggest that these persons must lay aside their personal beliefs in order to function within the business community, however to do so ignores a very fundamental truth. Every action a person takes is influenced by pre-conceived notions of what is right and wrong simply because decisions are made based on past experiences and on schemas adopted by the decision makers. The accounting community is bounded by the rules set forth by FASB and the SEC; however, the true postmodernist would view these rules as constructs set up by these boards as an effort to exert power over society. While absolutes may be necessary to keep the business and accounting world from losing their effectiveness and descending into an anarchy of purpose, it is difficult to conceive of a postmodern society becoming indignant over the postmodern actions of executives and accountants of the past year. So long as reality is fragmented, with each individual event of life being entirely unconnected to

subsequent or previous events (Takala, 2002) by any amount of truth or common meta-narrative, then any action that an accountant or businessperson chooses to take cannot be rationally condemned. Under the postmodern perspective an accountant would be entirely justified in distorting earnings figures so long as it fit his or her purposes. If they benefited from it, then any condemnation would be contradictory to the relativistic system. Such a person could dismiss the dissenters by simply asserting that to him, that action was not unethical, it presented a good image for his company, and that it is unfair for the other party to impose their ethics upon him. Such thinking is entirely justified. Or, take for instance, the businessperson who is faced with a difficult decision. Does she choose the option that would follow the law and codes of ethics but would have a negative personal impact? Conventional wisdom would say that she must make the objective and law-abiding choice, but postmodernism would allow her to choose the option with the greatest personal benefit and feel no guilt over it. Such dilemmas are what call the current sense of philosophical tolerance so harshly into question.

The maintenance of an equitable accounting system requires boundaries and rules, and a mentality of such ambiguous diversity strikes a critical blow to the essence of accounting as a reliable stewardship of information. Tuomo Takala, in his discussion of postmodern business ethics explains some of the implications that the worldview provides. When good is so loosely defined so as to be different for each person it fosters an environment when tragedies such as wanton oppression and destruction of natural resources could occur unchecked. As such, he comes to the conclusion that “[p]ostmodern business ethics cannot offer the [concept of] business ethics, not at least at this stage, any clear theoretical basis from which to start” (2002, par. 19). The postmodern dilemma paints a dismal picture for the business world. Thankfully, however, there is an alternative to the current trend towards relativism, and one only needs to look to recent history to ascertain how such a reversal might take place.

### **A Return to Absolute Truth**

The much-attacked concept of truth, especially absolute truth, is seen exhibited in nearly every aspect of Western business dealings. The very fiber of capitalism and free trade depend on having reasonable assurance that the person that one is dealing with will be fair in their negotiations and presentation of information (Behrman, 1981). Accounting, as a support sector to business dealings, also relies on absolute standards, truth if you will, to provide accurate, comparable, and useful financial information to foster business dealings. Charles Colson (2002) makes an analysis of Western capitalism contending that many of the values that the system depends upon were and are very much linked to concepts found in Judeo-Christian moral tenets. Without the rule of law, contract rights and other Biblical and Talmudic principles, the function of the market would be highly different. Much of the connection between such moral codes and the structure of Western capitalism can also be attributed to the historical congruence between both systems. As young America grew, so did the religious community. Carroll (1996) further asserts that such biblical influences extend through the Protestant work ethic, and personal dignity for all people, all of which are principles that most in American society would at least pay lip service to. That is not to say that capitalism is based on Christianity, but rather it is safe to assert that elements of Judeo-Christian values did grease the wheels of theoretical capitalism. Further, it is fairly well accepted that as Irving Kristol (1982) observes in his article “Business Ethics and Economic Man”, “[b]usiness ethics, in any civilization, is properly defined by moral and religious traditions, and it is a confession of moral bankruptcy to assert that what the law does not explicitly prohibit is therefore morally permissible” (p. 180). However, American culture has taken an almost violent departure from such ways of thinking, relegating religion and morality to the world of private life.

Critics contend that personal morality should have no influence whatsoever on a person’s professional performance and suggest that there is some way that these same people can compartmentalize their lives to exclude their moral schemas from

their professional dealings. Given the assumption of many in society that ethics are no more than a subjective construct, such a relegation of personal values is understandable. Unfortunately, the Enron crisis reveals serious flaws in such a mentality. The influence of personal immorality in the governance of daily affairs in the corporation is what eventually led to the corruption that ultimately brought Enron and the accounting giant Arthur Andersen to their knees. Colson (2002) contends that any economic system is only as helpful or useful as it is bounded by a system of moral absolutes. A system of such checks and balances is necessary to keep business from declining into an anarchistic incongruity of personal pursuits.

There is more to morality than simply not being immoral, and as Camenisch (1982) concludes, creating an ethical business environment must incorporate more than just avoiding unethical behavior. There must be an element that motivates accountants and businesspersons to act proactively and to use moral reasoning to gauge the appropriateness of their actions. Such a universal gauge is not present in relativistic schemas. In fact the crisis of cultural relativism has contributed heavily to a corrosion of the foundation of American and Western culture. James Sire (1997) explains that the philosophical devolution effects “not just the philosophy

**“There is more to morality than simply not being immoral.”**

that [the philosophic center] was based on, but...the whole superstructure of culture... When God dies, both the substance and value of everything dies with it” (p. 173).

### Conclusion

Postmodernism has done much to change the face of business, accounting, and culture, but traditional ethics offers an alternative to the decline. The lesson of the Enrons, WorldComs, and Arthur Andersens is that increased regulation can only do so much to prevent further unethical practice. Ultimately, the morality based upon Biblical and Talmudic principles must be retrieved. The tenets

that are represented must be related to the dynamic business environment to help their relevance be better understood (Sirico, 2002). It is important to notice, however, that a return to such religious ethical influences does not necessarily preclude the use of other methods to help curtail improper behavior. Inasmuch as it is necessary, new laws should be passed to foster an environment of accountability and responsibility, however, this must be tempered by a knowledge that “no regulation can effectively eliminate vice in the human heart” (De Vous, 2002, par. 5).

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# Foundation of Success by Timothy James McCollum

## Foundation of Success: Value System of the Marine Corps as a Model for An Organizational Value System

### Abstract

There has been a marked decline in the importance placed on values in organizations over the past generation as demonstrated by companies and organizations in the news. This paper revealed the importance of values, using the United States Marine Corps as a model of excellent applied values. Honor, courage, commitment, trust and

teamwork, respect, discipline, and adaptability are all values that give the United States Marine Corps a distinct identity. Each value is emblazoned in every Marine, and it is these values that have played a vital role in the success of the Corps. This paper proposed the idea that the implementation of Marine Corps values would benefit private sector organizations in everyday operations. Furthermore, five guidelines were provided for building values in organizations, and examples were given of organizations that have benefited from the implementation of values.

### Introduction

#### The Decline of Ethical Behavior in Business

*Decline of importance of values by generation.* There has been a noticeable change in the value placed on honesty and integrity by the current generation of businessmen. A survey reported in Inc Magazine discovered that only 34% of people surveyed under the age of 35 admitted to telling the truth all the time, compared to 54% of those people surveyed over the age of 45. Additionally, the study discovered that 62% of people under the age of 35 bend rules at work, where

**“Honor, courage, commitment, trust and teamwork, respect, discipline, and adaptability are all values that give the United States Marine Corps a distinct identity.”**

46% of people over 45 admittedly follow the same habits (Caggiano, 1992).

An analysis of literature regarding success reveals this movement away from values. The movement away from a focus on values has been occurring since shortly after World War II. For various reasons, the writing about success began to focus

superficial fixes that served to deal with mere symptoms rather than the causes of problems. This shift of focus away from a concentration on the right actions to a focus on actions that served to simply make a person feel fulfilled has subtly changed the way people choose to conduct themselves and choose to make decisions. Although the change of thought has been subtle, the actualization of false motivations

has taken place rapidly as is seen in various aspects of life (Covey, 1989). It would not be an accurate statement, however, to state that those who do not value honesty lack values. Rather, it is more accurate to state that they value their own self-interest higher than honesty. Every person has values. The values that people have are not always positive or desirable to the public, but they are values nonetheless. The

**“There are many stories of organizations and companies that have behaved unethically and received negative public attention.”**

difference between people is simply a variation in priority of values. The current deficit of character that permeates the society is a problem that appears to be greater among the younger generation. The most recent trend, however, is an increased emphasis placed on organizations to make ethical decisions by the

mainstream of society and government requirements (Marrella, 2001).

**Examples of ethical errors.** Over the past two years, the headlines have been saturated by stories of companies whose malfeasance resulted in the demise of their corporation. The sheer magnitude of the unethical practices by

companies is daunting. The problem of unethical practices is not something that is strictly limited to the business sector. The problems are affecting political officials and departments, non-profit organizations, and sporting associations. There are many stories of organizations and companies that have behaved unethically and received negative public attention. A major headline that is having immense

(Campbell, 2003).

A third company which was has recently charged with unethical

And illegal practices of hiding expenses and faking profits caused it to declare bankruptcy. The Enron case raised problems covering accounting practices, corporate governance, credit ratings, and corporate ethics (Enron revelations, 2003). The Enron executives were able to conceal the company's weaknesses for a long period of time due to the bribery of the auditors of a respectable accounting and consulting firm. The goliath of energy quickly slipped from the praises of financial analysts to the congressional hearings of Washington, while the un-

relenting leadership strived to conceal their wrongdoing.

Another company which has recently been exposed for its unethical business practices is Tyson Foods. It has recently been uncovered that Tyson was illegally importing Mexicans to work at minimal wages, without benefits, in dangerous plants across the United States. Furthermore, it has been estimated that over one-third of Tyson's employees were illegal immigrants. Its unethical, as well as illegal, practices also included providing forged documents to migrants (Campbell, 2003).

A third company which was has re-

cently charged with unethical practices is Rolls-Royce, whose name was once a byword for quality and reliability. This premier company has been charged with bribery and skullduggery that spans three continents. Rolls-Royce allegedly made multi-million dollar payments to an Indian company in order to receive exclusive rights to own and operate a power station in India. This action was in violation of laws restricting international bribery, an opportunity created by the privatization of many government owned industries in India. These payments, however, were merely a front to disguise the illegal activities that were being conducted (Barnett, 2003).

**“The problem of unethical practices permeates every sector of society.”**

The problem of unethical behavior is a reality for organizations outside of business as well. The University of Michigan was forced to forfeit 112 men's basketball regular season and tournament victories, which they amassed over five seasons, including the 1992 NCAA semifinal victory. The cause of this disciplinary action was the findings of a federal investigation that

revealed a former booster, Ed Martin, paid over \$616,000 to Chris Webber and three other ex-Michigan players. Furthermore, Michigan stated that they would return \$450,000 to the NCAA – money that they earned by playing in post-season games. The magnitude of the offense is astounding because of the strict regulations that the NCAA places against college athletes receiving payments for athletic participation

(Michigan forfeits, 2003).

The ethical predicament that is a reality of society is especially present in the political arena. There are many examples that demonstrate this reality. One example was the discovery, following the 1996 elections, that China had been pumping money into the U.S. Democratic election funds. Also, it has been revealed that Wall Street investors par-

ticipated by illegally selling fraudulent bonds exceeding \$100 billion from phony Chinese companies that are a front for the laundering of international funds. A supporting aspect of this is the estimation by Beijing that 20% of all bank loans have defaulted, indicating the magnitude of the corruption and the amounts of illegal funds that have

been filtered into the politicians in Washington (Top 50, 2003). The previous examples are a mere sample from a seemingly innumerable base of stories about companies, organizations, and politicians whose lack of moral fortitude have resulted in a marred image of the respective organizations. The problem of unethical

practices permeates every sector of society. These unethical practices are largely a function of the culture of the organization, which is but a mere reflection of the greater national culture. The activities and behaviors of employees are a direct result of the leadership of the entities in which they are employed. Ultimately, the managers are responsible for every-

thing that goes on within the confines of the business, whether the company is successful or not (Marrella, 2001). The primary problem is the lack of focus on positive values in the cultures of today's organizations. However, before the topic of values is addressed, the definition of culture must be defined in order to establish a common understanding of the topic.

**What is ethical behavior?** An important question to consider regarding the determination of ethical action is, "Who is it that determines whether an action is ethical or not?" There are several possible solutions to this question. DeLashmutt and McCallum,

noted writers and respected speakers on ethics, outline three different systems that attempt to answer the previous question. The first possible system of thought that would attempt to solve this difficult issue is the position of Nomism. Individuals of this view would state that there are ethical rules in the Bible that transcend time and culture. This view also would state that it is each person's responsibility to apply as many of the Biblical rules as possible.

Another view is Situationalism. Situationalism argues that every situation is different; hence there are no absolute rules because rules are inflexible and

each person must decide for themselves whether they think an action is right or wrong. Many people continue in this train of thought to the extent that if a person thinks an action right, then it is so.

The last major view is that of Principled Ethics. This view attempts to balance the previous two systems of thought. The primary supposition of this view is that one should take the general guidelines of Scripture and balance that with the natural law that is available absent from Scripture, i.e. government rules and regulations, societal expectations.

The discussion regarding how a person

**"An Important question to consider regarding the determination of ethical action is, "Who is it that determines whether an action is ethical or not?"**

should determine what is considered to be ethical behavior is not the purpose of this paper. From this point on, the definition of ethical behavior will be actions that supersede the expectations of society and requirements of government regulation.

### **Culture**

Culture is the learned frame of refer-

ence that provides a unique set of ground rules that act to distinguish one group from another. It is important to note that culture is shared among members throughout an organization, creating a sense of unity. Furthermore, one should understand that culture is developed over time. Culture is not quickly formed or shaped rapidly (Conner, 1993). So, what is culture? Culture is the "set of key values, assumptions,

understandings, and norms that [are] shared by members of an organization and taught to new members as correct (Daft, 2001, p. 511)."

