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DEPICTING PREFERENCE OF ECONOMIC VALUE ADDITION METHOD WITH RESPECT TO STATIC RETURN METHODS

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ABSTRACT

Throughout on compairing various results of the traditional and constant valuation methods vs. eva methodology for finding the rate of returns is the main concerned area of this paper. As of the required rate of return never seems constant in this ever-changing business environment, the eva valuation method has taken an important place as here the upcoming tentative market value of equity is determined by summing-up the book values of equity with present values of the proposed EVAs under some constant and variable situations. Here the outcome is giving somehow the more valid performance of the importance of the changing normal market returns under eva based models than the calculated static required returns with the help of eva model.

Keywords: *EVA, NOPAT, ROE, WACC, EP, FMCG, CVA, EBIT, LIFO, FIFO.*

Introduction

Capital appreciation which literally depends on the subsequent changes in the market value of companies shares and created wealth is measured in terms of the earnings they receive on their investment. Value maximization of shareholders which is at present emerging as a new corporate standard in our country. Indeed, this valuable phenomenon seeks to integrate financial hypothesis with strategic economic philosophy.

As we inquired from Stern Stewart & Company, which is a New York-based global financial consultancy depicting the results of their conducted survey on some top Indian Companies. This particular survey reports that approx. one fourth of India's top 10 companies due to one of the reasons recessions in recent years have destroyed their wealth by market capitalization in the last five years.

Literature Review

Companies were focused for squeezing higher revenues from protected markets and less about the cost of achieving these revenue. Now there is no doubt about it that some Indian companies guzzle maximum capital, and most of it went down under tubes. The Only reason behind this was the so called license permit raj. In An another equally important reason is the way companies have been locking their returns: earning per share, which is simply a post-tax profit per share. For an accountant, a company is doing fine as long as its creditors and the taxmen are paid and yes its depreciation is also provided for.

Not surprisingly, managements are pleased to treat equity as a "free" money on which no return become due until and unless there are no adequate profits. In this particular situation, shareholders value is often the result of accidental circumstances rather than the outcome of genuine efforts made by the professional management.

Rationale of Study

On the course Big giants, among listed public sector units, nearly five per cent of them swallowed up 30 per cent of the complete capital employed and they simply add it to their already created large capital base by 50 per cent over the last five years.

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All are probably aware about the subject within and outside any particular organization, but not many are aware about what to do and what not to do with reference to this particular concept. Nevertheless, this concept of good corporate governance is becoming very important and is making necessary by our country's government also. Now to stay in this country as shareholders and financial institutions turn more down to business, feels Tejparan, Gandhok, the Country Manager, India for Stern Stewart & Company. According to him, "As a whole Indian companies have a poor average in the subject of wealth creation." Over 400 companies now a days globally implement this economic value addition (EVA) program, but it is still relatively a newfangled technique for measuring the corporate performances in India.

A High-quality proficient management or a good corporate governance with a system for shareholders' value creation-these all are the motherhood statements we generally have in consideration As we know that equity is a post-tax charge on the earned profits, it does not matter much in our financial calculations.

EVA as a Tool of Financial Performance Measurement

EVA (economic value addition) is an estimate of "economic profit", the amount by which the earned earnings exceeds or may fall short of the required minimum rate of return that shareholders and lenders could get by investing capital in other securities of analogous risk.

According to the economic concept, business profit is considered to be that maximum amount, any business is capable of distributing to its shareholders while still remaining in the same position at the end of the period as it was at the beginning. On the other hand, in the accounting concept, business profit is measured by deducting expenses from income earned during that particular period. Notably, the accounting concept does not take into account the most important opportunity cost and risk adjusted return on capital employed in the business.

So it became necessary to overcome at least these limitations of this accounting-based measures of financial performance. As a result this particular phenomenon was adopted by Stern Stewart & Company which emerged as a modified concept of economic profit in 2015 which was named as Economic Value Added (EVA)."

Cost of capital which is the cost beard by any company for collecting the capital from external sources of finance and EVA as a tool of financial measurement enlightens us whether the operating profit is enough to cover the cost of capital or not? It is important for the long term survival of a company that its Shareholders must earn sufficient returns for the risk they have taken in investing their funds in company's capital.

