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ECONOMIC VALUE ADDED ACCOUNTING : AN APPROPRIATE CORPORATE PERFORMANCE MEASURE

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ABSTRACT Economic Value Added Accounting has been acclaimed to be the most recent and exciting innovation in company performance measures. It can bring great value to a company by focusing the entire organization on activities that produce results valued by shareholders. This study examines the benefits and limitations of using EVA Accounting as a performance measure.

Economic Value Added is a technique to measure wealth created for shareholders. EVA is the surplus generated by an entity after meeting an equitable charge towards providers of capital.

It is the post-tax return on capital employed (adjusted for the tax-shield on debt) less than the capital employed. Companies which earn higher returns than cost of capital are creating shareholder's value.This technique to measure performance of a company is far better than that of PAT, EPS, ROA.

KEYWORDS : Value Added, Economic value added, growth and profitability, Conventional Performance Measures, Shareholders.

Introduction:

Now-a-days the new corporate standard in the world is Maximizing shareholders value .Shareholder's wealth is measured in term of the returns they receive on their investment. The returns can either be in the form of dividends or in the form of capital appreciation or both. Capital appreciation depends on the subsequent changes in the market value of the shares. The number of factors that affect the market value of shares can be company specific, industry specific and macro-economic in nature.The value-based management systems have been developed for generating value for shareholders in order to help corporates. Indeed, value-based management, which seeks to integrate finance hypothesis with strategic economic philosophy, is considered as one of the most significant contributions to corporate financial planning in the last two decade or so.

Many of the traditional corporate performance measures have been found poorly correlated, or even conflicting, with management's primary objective which is maximizing the market value of a firm's stock. Now, there are several new measures in the financial world that attempt to align the behaviors of an organization with its stockholders' interests. One measure that has received a great deal of notice and acceptance is Economic Value Added Accounting(EVA) which was developed by Joel M. Stern and G. Bennett Stewart & Co.The EVA Accounting frame work, which is becoming more and more desirable tool for measuring the financial performance of corporates, offers a consistent approach to set goals and measure performance, communicate with investors, evaluate strategies, allocate capital valuing acquisitions and determine incentive bonuses.

EVA: Evolution and Growth

According to Wallace, one of the earliest to point out the residual income concept was Alfred Marshall in 1890. Marshall described economic profit as total net gains less the interest on invested capital at the current rate.[1] However residual income has been used by companies for years. For example, General Electric (GE) used residual income in the 1950s and 1960s to measure performance. During 1970s, the residual income concept did not get enough publicity and it did not finish up to be the prime performance measure of companies. However EVA, practically, the same concept with a different name, has come to fore in to fore in the recent years. Moreover, the propagation of EVA and residual income measure does not seem to be on an abating trend. On the contrary, the number of companies adopting EVA is increasing rapidly. One can only guess why residual income did never gain recognition of this level. One of the possible reasons is that Economic Value Added was marketed with a concept of Market Value Added (MVA) and it did offer a hypothetically significant connection to market valuations.[2] This relation can be observed clearly in the definition of EVA by Stern and Stewart (1990).[3] They expressed it appropriately:"EVA reflects a reality of the stock market and a reality of the capitalist society we live in. The reality is that all companies are in the same business which is to make efficient use of scarce capital resources. To be successful, companies must essentially "beat" their respective capital associates. They must earn returns on scarce capital that exceed the returns offered by its capital competitors who are also competing for scarce capital. Companies that succeed will add value to invested capital. The stock will then trade at premium to reflect this. Companies that don't succeed will essentially misallocate or misuse capital. The market will discount the stock accordingly…"

EVA Accounting is a powerful tool for several reasons: It aligns employee behavior with stockholder value generation, separates employee incentive compensation from the traditional performance measurement that compares actual to budgeted results, and it is relatively easy to communicate and understand.EVA Accounting can bring great value to a company by focusing the entire organization on activities that produce results valued by shareholders.