Culture has three different levels that can be observed by people. The first level is that of the visible level, where one would see artifacts such as dress, symbols, slang, and ceremonies. The first level is obvious and can be learned from simple observation of the opera-

**"The military of the United States is an excellent example of a strong culture."**

tions and appearances of members of the organization. The second level is the expressed values that define the attitudes of members. An example of an expressed value is that of the Marine Corps' Latin motto *Semper Fidelis*, meaning always faithful. The expressed value depicts the overt attitudes that are clearly articulated and empha-

sized by leaders. The last level of culture is that of the fundamental suppositions and intense assessments, which are non-negotiable factors that are basic to peoples' attitudes. The third level is less overt than the other two levels, but is the fundamental understanding that is the determining factor of the decisions that are made. These three levels are

**"Semper Fidelis...the expressed value depicts the overt attitudes that are clearly articulated."**

the practical manifestations and the ideals that define culture in general (Daft, 2001).

The military of the United States is an

excellent example of a strong culture. Although there is no single description of culture that can serve as a blanket statement for every branch of the armed forces, the analysis of each branch would reveal a distinct example of a strong culture. There are many characteristics in today's business world that are similar to those found in combat. In fact, James D. Murphy, a former F-15 pilot for the United States Air Force, stated that business is not like combat; business is combat, because in business, like combat, there are winners and losers. Victory in business is all or nothing—as in combat (Murphy, 2000). Since there is an apparent similarity between combat and business, there must be lessons that can be gleaned from an analysis of the fighting forces of the United States.

No other event in life challenges man like that of combat. S.L.A. Marshall stated that, "The battlefield is the epitome of war. All else...exists but to [assure] success on the field" (Marshall, 1947, p. 27). In combat the most primal fears of man present themselves to those involved. It has even been said that, "Fear is the common bond between fighting men" (Holmes, 1985, p. 204). There are many challenges that present themselves to the combatant in battle. Physical, mental, emotional, and spiritual challenges constantly barrage the soldier on the battlefield. Furthermore, there is an inner resistance to the firing of weapons in combat and the killing of a fellow human being. In the book titled "On Killing" by Lt. Col. Dave Grossman (1996), the author stated that the problem of "non-firers" is not a recent problem but something that can be identified back to the Civil War. He stated, "[There is] evidence [that] exists that during black-powder battles thousands of soldiers elected to passively submit to both the enemy and their leaders through fake or mock firing" (p. 21). The surprising reality is that men are much more afraid of disgracing themselves than of being killed or wounded before going into action for the first time. The fear of disgrace is magnified for officers and enlisted leadership, who have the most to lose from the physical display of fear in front of the men. The appearance of the absence of fear on the part of leadership provides encouragement for the troops to be courageous—to go against the natural inclination of self-preservation and to risk death or injury to accomplish the objective (Holmes, 1985). The suppression of fear by officers and enlisted leadership also

provides the leaders with a greater ability to persuade others to action. It was said by General Patton that, "Generals must never show doubt, discouragement, or fatigue" (Axelrod, 1999, p. 40). The very nature of men's behavior in combat in terms of self-sacrifice, courage, and commitment to the unit is a direct result of the values and the professional skills that are built within a combat unit. The values of such a strong culture and the elements to be pursued can be extracted from the analysis of the exacting technique used in basic training and in the calculated operations of a military unit. The benefits from the lessons of these professional units for private organizations are expansive.

There are many elements of military culture that could be discussed. However, the focus of this paper will be the element of values, the third level of culture, because it is this aspect of culture that is the determining factor from which individual decisions are made. It is important to note that there is no one specific description of military values that can be equally applied to every branch of the military. A description of the values of the Army would not be equally applied to the Navy, Air Force, or Marines. The values of the United States Marine Corps were chosen for a focus.

### *Values of the Marine Corps*

The Marine Corps has an illustrious history of conspicuous bravery dating back to the beginning of the United States of America. Through bloodshed and sacrifice the warriors from the sea have earned themselves the position of primary sea landed reactionary force of the United States. The very goal of the Marine Corps is to be a combined arms force in readiness with amphibious capabilities. The Marines are agile, flexible, ready, and deadly. What do Tripoli, the Solomon Islands, and Afghanistan all have in common? They were all places which saw the Marine Corps as the first enforcer of justice. There are numerous elements that make up all of the success that is associated with the United States Marine Corps. Foundational to every Marine who wears the Eagle, Globe and Anchor are the *Corps Values*, which are Honor, Courage, and Commitment. There are values that are also held sacred among Marines along with the *Corps Values*, and those are trust and teamwork, respect, discipline, and adaptability. Each value is expected of every Marine all of the

time. A Marine who does not hold to these values brings shame on both himself and the Corps.

**Honor.** The first of the *Corps Values* is honor. The word honor has many meanings and requirements. A Marine must never lie, cheat, or steal. Not only that, but a Marine must hold to the highest code of personal integrity, as well as be personally accountable for every action. The words integrity and reliability would be aptly applied to this section. Integrity and reliability are certainly expected of each Marine. The ability to trust someone to be faithful to complete a promised task is analogous with the ability to depend on someone to act in accordance with standards without supervision. The essence of these traits is to be trustworthy. There must be a reciprocation of trust between a military commander and the subordinates. If there is any doubt or lack of trust in the minds of the subordinates, the task or mission could be compromised and lives could be needlessly lost (Sturkey, 2001). One occurrence of an act of dishonesty or deceitfulness can ruin any esteem that had previously existed. The Marine Corps is like a machine that functions properly when each part is serving responsibly. However, when a part fails to function as intended, the results can be fatal. There is no dollar amount that can be placed on integrity and reliability in the Marine Corps.

**Courage.** It is the courageous acts of men that become legends. Stories are told over and over, until the warriors are emblazoned in history books of great warriors. Men are made immortal through the acts of bravery that so characterize the model military individual. These acts of courage are not entirely unconnected from the training and education that was received in Boot Camp or Officer School. Many individuals were able to build courage through the gradual acclimating to danger and the building of confidence that occurs in the initial training of recruits. It has been said that courage is not the absence of fear, but the willingness to continue on in spite of the dangers. Courage does not imply an unawareness of danger, but the ability to work through it (Sturkey, 2001). There are countless stories of gallantry by Marines since the founding year of 1775. The story of Captain Carl Sitter is one that represents this trait with incredible clarity.



Captain Sitter was a commanding officer of Company G, 3d Battalion, 1<sup>st</sup> Marine, 1<sup>st</sup> Marine Division serving in Korea. When ordered to break through enemy infested territory to reinforce friendly troops, Capt. Sitter continuously exposed himself to enemy fire as he led his company of Marines through deadly territory. After experiencing 25 percent casualties on the trip to the objective, the Marines occupied a strategic area that was swarming with hostile forces. Capt. Sitter then reorganized his depleted troops and led them up the steep frozen hillside under blistering fire. Following nightfall, the Marines received a vicious counterattack on the hilltop. The enemy's attack set the hill on fire from mortars, and the machine gun and automatic weapons took a heavy toll on the troops. In the midst of the attack, Capt. Sitter visited each foxhole and gun position encouraging and reinforcing with all available resources. He also made a concerted effort to promote the courage that was required to be successful, including the willingness to sacrifice everything to be victorious. The Marines frequently resorted to hand-to-hand combat with the enemy as they were penetrating the lines of defense. In spite of being wounded in the face, arms, and chest, Capt. Sitter refused to be evacuated until the successful defense of the area was assured. His superior tactics and valiant leadership, in spite of the 50 percent dead, wounded, or captured, earned him the Congressional Medal of Honor (Wallis, 2000). Courage—it is expected from Marines, because it has made the Corps what it is today. The stories of heroic actions by predecessors challenge all of those who follow to behave in a manner that is worthy of the respect of the title Marine that has been built by bravery and sacrifice of those who have gone before.

**Commitment.** No other value holds meaning by Marines like that of dedication. The motto of the Marine Corps exemplifies this characteristic. *Semper Fidelis* (Always Faithful) has been the battle cry of every Marine since 1883. All of the other values for the Marine are centered on this single principle. Commitment means total dedication to Corps and country. It is a selfless determination and a relentless dedication to success. For an officer of Marines, the responsibility to exercise this behavior is indispensable to the cohesiveness of the unit and the safeguarding of the respect of

the subordinates. If a Marine is given reason to think that the officer will not be committed to the unit in the difficult times, willful obedience will be hindered by the threat of abandonment by leadership (Sturkey, 2001). The importance of loyalty can be seen in the following story that best depicts the value and beauty of faithfulness.

1<sup>ST</sup> Lt. Clebe McClary was a young Marine infantry officer during the Vietnam War. He was married just before being sent to fight. After Lt. McClary arrived in Vietnam, he assumed command of a reconnaissance platoon whose job was to operate covertly behind enemy lines spying on "Charlie," the code name for the enemy. The reconnaissance platoon's primary mission was to detect the enemy troop movements and arms infiltration efforts, as well as gather information on the enemy's position, actions, and strengths. Confrontation with the enemy was avoided, as confrontation often resulted in dire injury. War was waged not only against Charlie, but also against the malicious elements that made the jungle home. Insects, heat, and diseases all presented themselves on a daily basis, and careful precautions were taken to handle such factors. Life was difficult for Lt. McClary and his platoon, but they successfully managed the challenges that were presented. After five months of relatively safe operation, Lt McClary was days away from a break from the war and time with his wife. Following the Tet Offensive, Lt. McClary and his Marines were ordered to take Hill 146—an observation post deep in enemy territory. Although Hill 146 was only roughly 75 meters by 50 meters, it held great strategic value for the US. For three days the Marines held the hill without event, but the ominous silence told them an attack from Charlie was certain. Shortly after midnight of the third day, the enemy hit with ruthless force. Lt. McClary heard the cries from the foxhole next to him and watched as PFC Johnson, who was an exemplary Marine, smothered the explosion of a fragmentation grenade with his body in order to save the lives of the other two Marines in the foxhole. Moving to and fro, Lt. McClary frantically directed the defense efforts to prevent being overrun. In spite of a fragmentation grenade blowing off his left hand, the young Lieutenant still directed the Marines as he fought with his troops. Although he fought

in spite of injury, another grenade came into his fighting hole and mutilated his eyes, ears, and his right hand. In route to a safer location, again another grenade shredded both legs with shrapnel incapacitating the unyielding young officer. As he lay near death, a soldier for the North Vietnamese Army (NVA) stood over him aiming to kill the wounded officer. However, a young Marine named PFC Hunter discovered the ominous scene and neutralized the enemy target. PFC Hunter stayed at the side of the Lieutenant fighting off the enemy. Had the enemy followed up the initial assault, the Marines would have been overrun, but the Marines continued to bravely fight off the enemy, protecting the wounded and guarding their injured officer. After receiving aerial support from gun ships, the Marines were air lifted from Hill 146 after an hour of violent fighting. PFC Hunter was ordered to leave Lt. McClary behind, because he was thought to be dead. But, against the the better sense of self-preservation, PFC Hunter ventured into the world of death and destruction to rescue the wounded commander. After a dangerous 50 yard dash with the young officer on his shoulder, PFC Hunter boarded the chopper and they returned home to fight another day. As the choppers lifted from Hill 146, over 150 NVA stormed the hill. A delay of mere minutes would have proven fatal. There were a total of eight dead or injured out of the compact group of 13 that defended the hill that night. Lt. McClary recovered from the injuries, although he was completely disabled (O'Leary, 2001). The commitment of the Marines in this inspiring story is apparent to even a casual observer. In this story, not only did the officer prove to be faithful, but the subordinates were faithful to the commander to whom they had grown so close.

**Trust and Teamwork.** Perhaps, the most foundational elements of Marine values are the intertwined ideas of trust and teamwork. From the beginning of Boot Camp, these principles are embedded in the new recruits. Activities and punishments are designed with the purpose of building a cohesive unit that is dependent upon each person fulfilling his own role in the unit. The goal is to remove the civilian mentality of individuality and graft the person into the unit. The first element in the removal of individualism is the removal of the words "I" and "Me"

from their vocabulary, beginning the sub-conscious separation of the individual for the building of a group as a team (Ricks, 1997). Physical training (PT) is also targeted at the building of trust and the exercising of teamwork. Log PT is an excellent training method that requires full cooperation of every element of the exercise. Log PT usually involves a squad of 12-15 people running or crossing obstacles together as a unit with a formidably sized log on the shoulder or above the head of each person. Another element of the same type involves taking the same log as mentioned before and performing various exercises, i.e. Bench Press, Shoulder Press, and crunches. The weight of the log is such that it is insurmountable individually, but as a cooperative unit the activities are achievable.

In addition to the language and team exercises, the punishment of misconduct is typically applied to the unit as a whole. A frequent punishment for an individual's lack of display of discipline is the exercising of the whole unit; this teaches collective responsibility to the unit. In combat, a mistake of an individual can cause the injury to a large number of people besides the person who was in error. There is a direct correlation between the harshness of basic training and the amount of group cohesion that emerges from it. In fact two psychologists experimented on the relationship between the two factors, and they found that those who experienced severe initiation found their group more attractive than those who encountered a mild initiation (Holmes, 1985).

**Respect.** Respect is developed within each recruit or candidate of the Marine Corps. In order for the military to operate effectively, each person involved must have respect for those lower in rank, those at the same rank, and those who are superior. Transferring from a civilian mentality of equality to the almost hierarchal type of organization can be nearly impossible without the presence of respect. Respect is built for Commissioned and Non-Commissioned Officers, the President, the flag, the National Anthem, the Constitution, military ancestors, the Marine Hymn, and the citizens of the United States of America.

The demonstration of respect takes many

forms and varies with the degree of sacredness. Deference to the citizens of the U.S. is shown through the use of polite language such as "Sir" or "Ma'am" as is appropriate for each individual case. The respect of military ancestors is also instilled through the gaining of knowledge about historic battles and the naming of streets and trails after those who have sacrificed for their country. The Constitution is especially emblazoned with esteem in the minds which have been charged with upholding its contents. The National Anthem is also established in the hearts of Marines with a greater degree of respect than held before. Additionally, the saluting of officers by enlisted personnel is a physical display of the respect held for those in command. Lastly, the President is held with the highest level of respect, as he is the Commander in Chief who charges the individuals of the military with the authority to carry out their assigned tasks. The President is assigned the highest level of respect of all people in the world. There is no minimizing the value that respect has on the proper functioning of the Corps (Ricks, 1997).