EVA: Evaluation and Growth

The father of management Peter F. Drucker, a contemporary management intellectual has propounded, "EVA which is based on something we have known for a long time: what we call profits, the money left to service equity, is usually not profit at all. Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind it pays taxes as if it had a genuine profit. The organization returns less to the economy that it devours resources... until then it does not create wealth it destroys it."

Corporations-like Infosys, TCS, Tech Mahindra, Reliance many automobile sector Indian and international companies as Hyundai, Honda, Ford etc. many big giants like Coca-Cola, Eli Lilly, Monsanto, Best foods, J.C. Penney, Bausch & Lomb etc.. Can say that almost every listed company in India and Abroad is adopting this method to calculate its financial performance.

Result through a Case Study

Companies have gone into EVA in a variety of ways. For example in the case of London-based Tate & Lyle, a global supplier of food and beverage ingredients to industrial markets known as a global giant in sweeteners and starches also, the initial interest was sparked a few years ago by a magazine article about EVA. When Two senior executives each came upon with the article independently and sent it to each other. Which was soon joined by the Group Finance Director Simon Gifford. Which depicts its importance. The attraction of EVA, Gifford recalls, was the capital discipline that it promised. “In the past”, says Gifford, “we had emphasized profitability, especially earnings per share, because of the demands of the City and the analysts.” Financial people like himself did focus on cash-the lifeblood of a company-but operation managers said emphasis on earnings measures. The consequence, says Gifford, was that “as a company we were not paying enough attention to our capital base, particularly our working capital.

This is important to assign a case study on this value based financial management concept as when Joel Stern, the cofounder of the consulting firm for corporate finance stern stewart & company, he is a consultant to hundreds of companies worldwide was invited to give a full-dress presentation on EVA to top management and, later that year, the company decided to sign up and form an EVA Steering Group to Implement EVA for evaluating the corporate performance . in the initial phase of this project, Tate & Lyle decided to pilot EVA in two businesses-UM, a UK-based molasses trading company, and Redpath, a Canadian sugar refiner. The objective was definitely to determine whether the theory of EVA would be appropriate in practice and as Joel is known to translate Miller-Modigliani valuation model into a practical framework for evaluating the corporate performances and to test the EVA ground rules formulated by the Steering Group.

A complete strategy was followed as at First, a retrospective study was conducted to provide a record of past EVAs, against which future performance was to be measured. Identification of the key value drivers was done, especially in the capital related areas, in addition to finding the opportunities to increase NOPAT (net operating profits after tax) through continuation of the existing cost management initiatives. The positive side of this study is this that pilot schemes appeared successful and demonstrated the merits of EVA, not just as a measure but also as a valuable management tool. It was then decided to roll out EVA throughout Tate & Lyle beginning with the training of all the finance managers of the various subsidiaries, followed by the operating people some 60 of the top managers had their cash bonus linked to EVA performance.

Nonetheless, EVA implementation proceeded rapidly. EVA is now used to analyze all proposed capital expenditures and divestitures. During the last financial year, proceeds from disposals increased significantly. "If it weren’t for the EVA", says Gifford, "some of these disposal decisions would not have been taken until later years." The foregoing discussion on the evolution and growth of the EVA, reveals that EVA is considered as a contemporary tool in financial management that has, been developed throughout the course of the 20" century by some distinguished economists and managers. Its straight forwardness is both its attraction and its limitation. While it fairly reflects the basic concept of single period residual income, it does not address the inter-temporal nature of the valuation problem. Without proper adjustments EVA may even short-change future growth opportunities of the corporate sector.

