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A STUDY OF VALUE BASED PARADIGMS OF WEALTH MAXIMIZATION

Dr. Sayee Kulkarni*

ABSTRACT

Performance Measurement is a complex area in business as it involves the study of various factors that define the performance of a business. There are many schools of thought which use different measurement techniques based on accounting data. Due to the problems of accounting data, there is more focus now on value-based measures as they give a better insight on the intrinsic company effectiveness or performance and also the extrinsic effectiveness based on the performance of the companies' stock in the stock market. The paper examines different performance measurement techniques which fall under the category of Value based performance measurement tools which are mainly developed by Stern Stewart and Co.

KEYWORDS: *Performance Measurement, Value-Based Measures, Extrinsic Effectiveness, Stock Market.*

Introduction

The word Value is an incredible term. Applicable in all walks of life. An old person when contemplating in his old age asks himself, "Have I added value to my family, to the society, to the world?" This question pretty much sums up his life. Our accounting conventions state that business is an artificial person. So assuming that business is a person, one question that every business should ask itself, "Have I added value?" .It is the final call that sums up whatever efforts a business has undertaken. Once a business knows the question that it should ask itself, and then a series of questions arise. "What is value?", "How is it measured?", "How will I communicate value?", "is my value greater than my competitor's value?", "How much value does my industry create?" etc. This brings us to an interesting and much debated issue in financial management about value based performance measurement. Two things must first be considered. For what purpose do we manage finances and how should we measure performance.

Objectives

- To study the concept of wealth maximization
- To examine the concept of value-based wealth maximization measurement techniques

Concept of Profit and Wealth

- **Profit Maximization**

  Every business is aimed at earning a profit. Profit measures the efficiency of a concern.

To measure the profit of an organization various tools and techniques are used. Since profit is considered to be an accounting concept, accounting based metrics were used to measure the profit and the efficiency of business. Tools like ROCE (Return on Capital Employed), ROE (Return on equity), EPS (Earning per share) are still popular measuring the performance of a business. But this point of view possess some shortcomings as they can measure profits but cannot measure the value created or destroyed by a business.

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* BBA, MBA++, NET (JRF), PhD, Assistant Professor, Kaveri College of Arts, Science and Commerce, Pune, Maharashtra, India (Affiliated to Savitribai Phule Pune University).

The objective of profit maximization is said to have a few shortcomings which are as follows:

- The duration of this objective is short term
- The issue of risk is completely ignored
- The means to achieve it are either price rise or unrealistic cost reduction, both of which are not beneficial in the long run.
- It completely ignores investment and capacity planning.
- It completely ignores the time value of money.

- **Wealth Maximization**

It is one of the new approaches to financial management. The word wealth means shareholder wealth or wealth to those who associated with the business. This objective is universally accepted

The objective of wealth maximization was introduced to overcome the shortcomings of profit maximization (Friedman, 1962). The objective of wealth maximization considered the following:

- The perspective of wealth is long term.
- Risks related to business like market risk, business risk, credit risk, etc. is considered in this objective. In other words for wealth maximization, risk mitigation has to be considered.
- Creation of wealth may need investment or expenditures in the short run, which may have a negative impact on profits, but in long run may contribute greatly to creation of wealth. For e.g.: expenses on research and development, advertisement outlay, etc.

Having agreed on the fact that wealth maximization is a robust and long lasting objective of business and financial management in general, the next question that arises is that how should we measure wealth.

- **Measures to Measure Wealth of a Business**

Having considered the fact that wealth maximization is a robust measurement of performance of a business, a though arises about measuring the wealth created by the business. Wealth created by a company will create a basis of comparison among various companies, measure the year on year performance of the business etc.

The traditional measures like ROCE, ROE, EPS, DPS, have been used to measure the company. However according to (Hasini S.M., 2012) these measures tend to completely ignore the cost of capital of the business. In order to overcome the limitations of traditional measures certain value based measures were developed.

Value based management traces its roots to the Discounted Cash flow approach and in precise manner the Modigliani and Miller Approach to the valuation of the enterprise. Also this concept traces its roots in the doctrine of economic profit which was propagated by Adam Smith in his book the Wealth of Nations. In the late 1980's companies started including cost of capital in their performance measurement systems.

The 1990's was a golden period for value based performance measurement systems. Joel Stern and Bennett Stewart revolutionized the concept of Economic Value Added (EVA). Stern and Stewart later on developed a few performance measurement tools which falls under the category of value based management. The concept of EVA has been rightfully explained the concept in the book, 'The Quest for Value.' (Stewart, 1991)

Economic Value Added

EVA™ reflects the residual wealth calculated by deducting cost of capital from the operating profit (adjusted for taxes on a cash basis) (Stewart, 1991) The true benefits of the EVA™ measurement are realized when management understands what the profitability of their organization entails and they become motivated to improve such profitability based on the findings of the measure. The formula for EVA appears to be simple

EVA™= net operating profit after tax (NOPAT) – [capital employed x cost of capital]

EVA is much more of an intrinsic measure of the performance of a business. NOPAT uses accounting data of the business. The concept of capital is more aptly means weighted average cost of capital (WACC) which is a combination of cost of debt and cost of equity. Cost of equity is calculated by the Capital Asset Pricing Method (CAPM), which includes the risk free return, the market return and beta, which is the degree of risk or variability with the index of the stock market.