**Discipline.** Discipline is the primary trait towards which all activities of training are focused. Discipline is not defined by punishment, but rather it is the conscious behavior and attitudes that conform to expectations. Discipline makes itself apparent in many forms; through movement, thoughts, and attitudes a person can demonstrate discipline. A person who dresses neatly and exercises shows discipline of action. Others who control their minds and force themselves to concentrate on the task at hand would be demonstrating discipline of mind.

In Boot Camp and Officer Candidate School, there are ample activities planned to

**"...when men face fear in battle the instincts they have gained will determine their response to threatening situations in war."**

build discipline in each person. Drilling of platoons is a primary method by which discipline is built. The tactical practicality of drill faded sometime in the early 20<sup>th</sup> century when the form of battle changed from the regimented units standing in ranks in open field to the trench and jungle

warfare that is seen today. In spite of the decentralization of combat that has become more common, there is still indispensable value in the discipline and instinctual response to commands

that is learned on the parade deck. An American drill-sergeant once said, "Give me control of their instinct, and you can have their reason" (Holmes, 1985, p. 40). There is the story from John Masters' (1961) book *The Road Past Mandalay* that shows the importance of instinctual training in combat:

The No. 1 was seventeen years old – I knew him. His No. 2 lay on the left side, beside him, head towards the enemy, a loaded magazine in his hand ready to whip onto the gun the moment to No. 1 said 'Change!' The No. 1 started firing, and a Japanese machine gun engaged them at close range. The No. 1 got the first burst through his face and neck, which killed him instantly. But he did not die where he lay, behind the gun. He rolled over to the right, away from the gun, his left hand coming up in death to tap his No. 2 on the shoulder in the signal that means *Take over*. The No. 2 did not have to push the corpse away from the gun. It was already clear. (p.207)

The importance of instinctual training can not be emphasized enough, because when men face fear in battle the instincts they have gained in training will determine their response to the threatening situations they face in war. Therefore, the military focuses the majority of the activities of training on the building of discipline within each person.

**Adaptability and Problem Solving.** A skill that is especially tested and built by the Marines in Officer Candidate School is the

ability to adapt to changing situations and solve various problems under pressure. One test of this ability is the Leadership Reaction Course (LRC). On the LRC, candidates are placed in a type of puzzle where they are presented with obstacles and an objective. The candidates are then given a time limit and are allowed to exercise their leadership and creative problem solving as well as exercise their ability to work as a team. Success is not based upon the achievement of the objective, but how the candidates communicated as they implemented the plan they put together. The Marines value the skill of adaptability as they are charged with the most difficult tasks by the President, while being the smallest and least funded branch of the military. Therefore, their ability to exist is dependent upon their ability to adapt to whatever challenge the chain of command passes down.

This skill of problem solving under pressure is exemplified by the story of Robert E. Lee who was a second lieutenant in the Marines in 1975 serving in Vietnam. After arriving in Vietnam, his first order was to take a dozen Marines and board a merchant ship packed with refugees whose ship had been seized by South Vietnamese soldiers. He was given no word on how he was supposed to go about boarding and securing a ship. After brief reflection, Lt. Lee decided to treat the ship like a building and work his way down. Deck by deck, he and his men finally secured the ship (Freedman, 1998). Through adaptability and creative problem solving, Lt. Lee was successful in accomplishing a task for which he had not been adequately trained, and advanced the ability and suitability of the Marine Corps.

It is this author's supposition that the heroic examples of courage, commitment, discipline, and adaptability are equal in value with the same character traits exercised outside of the field of combat. In the aspect of danger and immediacy of action, business and combat are drastically different, making the battlefield and the business world seem drastically different. However different they may seem, persons who choose to stand up for right should be appropriately respected for their courageousness in an instance that is a likely threat to their livelihood. Although heroic examples were provided of traits personified in deadly situations, it should

not be implied that the values of the Marine Corps are exclusive to combat. The values are applicable in other useful ways, capable of being exercised even in less threatening situations.

#### *How to Implement Values to Form a Strong Culture*

The leader of a civilian organization or business is at a disadvantage to those of the military. In the Marine Corps, boot camp is 13 weeks long. During that time, the recruits are infused with the knowledge, skills, and values necessary to serve in the Corps (Ricks, 1997). Although the management of businesses does not have the luxury of directly influencing employees in this manner, it is still possible to create a strong culture without this type of indoctrination. There are certain deliberate actions that should be conducted in order to instill the desired values in the subordinates. These efforts must especially be made when individuals join the organization with existing characteristics that are not in sync with the objectives of the leadership. In *Essentials of organizational behavior*, Stephen Robbins presented five steps that managers should take in order to build strong values in a culture that is responsive to the needs of society.

The first step that a manager should take in order to instill values in the culture is to be a visible role model for the employees, which is in correlation with the previously discussed visible level of culture. Leadership by example is the most effective leadership that a person can provide, as people desire to have a visible display of the expected behavior. Behavior in this manner provides people with a goal towards which to strive. The behavior of leadership will act as a measuring stick in which subordinates will determine the appropriateness of actions. However, when a discrepancy occurs between persons' actions and their words, people will believe the actions that are displayed before them (Robbins, 2003). There is an old saying that, "What you're doing speaks so loudly that I can't hear what you're saying" (Marrella, 2001, p. 1). This is especially pertinent here as people watch the actions of a person to determine if they are genuine about the stated commitments that are communicated.

Secondly, verbally communicating expectations must be done to build a culture with values. The reason that this is the second

step, after demonstrating with actions, is the essential nature of the visible precedence that is preemptory to the verbal communication of expectations, which is intertwined directly with the second level of

**"...the establishment of protective mechanisms serves to guard against rogue behavior."**

culture that was pre-

viously discussed. If a manager has not been acting in a way that is morally acceptable, then no amount of talk will influence people into being ethical. Furthermore, a "do-as-I-say-not-as-I-do" mentality will find utter failure when the physical presence of the manager is not experienced by subordinates. Once the manager is not present, the actions of subordinates will align with the harmful habits and behaviors of the group leader, because the manager has created a dependent culture through the inconsistent communication of his actions and words. Communication must take place in both written and spoken formats. Signs, banners, memos, and handbooks are all effective methods in communicating to employees what is desired of them. Explicit verbal and written communication can be used in conjunction to enhance their individual impacts and

create a greater effect than the methods individually.

The third step, after visible then verbal and non-verbal communication of expectations, is the training of employees in ethical matters, which works to build the third level of culture previously defined. Providing seminars, training videos, and weekly team meetings are all effective in the training and educating of employees on the current issues that they are facing in the workplace. Orienting new employees to the values and culture of an organization is essential to their effective union with the new environment. The need to train new employees is often enhanced by the acquisition of individuals who lack the desired values. Educating employees regarding the application of values to difficult problems is essential to the alignment between behavior and beliefs. Failure to educate employees will often result in undesired

actions or the creation of a harmful dependence upon the managers.

Next, a manager should visibly reward ethical acts and punish unethical actions that are not in accordance with the values of the organization. The enforcement of ethical standards is an essential portion of this process. When standards are enforced, the commitment of management is affirmed to the employees. Simply stating standards and not enforcing them will result in a failure to conform, due to the apparent insincerity of the standards. Additionally, only punishing employees for bad behavior will demoralize the workers and ultimately be a counter-productive force. The bestowing of rewards upon model employees will build a sense of *esprit de corps* that will serve to hasten the building of this desirable culture. The affirming through visible rewards operates better than any other device to encourage employees to conform to the desired behavior of management, because it may fill the innate need for affirmation and affiliation that exists within all human beings.

Lastly, the establishment of protective mechanisms serves to guard against rogue behavior. Although great examples could have been established and actions rewarded, it is necessary to hold employees accountable for their behaviors and not be naïve in wholeheartedly trusting employees to act according to established standards of the leadership. Audits, double entry accounting, and material acquisition forms are all methods to keep track of transactions and the proper dispersement of materials. Furthermore, it is important for employees to be capable of reporting actions that are not ethical or do not appear to be so. The necessity of this is known due to the media coverage that has been given to companies who are guilty of ethical infractions and the negative image and harm that information of this sort has on a company and the economy. If people are not able to anonymously report infractions, then the large majority of individuals will not take the risk of reporting such infractions.

### **Values in Real Organizations**

A company that has experienced success through the values that have been implemented is the mega-chain Home Depot. This company has evolved its values as the

company has grown and changed since its founding in 1979. When the company was first founded, their values were customer service, low price, and selection. In the early 1990s, the leadership found it necessary to evolve their stated values, until it became clear in 1994 that a change to a stronger set of values was needed to be successful. This new set of values consisted of eight different ideals that each employee should maintain. Deliberate efforts were made by Home Depot to instill these new values in the culture. Its success was a product of communication and of tangible and intangible rewards. The leaders found that, in order to be effective in communicating values, the venues and methods to communicate the values must be consistent, clear, and attuned to the needs of the audience. Through their endeavors they were able to embed values into the company, and have realized great growth and profits through the past decade (Hallam, 2002).

Another company that has been successful by holding tightly to its values is Lancaster Laboratories. In the early 1980s, Dr. Earl Hess, the founder, realized that technical expertise and efficiency were not enough to sustain the growing company. Consequently, Dr. Hess established a mission statement and a set of company values. He later initiated an Ethics Committee that existed to maintain commitment among employees to the values of Lancaster Laboratories, develop a total ethics process for orienting new employees, and serve as an oversight group for the operations of the company. Over the years, Dr. Hess has led his company to success with annual revenues in excess of \$30 million (Marrella, 2001).

### **Summary**

There have been many changes in the world over the past 50 years. The tools and methods of business have changed, and the importance placed on values by individuals has gradually declined. The decline that has occurred has recently materialized in the news headlines in a magnitude previously unheard of. Enron, Tyson, Rolls Royce, University of Michigan, and countless politicians have recently received significant publicity over the misconduct that was discovered. It seems that the problem that permeates the culture of these organizations is the lack of emphasis

placed on the previously discussed positive values. The values of an organization are a



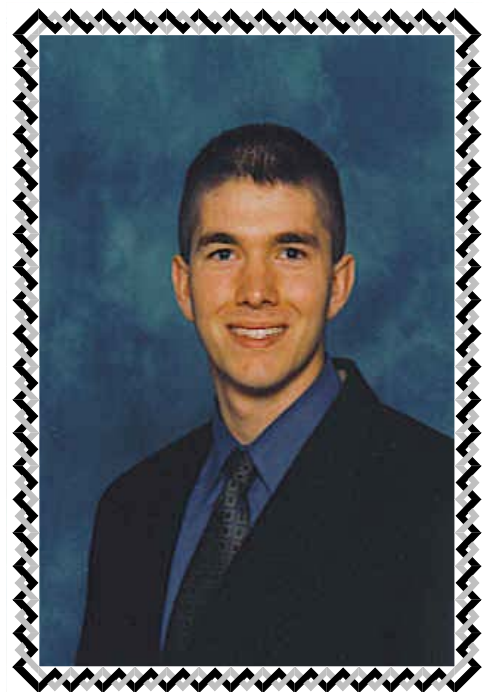
function of the culture that is developed by those whose leadership is often focused on profits rather than purpose.

The United States Marine Corps has been used as an excellent model of applied values. The Marines' focus on honor, courage, commitment, trust, respect, discipline, and adaptability should be pursued by every organization. The values provided are an excellent model for private organizations to follow. In addition to the values of the Marine Corps, five steps were provided for leaders of organizations to follow in order to develop the desired values in their organizations. These steps were provided in order to build employees within an organization whose actions were in accordance with the values and behaviors of the leaders and are able to build a strong culture at three levels. The first step for leaders to follow is to model the behavior which others should follow. Second, leaders should clearly communicate their expectations verbally and in written format on a consistent basis. Next, employees should be trained in order to ensure the proper values are exercised. Fourthly, employees should be rewarded for positive behavior and punished for negative actions that violate the culture. Lastly, protective measures must be installed to prevent misconduct and hold employees accountable for resources and interactions. It is the responsibility of every leader of every organization to pursue positive values through their own example and the clear and consistent verbal and non-verbal communication.

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# Foreign Currency Exposure by Huong T. Nguyen

## Foreign Currency Exposure and Foreign Exchange Risk Management in Multinational Companies

### Abstract

Due to saturation in domestic markets, and the rapid rate of globalization all over the world, investing in foreign countries has become the strategic move, extremely popular for companies both large and small. However, investing



abroad is a complicated process that requires careful research and planning, both short and long term. In order to succeed in the international market, a company must prepare itself by not only learning about the culture, infrastructure, and potentiality of the market to make profit, but also acknowledging the risk factor resulting from the usage and exposure of foreign currencies. This research will focus mainly on the importance of managing these risks, minimizing possible loss, and protecting profit for multinational companies.

The global market has undergone many changes in recent years. Governments in many countries have deregulated entry restrictions for foreign investors in order to attract foreign investments. In

addition, technological advancement reduces transaction costs significantly. Consequently, there is stiff competition in all industries in the international market. Domestically, when a business yields profit, the company only has to worry about how to make the best use of it. In contrast, if a business yields profit abroad, the company needs to take extra steps to forecast future performance of local and home-country currencies and take actions accordingly. It is critical for multinational companies - businesses that do trade in more than one country - to consider this factor to determine real profit of the firm. First and foremost, it is important to study the role and structure of international financial markets in transacting foreign

currencies.

### The Role of International Financial Markets

International financial markets play an important role in forming the financial environment in which multinational companies must trade. These markets have a major role in determining the demand and supply of most foreign

currencies. According to Czinkota (2000), "international financial markets serve as links between the financial markets of each individual country and as independent markets outside the jurisdiction of any one market" (p. 215). Because of this unique feature, international financial markets have the ability to present currencies traded by their truest value. Though there are many other financial instruments that

make up the international financial markets, the currency market is the heart of these financial markets.

