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ECONOMIC VALUE ADDED REPORTING IN INDIA

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ABSTRACT

EVA is superior to accounting profits as a measure of value creation because it recognizes the cost of capital. EVA could bring back the lost focus on Economic Surplus from the current emphasis on accounting profit. EVA and Market value added (MVA) are two different approaches based on different variables , but both are used to evaluate the shareholders value created by the company. There is no Accounting standard in India which makes disclosure of EVA mandatory to all listed companies. Some companies have already made EVA a part of their annual report. The present study covers 125 Public Ltd companies annual report for a period of five years from 1995-1996 to 1999-2000. This paper examines the various disclosure practices related to EVA as followed by Indian public Ltd companies In its annual report.

EVA, a financial management too], helps to evaluate the real profitability of a company. Just earning profits is not sufficient- a business should generate sufficient profits to cover its cost of capital and have a surplus left over for growth. Any profit earned over and above the cost of capital is Economic value added. Effective use of capital is the key to creating shareholders value. EVA thus represents value creation for shareholders. A negative EVA points to wealth erosion.

In the 1970s or even earlier, residual income did not get wide publicity and it was not regarded as the prime performance measure by a great number of companies. However, of late, the number of companies adopting EVA is increasing rapidly (Nuelle 1999, Wallace 1997, and Economist 1997). There are several value-based measures, such as Cash Flow Return On Investment, Cash Value Added, Shareholder Value Added, and Economic Value Added. Among these, EVA is the most widely used and popular, probably because it happens to be an easier concept compared to others and above all it is cost effective (M. Thenmozhi, 1999).

A sample of 125 public Ltd companies from various industries in India have been selected. Further, for the purpose of analysis, these companies annual reports

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have been examined for the last five years, i.e. from 1995-96 to 1999-2000. The present research paper is an attempt to investigate the EVA reporting practices in India, with the help of the annual report of Indian companies.

A. CONCEPT OF EVA

Stewart defines EVA as the surplus of net operating profit after taxes (NOPAT) after adjusting the capital cost. The concept of residual income did not gain as much popularity as EVA, may be because EVA was marketed with a concept of Market Value Added and it did offer a theoretically sound link to market valuation. The concept behind EVA is that shareholders must earn a return that compensates the risk taken. In other words, equity capital has to earn at least the same return as risky investment at equity markets. If that is not done, then there is no real profit made and, actually, the company operates at a loss from the point of view of the shareholders (M. Thenmozhi, 1999).

EVA = Net operating profit after tax (NOPAT)- cost of capital employed (COCE), where:

NOPAT = profit after tax (Net of extraordinary items) and before interest (Net of tax); and

COCE = Weighted average cost of capital (%) x Average capital employed.

Positive EVA implies that the company has managed to create shareholder value. If EVA is zero, then this should be treated as the shareholders have earned a return that compensates the risk. Negative EVA shows that the company has destroyed the shareholder. The attractiveness of the EVA lies in its use of cash flow and cost of capital that are the actual determinants of the value of the firm.

B. WHAT DOES EVA SHOW ?

EVA is the residual income after charging the company for the cost of capital provided by lenders and shareholders. It represents the value added to the shareholders by generating operating profits in excess of the cost of capital employed in the business. EVA indicates the impact on shareholders wealth. Whereas, other traditional performance measures such as, IRR, ROI, Return on capital employed, return on assets, Return on net assets, etc. indicates the rate of return. ROI and other traditional performance measures ignore the definite requirement that the rate of return should be at least as high as the cost of capital. Sometimes, ROI ignores projects yielding more than the cost of capital just because the return happens to be less than their current return. The above concept can be well understand with the help of an example, Let us suppose that a group has two companies, 'ANU' Ltd and 'BINU' Ltd.