EVA Accounting as a tool of financial management measurement

The important goal of financial management is to create highest capital employees (owners & lenders) wealth and consequently enhancing the value of the firm. Shareholder wealth is traditionally reflected by either standard accounting magnitudes (such as profits, earnings and cash flow from operations) or financial statement ratios (including earnings per share and the returns on assets, investment and equity). This financial statement information is then used by managers, shareholders and other interested parties to assess current firm performance, and is also used by these same stakeholders to predict future performance. The question then arises is whether these measures of corporate performance are linked to the expectation of the shareholders.The problem with these performance measures is that they lack a proper benchmark for comparison. The shareholders require at least a minimum rate of return that the above mentioned performance measures ignore. Most of the time the benchmark used is the industry average or the nearest competitor performance. But the fact the industry average or competitors performance may be below what is required by the investors is ignored. So a company may be earning returns better than others in the industry but it might not meet the capital employee's minimum expectations. An appropriate performance measure should assess how managerial actions affect the firm value. For this to be happen, the performance measure must incorporate at least three things.

a. the amount of capital invested
b. the return earned on the capital and
c. the cost of capital (WACC)

Over the past several years, an alternative performance measure called Economic Value Added Accounting (EVA) has been gaining acceptance in United States. It is acknowledged by institutional firms as a credible performance measure. In order to overcome the

limitations of accounting based measures of financial performance, Joel Stern postulated a modified concept of economic profit in 1990 in the name of Economic Value Added (EVA) as a measure of business performance.

Stern has claimed that EVA Accounting as a tool of financial management was neither just a phenomenon not it is limited to 'for profit' organizations. Economic Value Added Accounting has been put to use for management performance evaluation and much more than just a measure of performance, it is the framework for a complete financial management (for improving scarce capital allocation; and for valuation of a target company at the time of acquisition)

Definition of EVA Accounting:

EVA Accounting is defined as the excess of a company's after tax net operating profit over the required minimum rate of return that investors and lenders could get by investing in other securities of comparable risk. EVA Accounting is the financial performance measure that captures the true economic profit of a company.

A company that wishes to fill a demand for a good or service obtains capital (debt, equity), which is used to build products and services. In order to build these products, the company must buy materials, equipment, and labour which results in the company incurring operating expenses and affects on operating profit. In addition, the company must also pay the costs of obtaining the capital. If capital is in debt form, then the cost is simply interest. Equity is trickier. The cost of equity is simply a level of return that would be acceptable to its shareholders. This is essentially called the opportunity cost which is basically a return that a shareholder could have been obtained if the shareholder invested their capital somewhere else. These costs are defined as cost of capital. Then Net operating profit after taxes (NOPAT) subtracted with capital costs (cost of capital x capital employed), whatever remains is economic value added (EVA), which can be distributed or reinvested accordingly. If you have Positive EVA, congratulations, you have created wealth. If you have negative EVA, be worried, you've destroyed wealth in your company.Stewart defined EVA (1991)[4] as Net operating profit after taxes (NOPAT) subtracted with a capital charges.

EVA = NOPAT – CAPITAL COST
EVA = NOPAT – (COST OF CAPITAL x CAPITAL EMPLOYED)

Cost of capital or weighted average cost of capital (WACC) is the average cost of both equity capital and interest bearing debt. Cost of equity capital is the opportunity return from an investment with same risk as the company has.

Benefits of EVA Accounting :

Evaluating performance based on a single criterion will tend to encourage managers to behave dysfunctional so as to manipulate the performance measure. With this in mind, the benefits and limitations of using EVA Accounting as a performance measure will be assessed.The ultimate aim of 'for-profit' organizations is to generate acceptable returns for their shareholders. A problem with many traditional measures of performance such as ROI is that they are not highly correlated with the share price of the organization. One of the major selling points of EVA Accounting is that there is existence of a strong correlation.It is easy to understand and be linked to managerial compensation. Use of a performance measure which is highly correlated to share price makes it easier to ensure that mangers act in the interests of shareholders because the pay of managers can be closely linked to the creation of shareholder wealth.

When EVA Accounting is used as a performance measurement tool, it is helpful in making strategic decisions about subcomponents of the business. Because it highlights where shareholder wealth is being generated or destroyed, it is useful in deciding which business segments to expand or contract.

EVA accounting can be linked to customer profitability analysis as it is used to assess the value generated by any component of the organization including individual customers.Another benefit of EVA is that it highlights the cost of capital of the business. This may encourage senior management to more carefully examine the capital structure of the organization. In many small and medium sized business concerns, the capital structure can arise due to historical accident without having being subject to close scrutiny. Making the cost of capital (especially the cost of equity) explicit, may serve to concentrate managers' attention on financing the business in a cost effective manner.[5]

Limitations of EVA Accounting:

Firstly, like the majority of financial performance measures, EVA Accounting is inherently backward looking as it looks at the value added in the past accounting period and thus it measures the success of past strategic decisions and investments. It fails to explicitly consider the current strategy being pursued by the organization and does not attempt to assess whether the organization is taking action to ensure it will develop and maintain a sustainable competitive advantage. One result of this is that EVA Accounting would appear to be of limited use for a young growing company. Secondly, use of EVA Accounting may encourage short-term decisions amongst managers and may result in managers refusing to make investments. Thirdly, in common with other financial measures of performance, EVA Accounting does not explicitly attempt to place a value on the intellectual assets of an organization such as brands or goodwill. The result of this, is that EVA Accounting is not a complete measure of the manager's stewardship of the shareholders' investment (which is valued at market value and inherently contains a component of value for the future cash flow implications of the intellectual assets) and may therefore overstate the wealth generated during an individual accounting period.

In large multi-product organizations the difficulties in calculating EVA Accounting will multiply. Common assets and costs will need to be apportioned between divisions and/or products to enable calculation of divisional and/or product EVA. Of course, such problems do not solely arise in the calculation of EVA and already exist in the calculation of divisional/product ROIs. Use of activity based costing and activity based cost management techniques could assist in the apportionment of assets and joint costs between subcomponents of the organization.

A major practical issue that arises in the calculation of EVA is how earnings and capital should be defined. Stern Stewart has identified in excess of 164 alterations which might be required to adjust accounting earnings. It may be difficult for investors or analysts to make all the suggested adjustments because they will only have access to the information disclosed in the published accounts.[6]

EVA Accounting in Indian Corporates:

In the modern times,the corporate procedures have undergone through a deep-seated changes and the use of traditional financial variables to explain the behaviour of the present capital market is not an appropriate move toward. Further, in the changing corporate environment, the time has come to gaze at association between financial variables and stock prices or market risk in different way.

One outcome of the economic reforms implemented in 1990's in most of the countries around the globe is that the whole world is becoming a universal economy and the size of business entities has been increasing. This has been happening because, in order to compete in the world market, an organization needs to have sizable resources and the capability to be the best performer of these resources.

A question that arises, as organizations grow in size, get decentralized and are put into units, is that of financial performance evaluation. The financial performance evaluation measure used needs to be accurate, consistent, and globally analogous and should lead to goal similitude between the owners and managers. When all is said and is done, leading multinational companies, worldwide have already adopted EVA-based system financial management that out the system ahead of its competitors. In such circumstances, the Indian corporates simply may not stay behind for understanding and implementing the concept. For their long-standing persistent survival in global market, the Indian Corporates should be fully equipped. EVA Accounting is a measure that should be used by top management to evaluate investment centre managers because it considers goal picture between shareholders and corporate managers.Recently a lot of emphasis is being positioned on EVA rather than ROI, as a measure of corporate performance in the Indian financial literature. However, using the concept may not be suitable since it is not without deficiencies and pitfalls. Certain disputes regarding EVA calculation and implementation have been highlighted by Sateesh Kumar (2000).[7] Some of the important pitfalls in the use of EVA revealed by them.Most of Indian companies suffer from over-capacity situations, which distort the EVA results.EVA analysis does not give any idea about the financial performance of companies that are affected by business cycle variations.There is possibility of error in calculating NOPAT and also estimating WACC .

Conclusion and Suggestions:

Economic Value Added Accounting gives managers superior information and superior motivation to make decisions that will create the highest shareholder wealth in any publicly owned or private enterprise. It can improve the working lives of every one in an organization by making them more successful and can help them produce greater wealth for shareholders, customers, creditors and themselves. EVA as a tool of financial measurement enlightens us whether the operating profit is enough to cover the cost of capital. Shareholders must earn sufficient return for the risk they have taken in investing their funds in company's capital. The return generated by the company for shareholders has to be more than the overall cost of capital to justify risk taken by shareholders. If a company's EVA is negative, the firm is destroying shareholders wealth even though it may be reporting a positive and growing earning per share and return on capital employed.[8]

Economic Value Added simply balances a company's profitability against the capital it employs to generate this profitability. If a company's earnings, after tax, exceed the cost of the capital employed in the business, EVA is positive. Market studies have indicated that a company that continuously generates an increasingly positive EVA will be rewarded by a higher stock price. Of course, if a company's long-term prospects are impaired, due to market conditions, litigation, management change or some other reason, then its stock price will not necessarily increase.

Specifically, the advantage of EVA is that it tends to identify specific idle assets or, from a portfolio of assets, identify those that provide the lowest economic return.Despite 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 appearance of EVA, the managers may be quite aware

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