The currency market is a market that does not require physical locations. "The market for foreign currencies is a worldwide market that is informal in structure. This means that it has no central place, pit, or floor like the floor of the New York Stock Exchange,

**"First and foremost, it is important to study the role and structure of international financial markets in transacting foreign currencies."**

where the trading takes place (or in an alley). The market is actually the thousands of telecommunications links among financial institutions around the globe, and it is open twenty-four hours a day" (Czinkota, 2000, p. 221). The financial market is, therefore, a dynamic market, extremely sensitive to any changes anywhere in the world,

and at any given point in time. It is not limited within national boundaries or geographical restraints. Before looking deep into the foreign currency exchange markets and how managers should manage risks caused from the exposure to these markets, an overview of the market's history should be helpful in understanding the origin and

changes of the market over the years.

### History of the Foreign Exchange Market

The Foreign Exchange Market (FX or ForEx) that is known today originated in 1973. Though money has been around in history in one form or another merely as

a logical medium of trade, it has evolved to become an attractive tradable commodity itself. From the early stages of ForEx during the Middle Ages to World War I, the ForEx Markets were relatively stable and without much speculative activity. However, after WWI, the ForEx Markets became both volatile and speculative. Initially, speculation in these markets was not viewed favorably. In addition, the Great

bring the exchange rate back into the accepted range. The Bretton Woods Accord lasted until 1971 and subsequently was replaced by the Smithsonian agreement in December of the same year. Although the Bretton Woods Accord was only a temporary solution, it accomplished the initial goal of re-establishing economic stability in major economies.

firms, and individuals. Central banks intervene on occasion only to direct the currencies to move to a more desirable position. The underlying factor that drives ForEx today is supply and demand.

### Current Foreign Exchange Markets

The values of major currencies are now governed by a floating rate regime. The 1993 meltdown of the European rate mechanism completed the shift of structure for major foreign exchange markets to dominantly market-based. Before 1993, this mechanism provided a method of official pricing matrix for various European currencies. Currently, with the exception of only a few countries that either share currencies of another country or fix their exchange rate, virtually none of the major currencies apply the fixed rate ideology. According to Shoup (1998):

Rates of exchange are determined by ever-changing market forces which are political, economic, and psychological in nature. A massive volume of currency now exchanges hands on any given day. Currencies trade in the wake of efficient and instantaneous information flow. This flow does not readily differentiate among fact, rumor, and deception. Minor news items, even rumors, may quickly translate into major market moves before analysis can dampen the effect. The heavy volume, or *liquidity*, of the market may make exchange rate movements less violent than those of thinly traded markets, but it does not make a move any more predictable. Actually, greater liquidity may provide greater momentum once a trend gets under way, whether or not it is economically justified. (p. 14)

The unpredictability of exchange rates creates risks for companies all over the world. Exposures to the risks caused by exchange rate fluctuations can have an adverse effect on the business and the return on investment. This used to refer solely to the cost of “going offshore,” but the increasing globalization brings new risks and challenges for all types of businesses. Today, a sudden change in the money markets of one major market can disrupt the economic well-being of many throughout the world, whether or not they ever venture overseas.

Therefore, it is important that management

<p>1944 - Bretton Woods Accord is established to help stabilize the global economy following World War II.</p> <p>1971 - Smithsonian Agreement established to allow for greater fluctuation band for currencies.</p> <p>1972 - European Joint Float established as the European community tried to move away from their dependency on the US dollar.</p> <p>1973 - Smithsonian Agreement and European Joint Float failed, signifying the official switch to a free-floating system.</p> <p>1978 - European Monetary System is introduced to again try to gain independence from the US dollar.</p> <p>1978 - Free-Floating system is officially mandated by the IMF.</p> <p>1993 - European Monetary System fails, making way for a world-wide free-floating system.</p> <p>1997 - Global Forex Trading begins offering services to clients previously unable to enjoy the opportunities available in the Foreign Exchange market.</p> <p>1999 - The euro becomes the currency for 11 Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland).</p>
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pression and the removal of the Gold Standard in 1931 created a serious lull in ForEx activity. However, the ForEx Markets underwent many changes from 1931 to 1973 that impacted the global economies at that time. Though speculation was in small doses up to this point, the increasingly integrated global economy stressed clearly the growing importance that ForEx plays in business. A chronological timeline in Figure 1 will list major events that shape the ForEx Markets as they are today. The first significant agreement was the Bretton Woods Accord.

The Bretton Woods Accord. Toward the end of WWII, most European countries were in shambles. The Bretton Woods Accord was established to create a stable environment so that global economies could re-establish themselves. A system of pegging, called the Bretton Woods Accord, along with the International Monetary Fund (IMF) was formed in hopes of stabilizing the global economic situation.

Major currencies were pegged to the U.S. dollar, and the U.S. dollar was pegged to gold at a price of \$35 per ounce. Currencies under this agreement were allowed to fluctuate by one percent on either side of the set standard. When a currency’s exchange rate would approach the limit, the respective central bank would intervene to

The Smithsonian Agreement, the European Joint Float, and the introduction of the free-floating system. The Smithsonian Agreement was derived from the Bretton Woods Accord. Operated by the same concept, the Smithsonian agreement allowed a greater fluctuation band for currencies. In 1972, the European community tried to move away from its dependency on the dollar by establishing the European Joint Float, which was also similar to the Bretton Woods Accord but allowed a greater range of fluctuation in the currency values.

Both agreements collapsed in 1973, which signified the official switch to the free-floating system. This transaction occurred by default, as there were no new agreements to take their place. Governments were free to peg their currencies, semi-peg them, or allow them to freely float. In 1978, the free-floating system was officially mandated. Though Europe, once again, tried to gain independence from the dollar by creating the European Monetary System in 1978, but the attempt failed in 1993.

Major currencies today move independently of other currencies. Currencies are freely traded by anyone who wishes, at any time. This has caused an influx of speculation by banks, hedge funds, brokerage

effectively manage risks resulting from the foreign exchange exposure. Managing risk means finding a way to eliminate it or reduce it to acceptable levels. Foreign currency and interest risk management techniques should depend on how pervasive the risk is, as well as how the risk will affect the company financially in the long-run.

### Foreign Exchange Exposure and Risks

Foreign exchange exposures can arise from a variety of activities. A traveler may encounter the need to exchange one currency for another. He or she has the risk of losing purchasing power if the country's currency appreciates, which will result in a more expensive trip than anticipated. An exporter who sells products in a foreign currency faces the risk that the value of that currency could fall and subsequently affect the home-currency revenue negatively. Vice versa, an importer who buys goods priced in a foreign currency faces the risk that the currency may appreciate, making the cost in local currency greater than expected. Fund managers and companies who own assets that are exposed to rises and falls of a foreign currency have the risk of foreign exchange as the currency fluctuates. Other foreign exchange exposures may involve the exporting and importing in one's local currency, but the negotiated price is tied directly to the exchange rate movements. These transactions and even more complex trade activities are especially true for multinational companies due to their large scope and diversity of operations across countries of interest.

Supposing that multinational companies are adequately equipped and ready to do business abroad, they will immediately encounter the market of foreign currencies where "exchange rate determines how much one currency is worth in terms of another, and it influences the price of international exchanges" (Hubbard, 2000, p. 414). Herein, multinational firms undergo foreign exchange risk. Whether from needing foreign currencies to import materials, to invest, or to pay wages to local workers, multinational firms must have some knowledge of the foreign exchange risk in the market of foreign currencies.

To better understand the complexity of multinational companies' cash flows and their exposures to foreign exchange, the flow of currency chart (see Figure 2) provides a proposed illustration of how foreign currencies may play roles in a multinational company's operations. Flows of foreign currency in a multinational company can be quite complex and simultaneous.

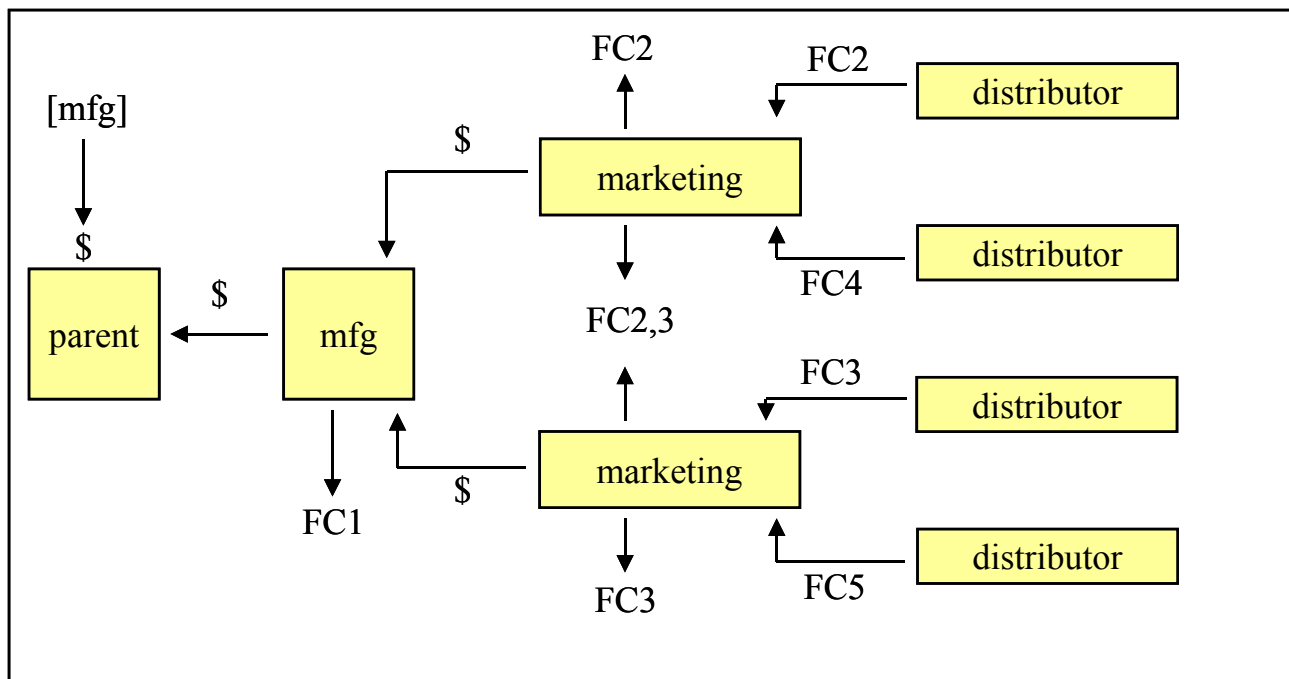


Figure 2. A multinational company's diagram cash flows.

As depicted above, a manufacturing unit may obtain capital resources from a parent company but market and operate in many other currencies. A change in one or more currencies will undoubtedly affect the overall profit.



According to Eiteman, Stonehill, and Moffett (2001), foreign exchange risk exposure exists when a firm may be adversely affected by a change in foreign exchange rates that consists of several components:

1. Transaction risk: the chance that the value of outstanding financial obligations already incurred will change because of an unexpected change in exchange rate.
2. Interest rate risk: the chance that the home currency equivalent interest costs of servicing various forms of foreign currency dominated debt will rise because of an unexpected change in foreign exchange rates.
3. Operating risk: the chance that the present value of the firm (calculated by the expected future operating cash flows) will fall because of an unexpected exchange rate change.
4. Translation risk or accounting risk: the chance that the accounting-derived value of owner's equity will drop because of the accounting process after making foreign currencies conversion.

Overall, loss due to foreign exchange risk is a direct result of an unexpected exchange rate change. Therefore, it is only logical that companies should carefully study the volatility of foreign currencies of interest, make financial adjustments, and prepare themselves for worst possible scenarios.

### Financial Risk Management

Because of the unpredictable nature of the *unexpected* changes of exchange rate, multinational firms' capital is at risk. Though risky businesses often yield high rates of return, multinational companies should protect themselves from unreasonable amounts of loss. Fortunately, there are financial instruments and management methods available to minimize loss and protect profit against undesired and unexpected exchange rate changes.

Transaction risk management. Transaction risk is the most common type of exchange rate risk. Transactions are exposed to this risk from the current date to the date of settlement per chance the exchange rate changes. The change can be either advantageous or disadvantageous to a firm. For example, if company A in the US purchased 100,000 Japanese yen worth of products from Japan when the spot exchange rate on the date of contract was 100 yen/\$, the U.S. firm would expect to pay 100,000 yen / 100 yen = \$ 1,000.

However, 30 days later, when the products are delivered and it is time for payment, if the spot exchange rate of Japanese yen changes to 120 yen/\$, company A will only have to pay (scenario 1) 100,000 yen / 120 yen = \$ 833.33. But if the spot exchange rate of Japanese yen changes to 80 yen/\$ instead, company A will have to pay (scenario 2) 100,000 yen / 80 yen = \$ 1,250.

In scenario 1, the Japanese yen depreciated (decreased) in value compared to the U.S. dollar. Company A, therefore, has to pay a lesser amount. On the contrary, company A has to pay more because the Japanese yen appreciated (increased) in value in scenario 2. Moreover, there is scenario 3 where spot exchange rate remains constant.

To eliminate or at least lessen the risk illustrated in scenario 2, multinational financial managers use either *natural hedging* or *contractual hedging*. Natural hedging is the term used to describe "how a firm might arrange to have foreign currency cash flows coming in and going out at roughly the same times and same amounts" (Czinkota, 2000, p. 592). This way, regardless of the exchange rate change, loss and gain in these transactions should break even.