Discussion

Bennett Stewart and Joel Stern jointly founded the New York- based global financial consultancy firm under the name "Stern Stewart & Company", they believed that EVA is that financial performance tool which is much closer than any other tools to capture the true economic profit of an organization. According to them, works on the principle that when managers make the best use of capital they must be paid for it just as if it were a wage. This EVA analysis, undoubtedly, has attracted much attention in the Western countries both in the field of management innovation as well as in stock market analysis. The acceptance of such a technique will be a complete diversification in Indian context. Some corporate houses like Infosys, Reliance Industries, Hindustan Unilever Limited, Ballarpur Chinni Mills, NIIT, Tata Consultancy Services, Godrej Soaps etc. have already started publishing EVA in their financial statements. While Majority among them still not willing to install this technique for evaluating their financial performances due to certain inherent difficulties associated with the computation. Again, observations done by some research scholars says that in Indian context it may be very difficult exercise to establish the existence of any relationship between stock price and EVA.

Calculation of the perfect relationship between different variables of computation is near to unfeasible, as the unavailability of an adequate data points across a uniform period. Secondly, the applicability of certain principles like Capital Asset Pricing Model has been debated in the Indian context too. Thirdly, computation suffers from some of the problems inherent in EVA itself as well sometimes the quality of underlying data also give the poor disclosure standard and the differences in accounting policies is definitely an another reason among corporates in India.

It is emerging out from the discussion made above that the global market place is changing the role of policy-makers and managers in corporate sector. There may be more pressure on them to play a proactive role within an organization. As information systems get more sophisticated, managers will have the task of providing top management with information that is Internationally competitive for corporate decision-making. EVA is a measure that should be used by top management to evaluate investment center managers because it considers goal resemblance between shareholders and managers.

EVA and its Uniqueness

The concept of EVA is well established in financial economics but only recently this term has moved into the mainstream of corporate finance, as more and more companies have started adopting it as the base for business planning and financial performance monitoring. There is growing evidence that EVA, not earnings before interest and taxes (EBIT), determines the value of a firm. The Chairman of AT&T stated that the firm had found an almost perfect correlation over the past five years between Its market value and EVA. Effective use of capital is the key to value, that message applies to business processes, too.

EVA is quantum of economic value or profits generated by a company in excess of its cost of capital. It has been observed that due to computational difficulties, the EVA concept is not receiving enough acceptability, even though the concept is based on a sound foundation. Although the concept sounds simple in theory, it can be equally tricky to apply it. The EVA measure may effectively be applied at two situations; first, to calculate the quantum of value the concerned organization has added from its current operations for its shareholders, and vice-versa, and second, to deploy the technique in strategic planning process, where it provides the basic information for additional value creation for its shareholders in future. The computation of EVA under both these circumstances is elaborated hereunder:

Computation of EVA to Determine the Past and Present Financial Performance

For computation of EVA of an organization for identifying the quantum of value creation or value destruction for its shareholders the following sequential procedure should be adopted: The sensitivity of the security returns to changes in the market returns. For the sake of computation, one has to calculate:

- The Market Return (Independent Variable)

$$\frac{\text{Current Index - Previous Index}}{\text{Previous Index}}$$

- The Security Return (Dependent Variable)

$$\frac{\text{Current Price - Previous Price}}{\text{Previous Index}}$$

Thus for increasing the shareholder's value in future, managers of a company may adopt any of the above three strategies. The whole process of the analysis for a shareholder value to strategic planning involves:

- Estimating the minimum pretax operating return on incremental sales required to create value for shareholders for each strategic sub-unit of the business and the business as a whole.
- Comparing minimum acceptable rates of return on incremental sales with rates realized during the past five years and its projections to the next year.
- Estimating the contribution to shareholder value, following different alternative strategies at the sub-units and corporate level.
- Evaluation of the corporate plan to determine whether the projected growth is financially feasible in light of anticipated return on sales, Investment requirements per rupee sales, target capital structure and dividend policy.
- A financial self-evaluation at the sub-units and corporate levels is required.

Let's take Return on assets which is also a more realistic measure of economic performance, cost of capital is ignored here too. It is like in a most profitable year, for instance any company's return on assets was over 11 per cent, but its cost of capital was almost 13 per cent. eventually Leading firms can obtain capital at low costs because of certain goodwill, via favorable interest rates and high stock prices, which they can invest in their operations at decent rates of return on assets. That tempts them to expand without paying attention to the real return, means that will certainly be called economic value added.