	ANU Ltd	BINU Ltd
Cost of capital	12%	12%
ROI	18%	10%

The group aims at maximizing only ROI. In this case, Anu Ltd will reject all the projects that yield a return below 18%; Whereas, Binu Ltd will accept all the projects with a yield have more than 10% (even if it is as low as 11%). In the above example, both the companies will maximize its ROI, at the same time, it decreases the shareholders value. To create and increase the shareholder value, Anu Ltd should have accepted all the projects with a return of over 12%. But Binu Ltd should not accept any projects below 12%, because this would destroy shareholder value.

EVA will increase if :

a) Operating profits can be made to grow without employing more capital, i.e. Greater efficiency.

b) Additional capital is invested in projects that return more than the cost of obtaining new capital, i.e. profitable growth,

c) Capital is curtailed in activities that do not cover the cost of capital, i.e. liquidate unproductive capital.

d) Reducing cost of capital, which means employing more of debt, as debt is cheaper than equity or preference capital. i.e. cost control.

C. EVA and MVA

The theory of EVA states that earning a return greater than the cost of capital increases the shareholders value. For listed companies, Stewart defined another method that assesses whether the company has created shareholder value that is MARKET VALUE ADDED (MVA) method.

As per the MVA approach, if the total market value of a company is more than the amount of capital invested in it, the company has managed to create shareholders value. When the case is opposite, then the company has destroyed shareholder value.

MVA = company s total market value- capital invested.

In other words,

MVA = market value of equity - book value of equity.

From the above two paragraphs one can understand that EVA and MVA are two different approaches used to find out the shareholder value created by a company. EVA is basically concentrating on NOPAT, whereas MVA is considering market value of equity.

In one of the previous research studies on EVA, it was stated that positive EVA means, positive MVA, and vice versa. This need not to be necessarily true, because there is various number of factors that influence market value of equity. EVA may be just one of these factors. So one can t always conclude that positive EVA means, positive MVA and vice versa.

Therefore, EVA and MVA are two different approaches based on different variables, but both are used to evaluate the shareholder value created by a company.

The following are some of the special feature compared to other performance measures:

D. FUNCTIONS OF EVA

The main functions of EVA are:

a) As a performance measure, and

b) As a corporate philosophy.

a. *EVA AS A PERFORMANCE MEASURE*

There is a continuous endeavor to develop a single measure that captures the overall performance, yet which is easy to calculate and is also economical. In order to achieve goal congruence, manager s compensation is often linked with the performance of the firm. Investors decide whether to invest in a firm, or to continue with the firm or to exit from it, only on the basis of overall performance of the firm. The only suitable solution to the above stated problems is 'EVA'.

ROI, ROE and ROA gives us the rate of return earned by the firm with respect to capital invested in the firm. The most important limitation of these measures are derived from limitations inherent in the measurement of accounting profit. But these limitations are also associated with EVA. The difference lies only in the fact that the cost of equity is also factored to arrive at the residual income.

EVA emphasizes that in order to justify investments in the long run they have to produce at least a return that covers the cost of capital as otherwise the shareholders would be better off investing elsewhere. This approach includes that the organization tries to operate without excess capital. While the accountants are familiar with the concept of residual value, its application in economic value measurement as a means of evaluating underlying business performance is nothing short of an overhaul of traditional accounting concepts.

b. *EVA AS A CORPORATE PHILOSOPHY*

EVA, when implemented at every level of managerial decision making process, encourages managers to deploy resources only on value enhancing activities and to align the interests of shareholders with managers. This involves two things- one is linking managerial compensation package with EVA and second is to inculcate the culture of evaluating every action from the viewpoint that it should generate EVA. The ultimate out come should be enhancement in the shareholders wealth measured by the capital market.

The simplicity of EVA in communicating the very fundamental principle that only the generation of surplus over cost of capital can enhance shareholders wealth makes it a management technique superior to other planning and control techniques.