Another option is contractual hedging. Contractual hedging is when "the firm uses financial contracts to hedge the transaction exposure" (Czinkota, 2000, p. 592). It consists of forward contract, currency futures, swaps, options, and other financial instruments and derivatives. However, the perfect hedge, in which risk exposure is completely eliminated, is rarely attainable. "The gain or loss from a hedge transaction seldom exactly offsets the gain or loss of the exchange rate move. The contracted hedge and the currency may change values at slightly different rates. Also, there are

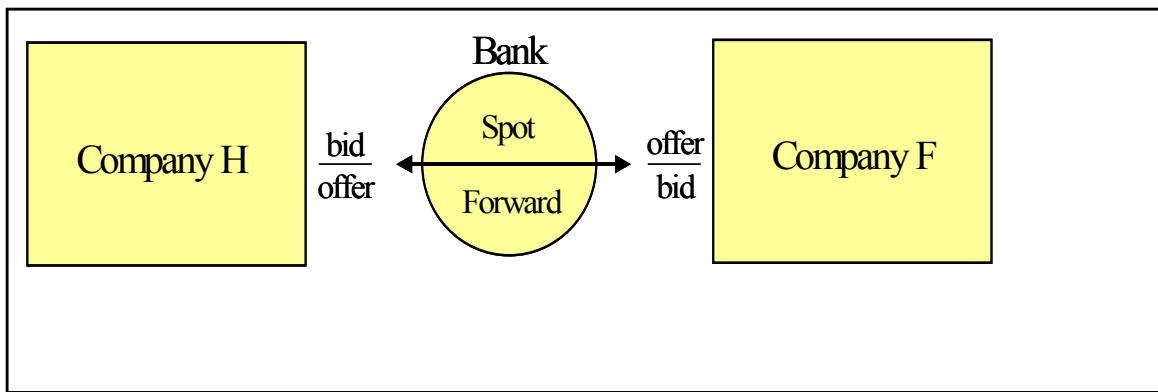
possible tax implications involving the market transaction, and there are always transaction costs to consider. Regardless, if the hedge is properly constructed, these factors are insignificant compared to the reduction in risk exposure" (Shoup, 1998, p. 17).

A closer look at a few major methods of hedging that protects the firm from drastic exchange rate changes is appropriate. The most commonly used method is the *forward contracts*.

Forward contracts allow the firm to obtain an agreed fixed rate of exchange at a stated future date. The price at which the transaction takes place is negotiated, and all terms and penalties are discussed and agreed upon by the two parties.

Another method is *futures*. Futures have the same attribute as forward contracts, allowing the firm to obtain an agreed fixed rate of exchange in a stated future date. However, they are traded on an organized exchange. "They have standardized, pre-determined terms and conditions of the product, and also have a third party that makes sure that the contract will be fulfilled" (The differences between, n.d., ¶ 3 - 4). Because of these attributes, futures provide standardization, attracting investors in the foreign exchange market. Businesses can also utilize this method to hedge their transaction risk exposure for short-term activities.

The use of *swaps* is also popular. There are numerous types of swaps. The general idea for using swaps is to take advantage of creditworthiness of businesses in their localities. For instance, company A located in country A does not have strong lender relations in country B and would have to pay a premium to borrow country B's currency from a foreign bank. In its own country, however, the company has a strong credit rating, allowing it to borrow at favorable rates. A similar situation applies to company B in country B. If both companies are interested in doing business in the other's country, they should consider a swap. Figure 3 will illustrate the use of swap more vividly in the case of a spot-forward swap between two companies. The swap will allow each to take advantage of the other's borrowing power and currency availability. Company A can borrow country B's currency with a more acceptable cost and company B can also do



likewise to obtain country A's currency  
*Figure 3. Swap.*

purchasing a currency option may be a wise solution to re

more reasonably.

As illustrated, suppose company H deals directly with the bank, which is the usual method of accessing the interbank at a retail level. The bank, however, seeks to offset its exchange transactions with other clients. Here, the bank acts as an intermediary. As far as each company is concerned, it is only dealing with the bank. If a company deals directly with another firm, there will be added credit risk.

Acknowledging the fact that many swap products have close relations with interest rates, more details regarding swaps will be discussed in the interest rate risk management section.

Another method of transaction risk management is through the use of *options*. Currency options work like all other types of options. "Since options cost less than stock, they provide a high leverage approach to trading that can significantly limit the overall risk of a trade or provide additional income. Simply put, option buyers have rights and option sellers have obligations. Option buyers have the right, but not the obligation, to buy (call) or sell (put) the underlying stock (or futures contract) at a specified price until the 3rd Friday of their expiration month" (Lycos, n.d., ¶ 1). Foreign currency options, in specifics, are options to purchase or sell one currency at a price denominated in another currency. The price of one currency in terms of another currency is known as an exchange rate. The exercise price of a currency option thus represents an exchange rate. If a company is exposed to a substantial amount of risk due to an unexpected exchange rate change,

duce the magnitude of this risk.

Interest rate risk management. By definition, interest rate risk is the chance that the home currency equivalent interest costs of servicing various forms of foreign currency dominated debt will rise because of an unexpected change in foreign exchange rates (Eiteman, Stonehill, & Moffett, 2001). To manage this risk, innovative ways were introduced to help firms to economically gain access to the needed foreign currencies. Two types of swaps are considered: interest rate swap and currency swap.

According to Czinkota (2000), the interest rate swap, also known as the "plain vanilla swap," allows one firm to use its good credit standing to borrow capital at low fixed rates and exchange its interest payments with a slightly lower credit-rated borrower who has debt service payments at floating rates. Each borrower ends up making net interest payments at rates below those it could have achieved on its own.

For example, say that company HC can borrow capital at lower fixed interest rates than company FC, company FC must borrow at higher rates, often at floating. If each firm were to borrow where it is well liked, according to its comparative advantage, it can swap debt service payments. Both will end up better off than what each was originally offered.

The currency swap is similar to the interest rate swap, only with a slightly different methodology of borrowing. Company HC in country needs home currency where company FC is; meanwhile, company FC needs company HC's home currency. So each company borrows money from its home market where it is known and can obtain capital at attractive rates. Then, through a swap dealer, each firm exchanges the debt service payment of its own to the other firm's debt (assuming the principal amounts borrowed are equal at

payments, the responsibilities over the debt will still rely on the initial borrower. This risk, referred to as counterpart risk, is a growing concern as swaps become a useful and popular tool in managing interest rate risk for multinational entities.

Operating risk management. The previous example (scenario 1), only viewed from the perspective of the seller (the firm that accepts payments in Japanese yen), is an example of operating risk. Operating or economic risk emphasizes the fact that there is a limit to a firm's ability to correctly forecast cash flows or exchange rates in the medium to long term. Activities in the international financial

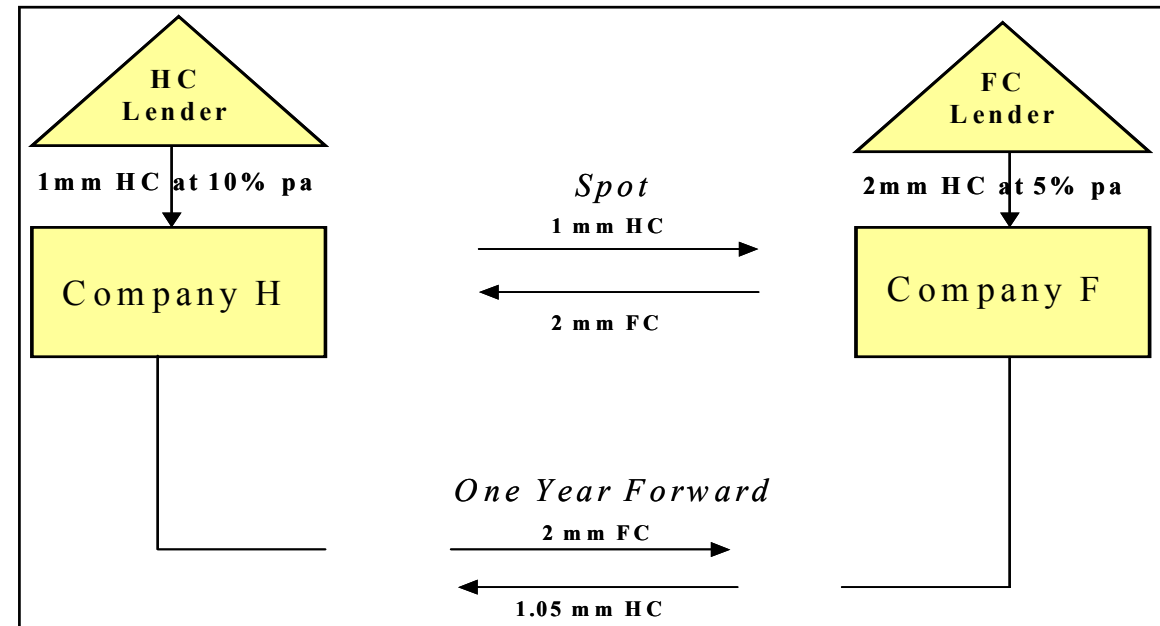
payment from the least to the most desirable from the buyer's point of view. Recognizing the conflict of interest between buyers and sellers that both parties want to have the possession of cash for as long as they can and as quick as they can to finance other activities or reinvest, buyers and sellers must contract and agree on acceptable types of payment.

The most desired payment method for sellers is *cash in advance*. This type of payment eliminates all collection burdens. However, all buyers want to utilize their capital as efficiently as possible. Therefore, buyers naturally want to keep their cash rather than paying in advance.

Consequently, sellers usually do not receive their payments with this method.

One of the alternative ways for cash payment is through the use of a *letter of credit* – buyer's bank assumes payment responsibility upon proof of shipment or receipt. This payment method is more ideal for buyers than cash. However, it requires a good relationship between the bank and the buyer. Letter of credits are easy to obtain for financially sound

businesses but may require a lengthy procedure for struggling entities and new start-ups. In addition, the bank takes on the risk from the time of the shipment to the



current exchange rates). Both will enjoy much lower interest payments compared to

markets, political conditions, and many other factors can affect operations of a firm. The risk here is that the value of the firm will de

what direct borrowing could offer, as exemplified by diagram:

Figure 4. Currency swap.

The figure above illustrates a one-year currency swap. The bank facilitates the swap as an intermediary. The contract terms are the same for a regular spot/forward swap, but are in written contract form for both parties. The bank introduces the parties, brokers the deal, and then leaves the parties to complete the transaction.

One disadvantage is when one of the swap parties defaults or fails to make

crease due to cash inflows, which are less than expected. One of the solutions to this is diversification of both operations and financing to spread out the risk. Again, by using either natural or contractual hedging in financing, the firm can lessen the risk from devalued, expected future operating cash inflows. Hence, the risk of a firm's falling value will be minimized.

Payments for cross-border businesses can be accomplished by cash in advance, letter of credit, documentary collection, open account, or local currency open account. The following section will discuss the concept of each type of

time the transaction is completely paid by the buyer.

Another alternative is through using a *documentary collection* – buyer's bank assumes payment responsibility upon the buyer's authorization. Similar to a letter of credit, a documentary collection is when the seller receives the payment from the bank on behalf of the buyer. The difference between these two payment types is degree of involvement of the bank. For documentary collection, the bank takes on the responsibility for the payment only

after receiving a notice from the buyer; any discrepancies regarding the transaction must be handled between the buying and selling parties.

*Open account* is a payment method when the seller invoices the buyer directly with previously agreed payment terms. This method is usually accepted between parties that have had regular businesses with each other and have built a substantial amount of trust. This method requires a good credit system from both parties.

The least favored type of payment for sellers is through using a *local currency open account* where the seller invoices the buyer directly with previously agreed payment terms, in which the invoice is denominated in the buyer's currency. This payment type is scarcely used because the seller will absorb all currency risks. However, it could be an effective marketing tool for disadvantageous sellers and/or products.

Depending on the chosen acceptable standards of payment a multinational firm agrees to with its foreign counterparts, the company's operating exposure will vary. Shoup (1998) states:

Although many cross-border trade relations begin with cash in advance or letters of credit, the usual objective is to progress toward more 'buyer friendly' methods of financing. This progression takes place as the counter-parties get to know each other, and as credit becomes established. Both the exporter and the importer benefit when the trade finance package becomes more attractive; the importer from a financial standpoint and the exporter from a marketing point of view. (p. 90)

However, many exporters refuse to offer the most attractive method of financing, invoicing in the buyer's currency on an open account basis, for two main reasons. First, it is traditional to price in dollars because it is the most widely used currency in international trade. This is reasonable because the U.S. economy is strong and relatively stable. The performance of this market has a great impact on other major markets and the world economy as a whole. Secondly, exporters are less able to

efficiently protect themselves from foreign exchange risk introduced by local currency invoicing.

Even a company that has little to do with cross-border businesses can also face operating exposure caused by foreign exchange rate fluctuation in a "hidden" sense. According to Shoup (1998), the measurement of operating exposure must take into account both the nature of the company as well as its competition. With few exceptions, operating exposure can be defined as the effect of foreign exchange on a company's competitive position, both at home and abroad (p. 91). A foreign firm that competes with a domestic company will have the advantages of lower production cost if that currency weakens. Consequently, this will put the domestic firm in a position of comparative disadvantage due to the strong currency. A good example of this was Chrysler in the late 1970's and early 1980's.

After numerous unsuccessful investment operations overseas throughout the 1960's and the 1970's, Chrysler retrenched and refocused on its domestic market. Chrysler sourced its parts from U.S. suppliers, assembled them in Michigan, and sold the finished products to America. However, as it was reorganizing, Toyota and other Japanese car companies began to aggressively export to America. Approximately 60 percent of their total cost was denominated in yen, at the exchange rate of 200 to a dollar, and still continuing to depreciate. With the cost of goods denominated in a relatively undervalued Japanese yen, manufacturing costs were much lower in dollar terms. Consequently, Japanese manufactured cars were priced lower in comparison to American made automobiles. Although Chrysler had no foreign currency exposure on the books, the dollar value of the Japanese yen was a definite factor contributing to Chrysler's loss of market share to the Japanese carmakers. Beginning in 1989, the yen/dollar exposure started to turn the losses of the 1980's into profits of the 1990's when the yen was exchanged at 100 to a dollar. Major Japanese carmakers, thereby, managed their currency exposure by strategically setting up manufacturing facilities in the United States (Shoup, 1998).

An effective way to manage operating risk is to convert it into another form of risk

exposure, usually accounting for cash flow

"An effective way to manage operating risk is to convert it into another form of risk exposure, usually accounting for cash flow exposures in which the company can effectively manage them through hedging, swaps, forwards, and *roll-overs*."

exposures in which the company can effectively manage them through hedging, swaps, forwards, and *roll-overs*. According to the London City Brokers, the concept and mechanism of roll-overs can be described as "the exchange of one currency for another on one day, matched by a reverse exchange on the next business day.