The only association of EVA with market data is the cost of equity. It is widely argued that wealth is not just reflected in the company performance in creating wealth, but due consideration must also be given to the performance of the company in the stock market.

In view of this Stern Stewart Consulting developed a metric which measured the value created by a firm in the market which is explained as follows:

Market Value Added

EVA concept says that a company adds value if the company earns more than the cost of capital, it creates value. A new method was developed by Stern Stewart and Co. (Stewart, 1991) tells us how much value the market adds over the book value of invested capital. It thus tells us the confidence of the market on the performance of the company. MVA is calculated using the following formula.

MVA= (Market Value of Equity+ Market Value of Debt) - (Book Value of Equity- book Value of debt)

The above formula states that the value that a company creates is represented by the increase in market capitalization of the firm. If we assume the book value of debt to be the same, MVA simply means Market Value of Equity- Book Value of Equity. This means the value created by the firm can be measured by the market capitalization or the stock prices of the shares of the firm. Another approach which Stern Stewart propagated that MVA is the book value of the firm and the present values of future EVA over a period of time. This means that the market value of the firm represents the future capacity of value creation of a company. If the market has high confidence in the company the future EVA will be high and will be represented in a higher market capitalization and vice versa.

Even though the above premise is considered to be true, it becomes really very difficult to prove that the future wealth creation capacity of the will be rightly reflected in the MVA. There thus existed the need for a quantitative and a constructive measure which would really tell about the wealth created by the firm in the stock market.

Wealth Added Index

Wealth Added Index was invented by Stern Stewart and Co. in the year 2002 and described as a company value creation metric that fulfill the following criteria:

- Reflects the relation between money introduced in the company by the investor
- The money generated for the investor
- Reflects the risk taken by the investor in the form of the required return
- Expressed as an absolute cash figure which facilitates easy comparison

(Dananjaya & Magdalena, 2013)

The WAI metric is a better perception of investor wealth created than the EVA or the MVA. It can be clearly seen through the formula of WAI

WAI= Change in Market Capitalization- Required Return + Dividend received by the investor

Change in Market Capitalization= Market Capitalization at the end of the period- Market Capitalization at the beginning of the period

Required Return= Market Capitalization at the beginning of the period* Cost of Equity

(Cost of Equity is to be calculated by the Capital Asset Pricing Method)

The WAI metric takes into consideration the actual yearly return received by the investor in the form of dividend and also the return that the market gives in the form of increase in market capitalization. The concept of Required Return is a substitution of the concept of Present Value of future EVA which was put up in the MVA Concept. The present value of future EVA was very difficult to calculate as it was a considerably theoretical concept. But in the WAI concept it has been adopted in a tangible format by devising the required rate of return. This is in exact number forms the future expectation of the investors from the business. The cost of equity is considered to be the return expected by the shareholders, keeping in view the risk that is to be borne by them. This is in line with the Net Operating Income approach, which states that the shareholder expects a greater return is the company is risky in the long run.

The WAI concept subtracts the required return from the market capitalization earned over the course of an accounting year. A company is said to have done good business and made its name in the market and fulfilled shareholders' expectation if the WAI becomes positive. Thus a company should earn more than the required return by the investors.

The WAI concept is better off than MVA as it facilitates easy comparison. It is an effective tool for intra and inter firm comparison and takes over many number of years. As it is an absolute cash measure, one can easily find out the wealth added index of the company and compare it.

It is many a times seen that companies which might be earning a good return on investment and a good EVA might not be a wealth creator as per popular belief. There are cases (Sayee, 2022) where the company has created a positive and EVA whereas the WAI is either negative or is less than the EVA. This implies that the investor has less confidence on the future prospects of the company. (PaniGrahi, Zainuddin, & Azizan, 2014). WAI has been popularized in countries like USA and Indonesia and is used widely by Stock Markets, investors and analysts alike to assess the wealth creation and the prospects of the business.

Scope for Further Research

The paradigm of wealth creation has been a recent concept as compared to the other concepts. Companies, investors and analysts are slowly considering these metrics popular equity analysis and company analysis. Even though the concepts are widely used in USA, Indonesia etc., it is at a very nascent stage in India. The Indian markets still use traditional tools like Return on investment, PE Ratio, EPS. EVA has gained popularity over a period of years, but WAI is used hardly. There is a wide gap which need to be filled. There is further scope for research in studies of EVA and WAI and how they affect the future of business. Both these measure provide a different perspective to the concept of Wealth Maximization.

Conclusion

The concept of performance measurement of businesses has seen a long and evolutionary journey. From analyzing the accounting figures like profit, to using certain tools like Return on Capital Employed (ROCE) to the very popular EPs, the accounting tools are still being used. With the complexity in business increasing day by profit measurement does not suffice. The buzzword is Value and Wealth. There also has been a gradual evolution in value-based studies of performance measurement with the introduction of measures like EVA, MVA, TSR, and finally WAI. There is still a long way to go to make WAI a popular method in analyzing the performance of a company. From the above discussions and deliberations, it can be concluded that if used in the correct perspective WAI can be used very effectively for comparison of firms across the same industries as well as across the different industries. The study in WAI can also be used for studying sector or industry performance due to the ease of the calculation and comparison platform.

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