EVA should be adopted as a management culture within the organization rather than as a project, There are more than 300 corporates worldwide that have adapted EVA as a corporate philosophy (A.K. Bhattacharyya & B.V. Phani, 2000). Many of these organizations are successful multinationals like Coca-Cola, Bausch & Lomb, Briggs & Stratton and Herman Miller. The advantage of EVA over other similar tools is that it improves business literacy. Business literacy is the effort of the management to convey to all the employees the fact that for any activity to be value enhancing, the return generated should be greater than the cost of capital employed for that activity. Use of EVA improves financial corporate governance in the sense that it motivates the manager to get rid of value destructive activities and to invest only in those projects that are expected to enhance shareholders value. Using EVA or residual income measures for incentive compensation leads to :

i. Improvement in operating efficiency by increasing asset turnover,

ii. Disposal of selected assets, which have failed in earning adequate returns.

iii. Reduction of new investments, which will have inadequate returns as compared to the overall cost of capital, and

iv. More share repurchases.

Teitelbaum observed that *EVA* has moved from buzzword to financial phenomenon. As a *performance measure*, as an analytic tool, and as a *management discipline*, EVA is cropping up all over.

E. PROBLEMS

The following are some of the problems associated with the calculation of EVA.

1. Stern Stewart & co recommends nearly 164 adjustments to the accounting figures for a realistic estimate of EVA. These adjustments truly complicate the calculation of EVA.
2. These 164 adjustments require in depth data. This involves additional costs.
3. The increase in the number of adjustments increase the subjectivity involved in measuring EVA (Damodaran, 1998).
4. It is very difficult to quantify all the value enhancement activities of a firm without involving a lot of subjective estimates.
5. It does not remove the limitations of the accounting profit that forms the basis for computing EVA.
6. It is difficult to measure exactly the risk -free rate of return, beta and risk premium.
7. There is no statutory regulation to monitor the EVA disclosure practices in India.

F. EVA REPORTING IN INDIA

In India, the entry of foreign institutional investors in the early 90s saw the concept of shareholder value gaining ground. Some companies have already made EVA a part of their annual report. Indian companies have started using EVA for improving internal governance.

At Parke Davis, the EVA rose from Rs. 8.04 crores in the financial year 1996 to Rs. 15.42 crores in 2000.

At Hindustan Lever Ltd, the EVA has increased to Rs. 694 crores in 1999 from Rs. 26 crores in 1991.

The EVA of Satyam computer service Ltd, has Increased from Rs. 4.08 crores in 1996 to Rs. 83.32 crores in 2000, as per their annual report.

At Nicholas Piramal India Ltd, the EVA rose from Rs. 7.6 crores in the financial year 1998 to Rs 14.9 crores in 2000.

As per the annual report of Linc pen & Plastics Ltd, the EVA has been a mere Rs. 0.41 crore in the financial year 2000.

The above are some of the examples of EVA disclosure in India.

The present study reveals that :

1. Out of 125 companies annual reports studied, only 12 companies have disclosed EVA.
2. Only one company has disclosed the EVA before the financial statements in the annual report.
3. 11 companies have disclosed EVA after the financial statements in the annual report.
4. The disclosure of EVA is something new to the Indian investors. Therefore, seven companies have disclosed all necessary theoretical information about EVA, before showing calculation of EVA.
5. 9 companies have disclosed the formula, which they have adopted in calculating EVA.
6. Only one company has disclosed EVA data for a period of the last 10 years.
7. 8 companies have disclosed EVA data for a period of 5 years, 2 (two) companies have disclosed EVA data for a period of 2 years, and only one company has disclosed EVA data for a period of one year.
8. All 12 (twelve) companies have disclosed EVA in the form of tables.
9. Only 4 companies have disclosed EVA in the form of graphs, in addition to tables.
10. The presentation of EVA data is different from company to company.

CONCLUSION

There is no Accounting Standard, which makes disclosure of EVA mandatory to all the listed companies. EVA calculation involves significant subjectivity and this reduces its informative value. Casual use of EVA for external reporting might mislead users of the annual report. However, in spite of these drawbacks, EVA is a powerful new management tool that has gained growing international acceptance as the standard of corporate governance. In essence, EVA is a way both to legitimize and to institutionalize the running of a business in accordance with basic macroeconomic and corporate finance principles. When effectively applied and implemented it provides an excellent tool for strategic planning, investment appraisal, pricing decisions and a basis for incentive compensation.

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