The two exchanges are made simultaneously. The basis of a roll-over is to move a given currency deal forward in time, based on the interest rate differential between the two currencies" (London City Brokers, n.d., Rollovers section, ¶ 1). For instance, if a hedger transacts a forward exchange swap and does not wish to pay back the currency to fulfill the short position, that hedger may take a new long position to offset the existing short, and establishes a new short position for a value date more distant. These transactions when performed simultaneously are known as *roll-over*. By using a series of roll-overs, a forward position can be applied indefinitely. The only difference of this method in comparison to fixed-rate borrowing is the interest rate adjustment each time a roll-over is made.

Operating exposure can also be managed by operating strategies, which will alter the way the company initially operates, avoiding or eliminating currency effects in extremely high risk markets caused by currency instability. Operating strategies are more permanent and never taken lightly. They include:

1. Retrenchment – withdrawing from unprofitable foreign markets and looking for alternative markets or alternative ways to do business. Pulling out of markets might be caused by numerous reasons, including political and economic

- instability. Reducing drastic currency risk may be one of the valid reasons to retrench.
2. Relocating plants – relocating plants or manufacturing facilities that may reduce operating exposure by matching the currency revenue with the currency in which goods and inventories are priced. Obviously, this strategy requires an extensive amount of planning and resources. To relocate, a company needs financial strength to acquire, build, or joint venture with local businesses.
  3. Operating in both strategic markets – exposures may be reduced by strategically managing the mix of marketing and production. Shoup (1998) suggested that this strategy is especially appropriate for an acquisition-minded growing company. For instance, a company that produces in the United States and markets in Germany may decide to acquire a German firm that produces a complementary line of products. These products would then be imported to the U.S. market. In this way, long exposures resulting from Deutsche mark revenues and U.S. dollar costs are offset by short exposures resulting from U.S. dollar revenues and Deutsche mark costs.
  4. Product modification – modifying the product line may reduce the operating exposure, especially with products that are under intensified price competition. If the company can come up with ideas to differentiate its products or focus on specific niche in the market so that its sales will not be as sensitive to price, operating exposure will be significantly reduced.
  5. Source flexibility – designating manufacturing facilities in a smaller scale may also reduce the operating exposure. This strategy is

used to fully taking the advantage over the weaker-currency economies. “They are inexpensive to start up, shut down, and moved around compared to full-scale manufacturing units” (Shoup, 1998, p. 93). These facilities are located in countries where labor is relatively cheap. Factors to consider are the skill of the labor force, cost of training and management, and regulatory factors.

Translation risk management. Translation risk, or accounting risk, “results from the conversion or translation of foreign currency denominated financial statements of foreign subsidiaries and affiliates into the home currency of the parent” (Czinkota, 2000, p. 599). This process is mainly for comparison purposes. Management often uses these translated statements to judge the performance of foreign affiliates. However, complication arises in determining which exchange rate to use: spot rate on the date of initial investment – historical; or spot rate on the date stated on the balance sheet - current.

Currently, in the United States, the Financial Accounting Standards Board provides the instructions and guidelines to the translation of foreign financial statements. FASB 52 states that if a foreign subsidiary is operating in a foreign currency functional environment, then most assets, liabilities, and income statement items are translated using the current exchange rates. Though the translation may incur a gain or a loss, the number is relatively immaterial to forecast into the future. According to Czinkota (2000), unless liquidation or sale is anticipated in the near future, neither the parent firm nor the subsidiary should pay much attention or resources on managing an accounting convention. However, because accounting exposure clearly affects the numbers on the reported financial statements, financial officers should understand and search for ways to combat this risk. After all, stockholders and creditors scrutinize the company’s financial statements more rigorously than they do its distributors’ and competitors’. By successfully reducing the negative effects of foreign exchange on the company’s financial statements, the company’s attractiveness will be

significantly enhanced.

To reduce or eliminate translation risk exposure, a company should attempt to do at least one of the followings:

1. Home-currency invoicing – if feasible, the company should simply price everything in the home currency. This method is most effective when the product line is unique and the home currency is relatively stable. Home currency should be closely monitored along with a careful market research. Managers should watch out for “hidden” sense of foreign exchange caused factors (similar to Chrysler’s). When financial statements are translated, the company is evidently exposed to little to no translation risk.
2. Strong-currency invoicing – if home currency is not one of the options for invoicing, the stronger currency should be used. This method will lessen the risk caused from translation of financial statements if the weaker currency continues to depreciate.
3. Home-currency sourcing – this method provides conformity for the company’s financial statements. The purchasing party A will encourage suppliers to agree to invoice in A’s home currency to protect itself from foreign exchange fluctuations. If the supplier is located overseas, it is a way of transferring risk to the other party. If the supplier refuses to accept the risk, negotiation may occur so that the supplier can include the cost into their price quotes.
4. Same-currency sourcing – purchasing from sources in the local currency will also help hedge the exposure. However, depending on the quality of the products and/or services, this method is for shorter-term contracts.
5. Long-term fixed-rate

borrowing – this method hedges exposure to nominal exchange rate changes. The remaining risk is on real rate of exchange because it does not cover the changes in inflation. This is the most common method used to hedge long-term translation exposure.

To reduce translation risk exposure, short-term instruments like futures and forwards will not be suitable for locking in the value of long-term assets, such as plant, equipment, and other capital assets on the balance sheet. However, long-term exposures can be managed most effectively by infusing the capital into the operation in the form of local bank borrowings in the foreign currency to create short positions, or by investing local currency in the country to hedge long-term liabilities.

Fixed-rate borrowing from a local bank in a foreign country is an effective financial adjustment hedge. Also, effective use of forward roll-overs will aid managers in managing translation risks by postponing the date of the transaction's completion.

### Conclusion

Multinational financial management is absolutely vital for multinational companies. The constant exposure to the market of foreign currency causes these companies to experience many risks. It is important, therefore, for multinational companies to acknowledge these risks, clearly recognize, and efficiently utilize available financial instruments to minimize potential loss due to foreign currency exposure. Though risk cannot be completely eliminated while practicing international business (or any type of business for that matter), a formulated understanding of foreign exchange risk will help lessen the potential loss from international transactions.

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Huong T. Nguyen

# EVA: The Public Corporation's Leverage Buyout

## by Kyle Phelps

### EVA: the Public Corporation's Leveraged Buyout

#### Abstract

This thesis discusses the historical progression of corporate governance systems in America and how they have affected business. Moreover, it explores the phenomenal success of the Leverage Buyout movement in the 1980s and how this movement helped put an end to the wealth destruction of large conglomerates. It demonstrates

that the old measures of financial performance that have long dominated corporate America have become obsolete. In the presence of a rapidly changing global economy, American businesses need to adopt a new and more comprehensive financial model that will bring about the true economic potential of an organization, not only for the benefit of shareholders but also for sheer survival. Thus, Economic Value Added, or EVA, will be discussed as the most effective corporate governance system because of its ability to model the principles and lessons learned from the successful Leverage Buyouts, thus emphasizing the maximization of the economic potential of an

organization.

#### Introduction

The main task of any public corporation's top management is to maximize the profit potential of the organization, given that the entire reason for the creation of a corporation in the first place is to create wealth. However, more than just the shareholders of a corporation benefit from this creation of wealth. Society at large benefits as well. This quest for wealth directs resources to the most productive and promising uses, and the more effectively these resources are

**“In the presence of a rapidly changing global economy, American businesses need to adopt a new and more comprehensive financial model that will bring about the true economic potential of an organization, not only for the benefit of shareholders, but also for sheer survival. “**

used the more robust the economic growth and the standard of living of a nation becomes. America benefits from one of the highest standards of living in the world. This directly stems from our efficient economic system that sets the landscape for innovation and more efficient and productive uses of resources.

However, even with one of the most

robust and efficient economies in the world, inefficiency leading to misallocation of resources is widespread. Thus, the economic potential of our nation, and more importantly, our attainable standard of living is not being reached. This is because many companies' quest for wealth is being confounded by obsolete corporate governance systems where managers are improperly and in many cases inade-

quately rewarded for their efforts. The wrong performance measures, financial goals, and valuation procedures are being emphasized, leading to misallocation of resources, which in turn destroys wealth, and reduces the nation's overall standard of living.

This misallocation of resources has not been more evident than what has been seen by the corporate scandals with such large and respected companies as

Huong T. Nguyen

**“...Economic Value Added, or EVA, as a corporate governance system, models the success of the LBOs of the 1980s, mainly by its emphasis on both a required return on capital and on ownership incentives, all without the financial risk of large debt financing.”**

Enron and WorldCom. The senior executives of these companies believed the market wanted earnings and wanted them now. Thus, to satisfy Wall Street's alleged craving for reported earnings, these top executives found ways to conjure up earnings with time consuming and unethical practices through accounting legerdemain. The

corporate governance system that rewarded this wealth destructive behavior was amplified by unethical behaviors that led to the financial devastation of many undeserving people. Unfortunately, many companies still employ these outdated systems. Therefore, it is incumbent upon companies and organizations to show due diligence in the

pursuit of finding the most successful corporate governance system that rewards managers and employees for wealth maximizing activities.

This paper will begin by describing the shortcomings of the EPS (earnings per share) based systems that dominated the business world in the two decades fol-

lowing the World War II. Next, emphasis will be put on the rise of hostile takeovers leading to the phenomenal success of the leverage buyouts (LBOs) in the 1980s as the market responded to the misallocation of capital created by large conglomerates in the 1960s and 1970s. Then, this analysis will argue that Economic Value Added, or EVA, as a corporate governance system, models the success of the LBOs of the 1980s, mainly by its emphasis on both a required return on capital and on ownership incentives, all without the financial risk of large debt financing. Therefore, it will be argued that an EVA system will lead to proper resource allocation that will generate shareholder wealth, and more importantly, will generate a higher standard of living for society as a whole.

### Post War Era

After World War II, many large corporations were centralized, and thus ran from the top down. This worked well for these corporations due to the relatively stable business climate that prevailed for the two to three decades after the war. In that age of economic stability, the majority of large U.S. companies aimed at producing stable growth in earnings per share. Therefore, they called on each of their operating divisions to produce a certain amount of earnings each year. Such a practice seemed to work well for corporations during the post war era because the top strictly controlled new capital appropriations for all divisions.

However, this attempt to control EPS spiraled down into desperate moves by many corporations to satisfy their EPS goals. For example, during the 1960's and 1970's it became popular for corporations to diversify into unrelated industries. This trend can be explained in part by top management's attempt to manage reported earnings. This unrelated diversification led to what is now known as EPS bootstrapping, which is buying companies with lower P/Es in stock to stock exchanges, thus automatically boosting reported EPS (Chew, 1999). However, such a practice was pure accounting deception and held no economic significance. Moreover, it made it extremely difficult for top-management to strictly control operations, as it was able to do when the company was specialized.

Because of management's emphasis on reported earnings, division heads, with

greater knowledge of their division than top-management, would underestimate their profit estimates during the annual budget negotiations. The way the majority of corporations' reward systems were designed explains this practice that is known as "sandbagging." For example, division heads annual bonus awards were capped at approximately 20% to 30% of base salary. Michael Jensen (1997) comments on this activity by saying that the budget process "consumes a huge amount of executives' time...encourages managers to lie and cheat...and penalizes them for telling the truth" (p. 65). Thus, it is extremely important to realize that the employee incentive program is the anchor to any corporate governance system. As Gregory Mankiw (1998), Professor of Economics at Harvard University, states in one of his ten principles of economics, "People respond to incentives" (p. 7). However, this practice took away any incentive for managers to produce significant profits, because if they did they would only receive a capped bonus as well as higher expectations for the next annual budget negotiations.

These problems associated with budget negotiations were obvious, which begs the question, why did CEO's not abandon the practice? The disheartening answer is that many top managers not only tolerated this practice but also encouraged such counterproductive practices. This is because the budgeting process enabled top management to meet its goal of a smoothly rising EPS that was needed to satisfy shareholders. Thus, division heads would be sandbagging their estimates to top-management leading to top-management's sandbagging their shareholders, in an attempt to manage investor's expectations while at the same time hiding the true economic potential of the business.

In regards to this practice, Gordon Donaldson (1994) argued that implicit in management philosophy during the 1960's and 70's was that shareholders were only one of several constituencies that needed to be served. He also explained that this leftist political climate influenced top management in a way that, "top managers saw their primary task not as maximizing shareholder value, but rather as achieving the proper balance among the interests of shareholders and those of other 'stakeholders' such as employees, suppliers and local communities" (p. 34). Thus, within this mindset, reporting steady

growth in EPS was equivalent to giving stockholders their due. In hindsight, such views awarded companies relatively well, that is, while the economy was relatively stable and intense international competition and corporate raiders stayed at bay.

However, the weakness of this top-down EPS based system began to reveal itself in the early 1980s. Many diversified conglomerates began to see their stock price significantly underperform market averages even though they had steady increases in their EPS. This is because many smaller firms that were more specialized began outperforming them. Therefore, it started to become clear that these conglomerates were worth far less than the sum of their parts (Thomas & Edwards, 1993).

"At the heart of the failure of the top-down EPS-based control system was its refusal to empower divisional managers, to make them feel and act as if they were stewards of investor capital" (Chew, 1999, p.124). Once again, managers' incentives were not correlated to maximizing shareholder wealth. Because of the emphasis on EPS, business units were evaluated based on their operating profit and had no incentive to be concerned about the amount of capital needed to achieve these profits, thus paying no attention to an adequate rate of return on this capital. Due to this emphasis on profits, managers would attempt to increase profits by either improving the efficiency of their current operations or by winning more capital appropriations from corporate headquarters. Since the corporate governance system did not hold managers responsible for new capital, it did not take long for division heads to realize that it was easier to gain higher profit by receiving additional capital than by trying to operate more efficiently. No thought whatsoever was given to the cost of this new capital and if it would produce an acceptable rate of return.