Financial measure Discounted cash flows which are very close to economic value added, with the discount rate being the cost of capital. Determining a firm's cost of capital requires making two calculations, one simple, and one complex. The simple one figures the cost of debt, which is the after-tax interest rate on loans and bonds. The more complex one estimates the cost of equity and involves analyzing shareholders' expected return implicit in the price they have paid to buy or hold their shares. Investors have the choice of buying risk-free Treasury bonds or investing in other riskier securities. They obviously expect a higher return for higher risk. To attract investors, weak firms must offer a premium in the form of a lower stock price than stronger firms can command. This lower price amounts to the equivalent of a higher interest rate on loans and bonds; the investor's premium increases the firm's cost of capital.

Right now Cash flow and the cost of capital employed to generate that flow have become the key determinants of business performance, with earnings per share increasingly a misleading or even damaging target for strategy and investment. Taking a cost accounting technique related to cost of materials, When a firm switches from FIFO (first in, first out) to LIFO (last in, first Out), its cost of goods assumes the price of the most recent purchases of materials in inventory. This typically reduces its profits because the older purchases cost less than the more recent ones in normal economic circumstances. Yet the firm's stock price will rise, even though it's reported profits drop, because its pays less taxes, thus increase its after-tax cash flow. The money spent to acquire the goods in inventory is exactly the same regardless of which method is used, but LIFO increases economic value added.

Hence, the key to implement EVA into corporate culture is to make it the focal point for reporting, planning and decision making. The best means of maximizing shareholder return is to provide incentives to managers for making decision that Increase long-term value. It may, to a large extent, ask the corporates to change the present system of financial planning, investment and financial controlling which is generally presented through EPS, cash flow, return on assets, return on capital employed etc. Thus, EVA method is concurrently poles apart from other paraphernalia for the purpose.

In India, companies like TCS, Godrej, NIIT, HLL, etc. are approaching Stern Stewart & Company for EVA implementation. Some other companies have attempted to implement EVA with in-house expertise. There is one big difference between the implementation of EVA through consultant firm like Stern Stewart & Company and in-house expertise. In case of former the EVA is linked to compensation whereas in case of later it is not linked which may become major flow if put under financial management testing tools.

Implementation can normally be achieved in a rapid timeframe at a fraction of the cost with many other solutions. The overall results create a sustainable environment that maximizes on-going support and development. Stern Stewart & Company claims that your organization would rapidly achieve scalability at all levels of your organization and near real-time performance reporting is delivered at all levels of management.

The complete EVA Software Solution can also help the company to:

- Develop action plans that create the most shareholder value.
- Upgrade and standardize the quality to business analysis.
- Assess the value of applied business model.
- Example outsourcing and partnering opportunities.
- Identify key value drivers for our business.
- Model the value added throughout our supply chain.

Establish platform for internal communication and many more.

Scope and Limitations of EVA in Indian context

Scope

The Scope of EVA is very well described by Stern Stewart with the help of four words beginning with the letter M stands for Mind, Measurement, Management and Motivation. On the other hand, EVA capitalizes R&D spending and amortizes it over an appropriate period of time. Similar adjustments are made in the balance sheet in order to get a more accurate accounting of the total capital invested in an Organization in order to assess the proper capital charge. Stern Stewart has identified more than 160 potential adjustments in GAAP-based financial statements in areas such as inventory costing, depreciation, bad debt reserves, restructuring charges, amortization of goodwill, etc. However, in most of the cases only 10 to 15 adjustments may be required in order to strike a balance between simplicity and precision.

EVA is an accurate measure that enables the companies to evaluate their financial performance, but the true value this measure comes in when it is used as the basis of a comprehensive financial management system. EVA system covers the full range of managerial decisions including strategic planning, allocating capital, pricing acquisitions, setting annual goals, etc. The use of EVA by the managers of the organizations Involves abandoning all other financial matrices, each of which can frequently mislead the managers to wrong decisions The uniform focus on continuously Improving EVA provides the best assurance that the financial managers are making the right decisions for the benefit of the shareholders. The managers taking recourse to the measure of EVA learn that there are three basic ways to increase value.

