Economic Value Added (EVA) as tool for Measuring Financial Performance

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Abstract

EVA has become recent ideal tool of measuring the financial performance in the corporate world. It is used to find out how well a company is performing and what will be the financial strategy of the companies. Economic Value Added (EVA) was introduced and advocated by Stern Stewart and Co. in 1982. EVA has been using by many MNCs like Coca-Cola, Sprint Corporation and Quaker Oats Infosys etc. to find out the true profitability of their company. This paper is related with how EVA has become better tools of measuring financial performance over the conventional measures.

Keywords:
Financial Performance, Performance, Measurement Tool; Conventional Measurement Tool, Economic Value Added

Introduction

Measuring the profitability and value of a business is very important because it is a key consideration when there is discussion of a merger or acquisition, when capital investment decisions are being considered, and in designing management incentive compensation plans." (Colley, Doyle, Hardie, Logan, Stettinius, 2007, p. 247) Measuring financial performance is an important part of running a growing business, especially in the current economic climate. Many businesses fail because of poor financial management or planning, business success can depend on developing and implementing sound financial and management systems. Measurement of financial performance can help to reassess business goals and plan effectively for improving the business. Accounting tools which are being used till today are not sufficient and unlikely in facing the challenge arising from efficient capital markets and owners. Value based measurement framework, a new economic dimension is required, which could better reflect the opportunities and downsides. There are number of value based measurement in the economic framework, for example Economic Value Added (EVA), Cash Value Added (CVA), Cash Flow Return on Investments (CFROI), Shareholder Value Analysis (SVA) and Market Value Added (MVA) The concept of economic framework is an innovative way to measure the value of a company. This economic measurement system determines companies’ worth and performance based on their economic situation not according to accounting numbers produced using traditional accounting rules. According to the past studies, economic frameworks set quality standard in measuring performance and it is necessary for company to create value for shareholders.
Factors affecting financial performance measuring Tools
Following are the financial performance measuring Tools used by companies

<table>
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<tr>
<th>Cash flow</th>
<th>Working capital</th>
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<td>Cost base</td>
<td>Borrowing</td>
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<td>Growth</td>
<td>Gross profit margin</td>
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<td>Operating margin</td>
<td>Net profit margin</td>
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<td>Liquidity efficiency</td>
<td>Return on capital employed</td>
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<td>financial leverage or gearing</td>
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A successful performance measure evaluates how well an organization performs in relation to its objectives. Since the primary objective of commercial organizations is normally assumed to be the maximization of the wealth of its shareholders, it follows that performance measures should evaluate this. In practice, many organizations use profit-based measures as the primary measure of their financial performance. Two problems relating to profit in this area are:

- **Profit ignores the cost of equity capital**: Companies only generate wealth when they generate a return in excess of the return required by providers of capital – both equity and debt. In financial statements, the calculation of profit does take into account the cost of debt finance, but ignores the cost of equity finance.

- **Manipulation while calculation of profit**: Profits calculated in accordance with accounting standards do not truly reflect the wealth that has been created, and are subject to manipulation by accountants. Economic Value Added – or EVATM – is a performance measurement system that aims to overcome these two weaknesses. EVATM was developed by the US consulting firm Stern Stewart & Co, and it has gained widespread use among many well-known companies such as Siemens, Coca Cola and Herman Miller.

**Concept of EVA**

Economic value added (EVA) is a measure of a company's financial performance based on the residual wealth calculated by deducting its cost of capital from its operating profit, adjusted for taxes on a cash basis. EVA can also be referred to as economic profit, and it attempts to capture the true economic profit of a company. EVA is the incremental difference in the rate of return over a company's cost of capital. Essentially, it is used to measure the value a company generates from funds invested into it. If a company's EVA is negative, it means the company is not generating value from the funds invested into the business. Conversely, a positive EVA shows a company is producing value from the funds invested in it.

**Calculating EVA**

The goal of EVA is to quantify the charge, or cost, for investing capital into a certain project, and then assess whether it is generating enough cash to be considered a good investment. The charge represents the minimum return that investors require to make their investment worthwhile. A positive EVA shows a project is generating returns in excess of the required minimum return.

The formula for calculating EVA:

\[ EVA = (r-c) \times \text{Capital} \]

\[ EVA = (r \times \text{Capital}) - (c \times \text{Capital}) \]
EVA = (NOPAT - c x Capital)
EVA = operating profits - a capital charge
where: r = rate of return, and
c = cost of capital, or the weighted average cost of capital.