Historical analysis shows that earnings, earnings per share, and earnings growth are misleading measures of corporate performance. This misconception occurs because accounting numbers as dictated by GAAP (Generally Accepted Accounting Principles) distort economic reality and lead to misallocation of capital. Pettit (2000) states, "a lesson overlooked by business schools is that accounting often drives major business decisions despite and not because of the economics" (p. 9). These dis-



tortions implicit within accounting statements are what led to the major flaws in incentive programs that reinforce GAAP by using EPS or other accounting measures. Instead of managers being concerned about creating value, they get caught up in financial game playing. As Don Cohen (2002) states in the *Harvard Business Review*, “Financial game playing does its damage by diverting attention, energy, and resources away from value creation and toward the pursuit of an essentially meaningless objective” (p. 46).

Thus, such a practice is giving management incentives to destroy wealth. For example, what would a manager be expected to do if 60% of his incentive was tied to net earnings? Would they be tempted to cut back on marketing and research and development or other items such as this that GAAP treats as cost (but in economic reality is an investment that requires a return) if management saw their earnings deteriorating? At best, EPS only measures the quantity of earnings but tells nothing about its quality. This is because rapid earnings growth can be manufactured by dumping money into substandard projects, resulting in widespread corporate misallocation and the destruction of wealth. This is evident as the cause of the problems for the majority of corporations during the 1960s and 1970s. These companies generated a large amount of cash, more than managers could have spent in projects that had acceptable rates of return.

According to Jensen (1997), while speaking at a Bank of America Roundtable on the topic of capital structure and its relationship with value creation,

By the late 1970s and early 1980s, it reached the point where companies could destroy as much as one half of their value

**“In the 1980s, the corporate raiders dominated the scene, and they were more interested in a company’s ability to generate cash flow and their efficiency in using the amount of invested capital.”**

by failing to pay out their free cash flow and instead reinvesting in low-return projects or diversifying acquisitions. The failure of organizations to pay out their

excess capital led to the invention—or, more precisely, the ‘reinvention’—of hostile takeovers and leveraged acquisitions. (p. 67)

Jensen (1988) explained clearly that excess funds produced by a corporation were being used to cross-subsidize low returning projects, especially those in unrelated industries. This practice served managers well at the time, due to poorly designed incentive programs that rewarded them for poor decisions, but it was destroying shareholders’ wealth. Thus, managers’ interests and shareholders’ interest were at conflict.

However, academia has known, since the late 1950s, that the economic model of a firm, not the accounting framework, is to be preferred because it aligns management and shareholders’ interest. For example, Merton H. Miller and Franco Modigliani (1958) made such an impact with their research, which successfully demonstrated this concept, that they were both awarded Nobel Prizes. Why was their study so revolutionary? “In its simplest terms, the Miller Modigliani framework showed us why discounted cash flow as a process and net present value as a measure reflect how markets work in the real world, and thus comprise the approach managers should employ if they are concerned with the impact of their decisions on shareholder value” (Groth & Anderson, 1997, p. 476).

However, if this study was revolutionary enough to win a Nobel Prize in Economics, why did it not catch on in the corporate world? Even though the top business schools graduated more than 100,000 MBAs between 1958 and 1991, management still adopted accounting measures of performance, especially for benchmarks in their incentive programs (Ehrbar, 1998). Something was clearly wrong. Management was still leaning on earnings per

share. It became so absurd that, as mentioned earlier, “...firms that commanded high price-to-earnings ratios supposedly could purchase firms with lower P/Es because in equity exchange the buyer’s EPS

increased. But the reverse transaction was anathema in the boardroom because it lowered earnings per share” (Groth & Anderson, 1997, p. 476).

This was the height of the accounting absurdity because the firm was the same economically, no matter who did the acquiring. The widespread rejection of net present value and discounted cash flow, both of which use the cost of capital, puzzled the academic world whose research indicated that using EPS as such a dominant measure in the analysis of acquisitions and the tying of employee incentives was complete nonsense.

However, it did not take long for the investors to realize that there was a mass amount of capital being wasted by these conglomerates.

### **Onslaught of Corporate Raiders**

In the 1980s, the corporate raiders dominated the scene, and they were more interested in a company’s ability to generate cash flow and their efficiency in using the amount of invested capital. These corporate raiders at the time were paying high premiums over prevailing market price for these takeovers. The reason that this was possible is that they realized these conglomerates’ parts were worth more than the whole. Thus, in the majority of cases, the takeovers created by the corporate raiders led to cutbacks in employees and investment; however, this downsizing is exactly what these companies needed and it led to improved capital efficiency. Then they would sell the company at a substantial gain to single-industry firms or to private investment groups, who then would likely take the company back public, thus creating the Leveraged Buyout (LBO) movement of the 1980s (Chandler, 1993).

### **Rise of the LBOs in the 1980s**

This problem of companies’ not properly allocating their free cash flow was an enormous problem during the late 1970s and early 1980s. How might managers be motivated to pay out excess capital when they no longer have any projects that return their cost of capital, since, as was indicated earlier, they were not rewarded for such prudence? Instead, managers pushed to get more funding for their pet projects; this

resulted in the “gold-plating” and empire building of organizations at the cost of shareholders. The problem was that these large mature organizations could operate with 20% debt and 80% equity; and according to the accounting statements they were making a lot of money, when the fact of the matter was they were destroying wealth because they were not earning their cost of capital. According to Jensen (1997), “When dividend yields are low and the cost of equity doesn’t show up in the accounting statements, managers can easily get into the habit of thinking that equity is costless when, in fact, it’s the most costly source of financing” (p. 45). This statement highlights one crucial weakness of managers’ dependence on GAAP financial statements; they treat equity as being free. Managers’ dependence on traditional accounting measures was not only irresponsible, but this imprudence meant the demise of many of these corporations, since they were being brought private by the purchase of private investors in leveraged transactions; this was the market’s answer to the misuse of free cash flow.

One of the most fascinating aspects to look at in regard to LBOs is the difference in which they were operated compared to when they were public companies. The LBOs were not concerned with reporting higher EPS. Therefore, they chose accounting methods that would reduce their reported earnings leading to higher operating cash flows. Conversely, when these companies were public they were so fixated with reaching their expected earnings that they concocted accounting methods that reported higher earnings, thus resulting in higher taxes leading to less cash flow.

One of the main reasons behind LBO’s goal of producing higher cash flows was simply, they had no choice. They needed the cash to be able to cover their high interest and principal payments. The average LBO during the 1980s had a debt-to-asset ratio of 90%. Essentially, this caused the cost of capital to be an explicit cost and contractually binding, since most of the capital was debt instead of equity. Therefore, the cash cost associated with the financing showed up under GAAP accounting statements. This resulted in tight corporate governance. Therefore, when a product or new venture was not performing, management would quickly intervene, whereas in public companies that were

largely equity financed, the problem would not be dealt with as urgently because of the cushion equity provided.

In addition to an explicit cost of capital, the next crucial ingredient in the success of LBOs was that operating managers were required to purchase a significant stake of equity within the company. This was facilitated because owners realized that without management having a direct stake in the long-run success of the company their incentives for short-term profit would be too high. Therefore, management became interested in whether or not the investments undertaken were productive for both the long run and short-run, since they were the owners. Since an LBO is eventually going to be cashed out, it is in the management’s interest to make the firm as valuable as possible because they directly benefited, and quite dramatically at that. According to Jensen (1998), since the entire operating management team ended up owning roughly 20% of the equity stake, they would earn close to \$200 per \$1000 change in company value,,,,, thus if the value of the company increased the more the managers were going to receive when the company was brought back public. This large portion of ownership by managers was possible due to the high amount of leverage created by the debt financing. This put managers’ wealth at high risk but also in a position to gain astronomical returns if they managed the company correctly.

Given both the explicit cost of capital resulting from these highly leveraged transactions and the concentration of ownership it is not surprising to see major improvements in these companies taken private by LBOs. Krishna Palepu (1998) wrote extensively on the LBOs in the 1980s and gives academic evidence that back up the following list of results from successful LBOs:

Shareholders earned premiums of 40% to 50% when selling their shares into LBOs; operating cash flow of LBOs increased by about 40%, on average, over periods ranging from two to four years after the buyout; in cases where LBOs later went public or were sold to another company or investor group, the average firm value (that is, the market value of debt plus equity) increased by 235% (96% when adjusted for general

market movements) from two months prior to the buyout offer to the time of going public or sale (a holding period of three years, on average); there is little evidence in LBOs of a drop in employment levels or average wages of blue-collar workers; LBO firms were not doing much R&D to begin with; only about 10% of LBO firms were engaging in enough R&D before the LBO to report it separately in financial statements; LBO boards, with typically eight or fewer members, represent about 60% of the equity on average. (p. 254)

It is hard to believe, while studying this evidence, that there was that much profit potential hidden by these companies while they were public. Moreover, realizing a cost of capital and aligning goals and procedures to be tied directly to maximizing shareholder wealth can create such value. However, understanding how poorly aligned managements’ incentives were with shareholders during the 1960s and 1970s, it is easy to see why LBOs were so successful, since they created an environment where operating managers owned approximately 20% of equity in these LBOs; how can one get management’s incentives tied to creating shareholder wealth any better than that? The managers were the owners.

However, the success of LBOs eventually began to deteriorate around the late 1980s. This is partially explained by the burgeoning popularity of LBOs due to success of the early 1980s. This led to dealmakers promoting transactions that were highly overpriced and poorly structured. An important study was undertaken by Steven Kaplan and Jeremy Stein (1993) demonstrating that “buyout prices as multiples of cash flow rose sharply in LBOs completed in the period of 1986-1988, especially in junk-bond-financed transactions; junk bonds displaced much of both the bank and the private subordinated debt in later LBOs, thereby sharply raising the costs of reorganizing troubled companies; and management and other interested parties, notably the dealmakers, put in less equity and took out more up front in later deals” (p. 65). Therefore, many of the incentives that had made the LBOs successful were taken away, and the cost of capital was too unrealistic to be ascer-

tained.

There are also some inherent weaknesses in LBOs that limit their effectiveness. Due to the large amount of debt LBOs acquire they are only attractive in “primarily mature industries with modest capital requirements, tangible assets, and highly stable cash flows” (Barclay, Smith & Watts, 1995, p. 112). Therefore, high-growth, high-tech companies are not good candidates for a leverage buyout due to risk associated with such companies. With the amount of risk involved, with high tech companies, equity financing instead of debt is advised. Therefore, only select groups of companies that earn an adequate and predictable amount of cash and are struggling with free cash flow misallocation face a high risk of being bought out in a leveraged transaction.

### **Climate of the 1990s to Present**

There were several reasons for the move away from LBOs during the early 1990s. As mentioned previously, many LBOs were starting to fail in the late 1980s due to the large number of deals that were being made that were overleveraged. In addition, there were heavy regulatory changes taking place in the late 1980s and early 1990s, due to the Savings & Loan crisis, that led to a downward spiral in high-yield bond prices, thus affecting the financing available for LBOs. In addition, there were tax law changes that penalized private workouts for these LBOs when they ran into financial difficulty (Kaplan & Stein, 1993). The tightened oversight by federal regulators made it nearly impossible to reorganize without going into Chapter 11 bankruptcy, thus making these deals even more risky, and making financing that much more difficult. Therefore, due to the changing economic climate, the advisable debt ratio decreased. However, to keep everything in perspective in regard to the failure of LBOs during the late 1980s, Jensen (1997) comments, “Total creditors’ losses in all the deals of the 1980s probably did not exceed \$30 billion—a number that seems trivial when set against the trillion or so dollars of value that was added by leveraged restructuring over this period” (p. 43).

On top of all the other factors just mentioned, state takeover laws also came into effect that shut down the ability of capital

markets to curb the amount of capital destruction that was seen in many organizations with too much cash. However, during the 1990s institutional investors like “Calpers and the United Shareholders Association” began to take a more active role in putting pressure on companies that were underperforming. This pressure, as well as the fear of takeovers that was caused from the 1980s, resulted in management’s being far more concerned with their use of capital (Chew, 1999). Moreover, heightened foreign competition was putting a squeeze on profit margin. Thus, the economic climate was becoming far less stable compared to the post war decades; as a result, companies were being forced to reconsider their use of free cash flow. For this reason, many companies were beginning to reconsider their old measures that relied on standard accounting measures and were becoming far more interested in the economic impact of their decisions. Thus, companies began showing interest in adopting EVA-type systems, as will be explained shortly, that attempted to reproduce the lessons of capital discipline learned from the LBO movement; thus they were becoming far more concerned with the economic impact of their decisions.

In addition, it is important to look at the broader environment that was affecting the economic climate in the 1990s. This time in economic history is often considered by historians to be called “the Second Industrial Revolution” (Wallace, 1997, p. 33). This is because huge improvements were being experienced in productivity resulting in the dramatic reductions in prices. As these increases in productivity were causing huge decreases in prices, they were also causing products to become obsolete extremely fast, resulting in many industries facing over-capacity. For example, taking a look at the computer chips and computer industry in the last 20 years and relating that to the automobile industry, a \$20,000 automobile in 1980 would be selling for approximately \$2 today (Shand, 2000).

As a result of these rapid technological changes and dramatic increases in output and falling prices, most managers, nonetheless, continue to be ignorant of the fact that these changes are resulting in excess capacity and huge amounts of free cash flow. Therefore, there is a resurgence of free cash flow misallocation, as was seen in the 1980s. However, what manager is

going to concede that his operation is over-producing and must reduce production, or must discontinue the operation altogether. Nobody is going to volunteer to leave, especially since many companies have not learned the lessons from the past and still tie management incentive to accounting measures.

Moreover, on top of all these changes the global economic climate is rapidly changing. The world has seen the failure of closed, centrally planned economic systems, such as Russia and other countries in Eastern Europe, that have moved and are moving towards an open capitalist system. This phenomenon of countries embracing the free market ideology and capitalist system is also being seen in Latin America, India, and many Asian countries. According to Jensen (1997), approximately 1.2 billion laborers will be coming into the world labor markets. Moreover, approximately 1 billion of these laborers earn less than \$3 a day. Comparatively, average daily wages in the U.S. are about \$85 and the labor force is around 250 million. In short, these wage differentials across national economies cannot survive for very long. This is why many of our labor-intensive industries, such as the U.S. textile industry, have moved overseas. This activity has enormous implication for political conflict, U.S. labor unions, and intense trade wars. Thus, there are the same economic forces at play that were seen in the 1980s but intensified by the political revolution that is seen globally.