- Increase the returns from the assets already in business by running the income statement more efficiently without investing new capital;
- Invest additional capital and aggressively build the business so long as expected returns on new investments exceed the cost of capital; and
- Release capital from existing operations, both by selling assets that are worth more to others and by increasing the efficiency of capital by such things as turning working capital faster and speeding up cycle times.

For the purpose of motivation, Stern Stewart has designed cash bonus plans that enable managers to think like and act like owners because they are paid like owners. Under an EVA bonus plan, the only way managers can make more money for themselves is by creating even greater value for the shareholders. This makes it possible to have bonus plans with no upper limits.

As a result of the above mentioned positive features of EVA, it is a system of internal corporate governance that automatically guides all managers and employees and inspires them to work for the best interest of the owners. The EVA system also facilitates decentralized decisions-making because it holds managers responsible for-and rewards them for-delivering value.

Most of the companies in India today are venturing to devise ways and means for enhancing shareholders' value. One of the appropriate indicators of shareholders' value is to take into account the responses of the shareholders to various management decisions. Accordingly, a business concern has to make consistent efforts to improve market capitalization. It is only through such improvements that a company can maintain its supremacy in a particular industry.

'Shareholders activism' is a new concept in Indian industry. This concept assumes that the shareholders are the ultimate masters and should be taken care of. The success of the company can be gauged by the extent of value which it generates for its shareholders. This has greatly enhanced the significance of EVA concept. Consequently, many Indian companies along with multinational companies have started & publishing. EVA results in their annual reports, for instance. Infosys Technologies is pioneer in this respect. Many other companies like Hindustan Lever Ltd., BPL, NIIT, TCS, Godrej Soaps have gone after the same dress. The scope of EVA in India seems to be bright and in the times to come more and more Indian companies are likely to follow the suit.

Conclusion

Many western companies have now started realizing that financial tools like ROI, ROCE, EPS, NPV etc., fall short of achieving the corporate objective of maximizing shareholders' wealth. For example, in simple words, it can be understood that an Increase in ROI does not mean a corresponding increase in the shareholders' wealth. In fact, companies have now stared considering ROI as a short-term indicator. They argue that the problem with ROI is that companies get more of 'R' by starving the I side of the equation.

Some of the important pitfalls in the use of EVA revealed by them are as follows:

- Most of the Indian companies are plagued with over-capacity situations, which distort the EVA results.
- EVA model does not incorporate items like brand equity, human resources, etc.
- EVA analysis does not give any idea about the financial performance of companies that are affected by business cycle variations.
- Possibility of error in estimating WACC is another gray area.
- When EVA is used as a measure to evaluate the performance of managers and their units, they feel reluctant to acquire new fixed assets even if the circumstances demand so. Further, even if managers acquire new fixed assets they are tempted to use annuity method for depreciation in order to report positive EVAs. The managers of various divisions also try to take assets on lease

rather than acquiring them in order to report positive EVAs. Taking assets on lease increases the risk involved which pushes the cost of capital on the higher side. But EVA usually does not take into account such factors while calculating the cost of capital

- Generally, the cost of equity is considered to be more than that of cost of debt. But as the company raises equity to pay-off debt, the company becomes less risk prone thus reducing the total cost. Such factors are not taken into account in EVA calculations.
- Fast moving consumer goods (FMCGs) and pharmaceutical companies are less capital intensive because of which EVA of such companies is generally higher as compared to the capital intensive companies. This makes the inter-firm comparison in different industries, unrealistic.

But in spite all these arguable issues, EVA has made a position for itself not only in the Western business community but also in the Indian corporate sector. However, the recognition of this concept in India is gradually picking up and it is expected that in the coming years, more and more Indian companies will start relying upon this new measure of financial performance. This would, possibly, catch the attention of policy-makers at Government level, corporate level and NGO's engaged in investors' protection to press the corporate managers to come up to the expectation of shareholders in the country. With the advent of EVA, the corporate managers may be quite clear in their thinking that shareholders are not saints and the return expected by them are invariably higher than return expected by the debt holders. That is why, now a days, the corporate managers are being required to work on the model of trading on equity that would design some surplus for equity shareholders. This surplus, if placed under technical terminology, may lead to positive EVA for the organization.

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