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Does EVA performance evaluation improve the value of cash holdings? Evidence from China

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ABSTRACT

This paper investigates the influence of the economic value added (EVA) performance evaluation, issued in 2010 by the State-owned Assets Supervision and Administration Commission of the State Council, on the value of the cash holdings of central state-owned enterprises (CSOEs). We find that EVA performance evaluation has some influence on the overinvestment of CSOE cash holdings and significantly increases the value of CSOE cash holdings compared with the cash holdings of local state-owned enterprises. The greater value of CSOE cash holdings derives from underinvestment modification and overinvestment restraint. The value of cash holdings increases more for companies with better accounting performance. Thus, the EVA performance evaluation policy increases CSOE efficiency. This study contributes to the emerging literature related to cash holdings and the economic consequences of the EVA performance evaluation policy. It expands the literature related to investor protection in countries experiencing economic transition.

1. Introduction

Jensen and Meckling (1976) find that managers routinely waste their firm's cash for personal benefit. Furthermore, Jensen (1986) observes that managers hold on to excess cash for personal benefit. These arguments have been widely cited in the domestic and overseas literature. Due to the separation of ownership and control, managers often consume corporate cash to maximize their own benefits or act in a way that fails to maximize the benefits of stockholders. The agency costs resulting from the separation of ownership and

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control rights may be more serious in state-owned enterprises (SOEs) in China due to a lack of individual shareholders. The consumption of cash is likely to be an important component of agency costs.

Cash is very important to the management and operation of a corporation. Cash holdings provide money to meet the daily needs of a corporation and decrease financial risk. In addition, a firm's value rises when its cash is invested. Compared with other kinds of assets, cash is a form of profit and can be easily transformed into a personal benefit at a lower cost (Myers and Rajan, 1998). Given the separation of ownership and control, inside managers can affect the decisions made in relation to cash holdings via residual control. They hold more cash and accept projects that are harmful to shareholder interests, which decreases the value of the cash holdings and decreases their firm's market value to a point lower than book value (Jensen, 1986).

There are two factors that affect the value of cash holdings. The first is financial characteristics, including financing constraints, growth opportunities and investment opportunities. A firm's level of cash holdings affects its market value, which increases as cash holdings rise. The connection becomes stronger if a firm faces better growth opportunities (Saddour, 2006). In theory, a shareholder believes that \$1 of a firm's cash holdings is equivalent to its book value. However, for a firm with better investment opportunities, a premium exists in its cash holdings (Pinkowitz and Williamson, 2007). The second factor is corporate governance. The effectiveness of a firm's corporate governance reflects the market value of its cash holdings, which in turn influence the firm's value. Firms with good corporate governance enjoy twice the cash market value of firms with poor corporate governance. The negative effect on operating performance resulting from holding large amounts of cash is suppressed in firms with good corporate governance (Pinkowitz et al., 2006; Dittmar and Jan, 2007).

Agency problems are common and agency costs decrease the value of cash holdings. Therefore, managers who restrain their self-interest may significantly increase the value of their firm's cash holdings. When discussing how manager's performance evaluations influence the value of their firm's cash holdings, it should be made clear that appropriate evaluation is the premise for encouraging managers to increase the service efficiency of their funds. Choosing a core performance evaluation index is the key point in a manager performance evaluation system. When a manager's income is positively related to the performance of his or her firm, economic value added (EVA) can operate as a performance evaluation index that encourages managers to make efficient investment decisions that raise the value of their firms (Rogerson, 1997). In addition, when EVA is included in a manager's compensation incentives, that manager will cut down financing decisions out of self-interest, which has little effect on any increase in firm value (Stern and Stewart, 2004). This paper considers whether an effective manager performance evaluation system decreases agency costs and improves the value of a firm's cash holdings.

Given China's unique institutional background, central SOEs (CSOEs) play an important role in economic growth and the development of a healthy securities market. Although CSOEs have undergone many reforms, many problems remain unsolved. For a long time, CSOEs failed to focus on their main businesses, electing instead to pursue large-scale projects and lowering the efficiency of their funds as a result. To correct this development pattern and protect small investors, the State-owned Assets Supervision and Administration Commission (SASAC) of the State Council issued its *Interim Measures for Business Performance Appraisals of Persons-in-Charge at Central Enterprises* in 2010. Since then, the performance of CSOE heads has been evaluated based on the EVA index.

The main change in this regulation was the use of EVA. EVA comprises 40% of the core index of return of assets. The key point in manager performance evaluations therefore changed from profit to value, forcing CSOEs to focus on value management rather than strategic management. In addition to total profits, capital efficiency is an important factor influencing EVA. In short, EVA value, which represents the value of a firm, grows as the firm's capital efficiency improves. The wise management of capital, achieved by decreasing the cost of occupied capital and improving the efficiency of used capital, is an important approach to improving firm value. Meanwhile, as mentioned in the *Notice on accomplishing the financial budget management and preparation of statement work at central enterprises* in 2013, CSOEs are required to stick to the rule that cash is king in budget management, highlighting the importance of capital management. This regulation asks CSOEs to put cash management first, detail their capital budgets and arrange their financial resources efficiently. In a macro-policy setting, we research cash holdings in CSOEs from an EVA perspective of value creation. The relationship between EVA and cash holdings in CSOEs is readily apparent. Furthermore, it would