What does all this mean for American business? Currently, as many have predicted, LBOs have come back stronger than ever; however, sponsors are putting up far more equity and much less debt than they did in the 1980s. Nonetheless, they seem, thus far, to be successful at consolidating fragmented industries and reducing excess capacity, as well as putting public companies under pressure so as not be candidates for takeover. However, as mentioned earlier, not all companies are well suited for a leveraged buyout. Moreover, must a public company become private to be able to properly allocate its free cash? Must all large public companies be irresponsible in their use of excess cash? Many companies today are answering this question with an adamant no. There is no reason that these companies cannot apply the lessons learned by leveraged buyouts to resolve their free cash flow and corporate

governance problems. Many companies have demonstrated that the EVA corporate governance system comes closer than any other system to applying the key ingredients to success that were evident by the LBOs, all without the high amount of financial risk.

### **EVA: the Public Corporation's Leverage Buyout**

Public Corporations have varied strategies and objectives that differentiate themselves from each other; however, overarching the means of achieving these strategies and

“Therefore, EVA, when implemented effectively, properly motivates all departments of an organization to pursue only value added projects.”

objectives is the single corporate mandate: maximize the wealth of the shareholder. “It is the single financial purpose for the existence of any corporation. Executive management recognizes that as agents of the shareholder-principal, meeting this maximization goal is the best means of retaining their position within the organization” (Dilon & Owers, 1997, p. 2).

EVA, as a corporate governance system, has been demonstrated to meet this single objective better than or as well as any other metric based system. According to Steve Davidson (2001), “EVA has been found in the firm’s research and among academics to be a better predictor of stock price movement than earnings-per-share growth” (p. 84). In terms of a performance measure, this is easy to explain because EVA incorporates the cost of capital, thus recognizing that equity has cost and the amount of capital employed requires a return.

### **EVA: Recognizing the Cost of Capital**

One of the most important elements of EVA is that it forces managers to be responsible to their cost of capital by explicitly accounting for it as a dollar charge. Thus, EVA incorporates one of the main ingredients that made LBOs successful. It makes the cost of capital explicit for the organization and holds managers responsi-

ble for providing an adequate rate of return for the capital employed. To understand how EVA makes the cost of capital explicit, it is important to understand how the metric works.

### **How to Calculate EVA**

The basic EVA calculation begins with a firm’s net operating profits after taxes and then adjusts this figure to eliminate any accounting distortions. The most common distortion is that of research and development. Accounting rules require that Research and Development be treated as a cost to be expensed. However, Stern Stewart & Co., suggests amortizing them over several years, since a company only conducts R&D if it expects a payoff in the future that is greater than the cost of capital. Thus, R&D should be treated as an asset and not as a cost (Ehrbar, 1996).

However, the number and types of adjustments that need to be made to accounting statements vary with the company and with the industry. Al Ehrbar (1996), senior vice president with Stern Stewart, suggests three criteria for determining whether to make an adjustment: “Will operating managers understand the change? Will it influence their decisions? Finally, can the necessary data be obtained? If the answer to any of these questions is no, the company may be better off leaving the numbers alone” (p. 212).

The next step in the calculation is determining the amount of capital invested in the business. This number includes all fixed assets (such as machinery and buildings) and all working capital (such as cash, inventory, and receivables) (Kroll, 1997).

Finding the capital charge varies among different companies, and no matter what method is used, the process becomes very subjective. Most companies rely on the Capital Asset Pricing Model (CAPM), which theoretically allows for a specific, market based evaluation of risk for a company and its individual business units using the concept of a “beta.” However, in the words of Warren Buffett (1993) who rejects the CAPM, “I would rather be approximately right, than precisely wrong” (pg. 55). Realizing the amount of subjectivity and amount of time wasted trying to find the exact cost of capital Al Ehrbar (1996) suggests:

Whether the true weighted average cost of capital is 11.5% or 13.2% is of far less importance than having everyone understand that capital is expensive and behave accordingly. Some companies prefer to keep the cost-of-capital issue as simple as possible, figuring refinement would merely confuse some people without improving decisions. Coca-Cola, for example, uses 12% as its single cost of capital worldwide, expressed in dollars. Why 12%? Because it’s 1% a month. (p. 143)

Finally, multiply the total capital invested in the business by the capital charge. Then subtract this number from the adjusted net operating profits. In equation form:  $EVA = NOPAT - (Total\ Capital\ Invested \times Cost\ of\ Capital)$ . When this number is calculated, if the resulting figure is positive the firm has created wealth, if it is negative wealth has been destroyed. To further illustrate, if a firm with a 10% cost of capital earns a 20% return on \$100 million of the total amount of capital invested, then it has an EVA of \$10 million (Shand, 2000).

The premise behind EVA, that business must return its cost of capital, is not new or even radical; however, since companies have neglected to do this for such a long time and have relied on accounting measures of performance instead, the implementation of EVA can be eye opening. According to George Harad, chairman and CEO of Boise Cascade, “We’ve been pleased and surprised. Most of our managers are financially sophisticated, but it has made a difference. It’s not a large departure, but an important one” (Kroll, 1997, p. 22).

### **Financial Management System: The True Merit of EVA**

Corporate governance has become a major topic in today’s business world. Many corporations today, if not most, have numerous situations where management has a conflict of interest between acting on behalf of shareholders or in its own self-interests. For example, company growth is usually in the best interest of management because its compensation is based on factors such as sales volume, size of depart-

ment, and size of budget. This gives management incentive to acquire too much capital with no thought of the cost of this capital. Yet, if incentives are tied to EVA, only growth that provides a positive EVA will be rewarded.

When EVA is incorporated as the basis for management incentive compensation, management's decisions become aligned with that of the shareholders. When a company continually makes decisions that increase EVA, the company will be rewarded with a

**“Therefore, EVA, when implemented effectively, properly motivates all departments of an organization to pursue only value added.”**

higher stock price. Also, there is the added benefit of doing away with the annual budget negotiation, which Jensen (1997) referred to as a forum that “produces lies and deception,” (p. 65) thus eliminating a lot of time wasting and internal sales pitches that result in the best negotiators getting the most achievable budgets. Not only does EVA eliminate this process but also rewards only those managers that produce results that are aligned to creating shareholder value.

Incentive compensation using EVA is formula driven, and thus is automatically adjusted each year for the current year's performance. Therefore, the budget process becomes one of maximizing EVA through proper balance sheet management and increasing profitability (Stephens, 1997).

Moreover, EVA as a corporate governance tool is beneficial because of its ability to be understood and applied by all employees of an organization and can be practically applied to their daily activities. This is because one does not need to be a financial guru to understand it. It is a simple message of keeping the amount of capital tied up in the business low while increasing overall profitability. Everyone within an organization can understand and apply this concept.

Therefore, EVA, when implemented effectively, properly motivates all departments of an organization to pursue only value added projects. Public companies are always under intense pressure from Wall

Street to meet quarterly estimates of earnings. This has often pushed manufacturing to rush orders to completion in an effort to “make the quarter.” This results in a higher operating expense resulting in a lower profit as well as a higher capital employed charge because the inventory is converted to receivables. EVA discourages such activities and encourages smoother production and shipment throughout the quarter, because management has no incentive to meet these estimates.

The EVA message sent to the sales department is that extended payment terms result in higher receivables, and consignment inventory results in higher inventory. Thus, sales managers must balance the incremental sales against the higher charge for capital employed. For industries that require large production times the message is clear that advanced payments and progress billings can have a substantial beneficial effect on EVA (Stephens, 1997). This simple message is far from new, but now there is an economic incentive for managers to put it into practice.

EVA has also proven itself effective while considering potential acquisitions. Harnischfeger Industries Inc., implemented an EVA program in 1992. Francis Corby, executive vice president for finance and administration, explains, “With a 12% (Harnischfeger's cost of capital) after tax bogey, the only acquisitions that will work are those that are a strategic fit. If it's just additive, with no potential for integrative benefits, you won't get the return” (Kroll, 1997, p. 102). Thus, EVA effectively punctures the idea of growing the top line at the expense of all else.

Moreover, EVA immediately notices any part of the business that is not producing a positive EVA, thus, focusing management's attention on resolving the destruction in value, as well as prudently divesting parts of the business that are not producing. Within an organization there are three ways to create value: stopping any activities that return less than their cost of capital; improving projects that are returning their cost of capital, thus creating value; and investing in projects or assets that provide a return adequate to meet the required cost of capital (Pettit, 2001). EVA successfully focuses management's attention on all three areas because of its emphasis on meeting the cost of capital.

### **EVA Incentive Program; Making Managers Act Like Owners**

For better or for worse, executive compensation plans constitute a major part of the marketplace for executive behavior. Some people argue that compensation plans really do not influence employee behavior; however, Jay Galbraith, an organization design expert, states that, “The trouble with compensation plans is that they do work” (Fisher, 1995, p. 148). According to Professor Kevin J. Murphy, from the University of Chicago, the biggest problem with top management salaries is that managers, instead of being paid like maximizing entrepreneurs, are paid like bureaucrats (Murphy, 1990). He also states that the traditional bonus systems provide far too small of incentives for good performers and guarantee too big of compensation for mediocre performers. Once again, “people respond to incentives,” and this response to incentives was seen both in the conglomeration movement where executives were concerned with the steady rising EPS, and with the LBO movement where managers were owners, thus receiving a significant portion of the value created.

Therefore, what was learned from the takeovers and LBO craze in the 1980s was that when managers became the owners, good results soon followed. However, public companies have struggled with finding a way to incorporate this concept without diluting current shareholders holdings, as well as finding ways to tie incentive compensation to things lower managers feel they can influence. EVA, when incorporated as a complete corporate governance system, is able to simulate manager ownership by tying bonuses to improvements in EVA over time. Thus, the second major concept learned from the successful LBOs of the 1980s, making managers behave like owners, is incorporated into the EVA governance system.

The emphasis in this system is on improvements of EVA. This is designed primarily to solve the problem of unequal bonus potential so that one manager placed in a business with negative EVA can be given incentive for a turnaround, and those managers producing large EVA will not be given an incentive for just showing up but for finding ways to improve it further.

Such an emphasis put on EVA has been well received by shareholders due to its effect on the company's value over time. Research has shown that over a five year period changes in EVA account for 50% of the changes in companies' market value. Conversely, sales explained just 10% of the changes in market value, while growth in EPS explained 15% to 20%, and return on equity returned 35% (Fisher, 1995).

One of the main reasons for this high correlation between EVA and stock price is EVA's ability to make managers feel like owners. In order to motivate managers to behave like owners, they should not have their bonuses limited just as shareholders would not like to have their profits limited to a certain level either (Aggarwal, 2001).

Moreover, as with true ownership stake, the bonuses for corporate managers should always be tied to long-run EVA, because if tied to short run, managers will have an incentive to manipulate short-term EVA upwards. Tying incentives to long run EVA can be done by "banking" the bonuses. This means that when bonuses are paid, managers only receive a certain percentage and are not paid out entirely (Kroll, 1997). Stern & Stewart Co. advocates that only one-third should be paid out to managers and the rest should be put in a bonus bank (Stewart, 1999). In the following year, the manager will again earn a certain bonus, and this bonus is also put in the bank and the managers are paid one-third of what is in the bank. Conversely, if the EVA is negative, then the bonus put in the bank is negative and decreases the amount already in the bank. This exposes the managers to the same risk as the shareholders. "At the same time it gives golden handcuffs to the good performers (with big positive balance in the bank) and encourages the bad performers (with negative balance in the bank) to leave the company" (Makelainen, 2000, p. 12).

Another important benefit from tying incentives to EVA is that it helps streamline the budgeting and planning process. A couple years after implementing an EVA system Chuck Bowman, director of financial planning and analysis for SPX Corp explains, "No more fussing around in the fall for months, messing around with huge planning documents and worrying about sand-

bagging and things like that. It's gone," (Kroll, 1997, p. 102). Because compensation is measured against improvement in EVA, Bowman goes on to add that, "it always pays to do as well as you can, as soon as you can" (p. 102).

Therefore, in a profitable year, a manager is rewarded with an increase in both the cash bonus paid out and in the bonus bank carried forward, much like a shareholder who receives cash dividends and capital appreciation. Conversely, in a poor year, the penalty is in a shrunken cash distribution and depletion in the manager's bank balance that must be recouped before a full cash bonus distribution is possible. Therefore, with such a system the lines between the long-term and short-term become blurred, because the bonus paid in any one year is an accumulation of the bonuses earned over time.

### Conclusion

In today's current economic climate, all of the forces that were at play in the 1980s are back again, but they are being intensified by the political and economic revolutions taking place around the world. The transfer of many American facilities and capital to emerging economies is going to make our economy as well as the emerging economies better off. However, this is going to require lots of downsizing and restructurings to accomplish these changes.

LBOs and the risk of hostile takeovers have once again come back and are stronger than ever, and this is putting added pressure on public companies to perform. However, companies now have the knowledge and ability to use EVA that combines all the essential features of a leveraged buyout. Moreover, it revolutionizes a company's culture and way of conducting business. It is also understandable, not only to the top executives, but to all members of the organization as well as other stakeholders, including shareholders, members of board compensation committees, and investor analysts. It also balances long-term and short-term aspects, overall corporation as well as individual unit aspects, and retains talented management with its unlimited bonuses, all this in one inclusive package. EVA as a corporate governance system fosters a culture that prizes creating value and building wealth above all else. It is a system that focuses upon maximizing the economic return of an organization, thus leading to the creation of shareholder wealth, but more importantly, contributing to a higher standard of living for society as well.

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# Back to the Future by Dr. Bruce K. Bell

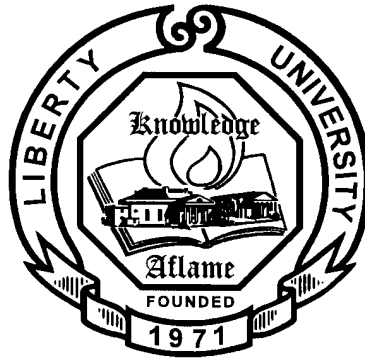
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