NOPAT is profits derived from a company’s operations after taxes but before financing costs and noncash-bookkeeping entries. It is the total pool of profits available to provide a cash return to those who provide capital to the firm.

Capital is the amount of cash invested in the business, net of depreciation. It can be calculated as the sum of interest-bearing debt and equity or as the sum of net assets less noninterest-bearing current liabilities.

Capital charge is the cash flow required to compensate investors for the riskiness of the business given the amount of capital invested. The cost of capital is the minimum rate of return on capital required to compensate debt and equity investors for bearing risk.

RONA
Another perspective on EVA can be gained by looking at a firm’s Return on Net Assets (RONA). RONA is a ratio that is calculated by dividing a firm’s NOPAT by the amount of capital it employs (RONA = NOPAT/Capital) after making the necessary adjustments of the data reported by a conventional financial accounting system.
EVA = (Net Investments)(RONA – Required minimum return)

If RONA is above the threshold rate, EVA is positive.

EVA and ROI
EVA is better than ROI (RONA, ROCE, ROIC) as a controlling tool and as a performance measure because of the following reasons

1. **Steering failure in ROI:** Increase in ROI is not necessarily good for shareholders i.e. maximizing ROI can not be set as a target. (Increase in ROI would be unambiguously good only in the companies where capital can be neither increased nor decreased -> however we leave in a world where both operations are easily executed in almost all companies)

2. **EVA is more practical and understandable than ROI:** As an absolute and income statement-based measure EVA is quite easily explained to non-financial employees and furthermore the impacts of different day-to-day actions can be easily turned into EVA-figures since an additional $100 cost decreases EVA with $100. (ROI is neither easy to explain to employees nor can day-to-day actions easily be expressed in terms of ROI)

The purpose of EVA is to assess company and management performance. EVA as a performance indicator is very useful. The calculation shows how and where a company created wealth, through the inclusion of balance sheet items. This forces managers to be aware of assets and expenses when making managerial decisions.

Arguments for using the EVA measurement include:
- It is consistent with discounted cash flow methods of making investment decisions.
- It enables management to evaluate the efficiency and effectiveness of capital utilization throughout the organization and to increase economic income by:
Increasing revenue while maintaining the same amount of investment.
Reducing investment while maintaining the same revenues.
Choosing assets that have return greater than the cost of capital.
Empirical evidence shows that increases in EVA are closely linked to increases in share prices.

Limitations of EVA

However, the EVA calculation relies heavily on the amount of invested capital, and is best used for asset-rich companies that are stable or mature. Companies with intangible assets, such as technology businesses, may not be good candidates for an EVA evaluation. Although EVA has benefited the shareholder more than the traditional measures still it has some limitations like EVA cycle does not give any idea about the financial performance of companies which is affected by the business cycle. Possibility of error in estimating WACC (Weighted Average Capital Cost) is an important aspect and the calculation of cost of equity is also very difficult to compute. With the help of NPV (Net Present Value) an individual project can be selected and rejected. It can happen that any project has positive NPV and the company selects that project. But for the initial year the project can give negative NPV so the starting EVA of the project can be negative so it can be a loss making project then it should not be taken but in future this project can give higher positive cash flow. Fast moving goods are less capital intensive so these companies has more EVA than any other company which is more capital intensive. This is the reason that inter-company comparison will get unrealistic.

Conclusion

At last we can conclude that EVA is a financial measure based on operating income after tax. EVA is the most reliable source to know the performance of the company in today era. A company should be a wealth creator not the wealth destroyer for the shareholder. In the EVA system a company will be a wealth creator if its operations are as good as it can generate profit more than the cost of capital which includes the cost of equity as well.

Economic Value Added (EVA) is a measure of financial performance based on the concept that all capital has a cost and that earning more than the cost of capital creates value for shareholders. It is after-tax net operating profit (NOPAT) minus a capital charge. It is true economic profit consisting of all costs including the cost of capital. If a company’s return on capital exceeds its cost of capital it is creating true value for the shareholder. EVA has been adopted by the advanced economies as financial performance measurement tool and corporate strategy which helped EVA to be identified as an important financial performance measurement tool over the conventional tools around the world.

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