CHAPTER - 1
FRAMEWORK OF THE STUDY

1.1 INTRODUCTION

Maximizing shareholders’ wealth has become the new corporate paradigm. Shareholders’ wealth maximization has traditionally been recognized by managers and researchers as the ultimate corporate goal.

In the past decade a sea of changes has been made in the organizational goals and systems which have led to a revolutionary change in the performance and measurement criteria of corporate entities, from the traditional profit based measures like, Earning Per Share (EPS), Return On Capital Employed (ROCE), Return On Net Worth (RONW), Net Profit Margin (NPM), Operate Profit Margin (OPM), to the new ‘trendier’ value based performance measures, like, Market Value Added (MVA), Shareholder Value Added (SVA), Cash Value Added (CVA), and Economic Value Added (EVA). Among these concepts, Economic Value Added (EVA) has received attention and recognition in accounting and financial literature as a vital tool to measure corporate performance. In using the EVA system employees focus on how the capital is being utilized and how the cash flow is generated from it. EVA makes managers care about managing the assets as well as the incomes and helps in bring up a balance between the two.
Indeed traditional profit measures do not adequately consider a company’s true cost of invested capital. No doubt, the determination of net income includes such costs as depreciation (the recognition of the historical cost of fixed and other long-term assets) and interest (the cost of debt). Net income does not, however, include the cost of equity, which is the return desired by investors. As a result, performance measures based solely on operating profit or net income tend to promote more short-term decision-making. They do not inform the investor as to whether the profits generated are sufficient to exceed the true economic costs of capital employed in the business. Only the study of EVA can provide a more complete measure of economic profit.

1.2 SIGNIFICANCE OF THE STUDY

One of the most basic and fundamental tenets of capitalism is the obligation to maximize owners value.

The owners of the company i.e. the shareholders are more interested to maximizing their wealth. Maximization the shareholders wealth means maximizing the net worth of the company for its shareholders. This is reflected in the market price of the shares held by them. Therefore wealth maximization means creation of maximum value for company’s shareholders which mean maximizing the market price of the shares. With greater profit, the EPS (Earning per Share) goes up, resulting in an increase in the price of shares belonging to the shareholders.
Also an expectation of bigger EPS is created with every rupee that is raised and invested. A tacit promise to maximize value is made to shareholder with each rupee of profit that is retained rather than distributed. The litmus test behind any decision to raise, invest, or retain a rupee must be to create more value than the investor might have achieved, with an otherwise alternative investment opportunity of similar risk.

Shareholders value maximization, which is the heart of economic growth, as a long-term proposition that delivers higher economic output and prosperity through productivity gains, employment growth and higher wages. Management’s most important mission is to maximize shareholder wealth.

Therefore wealth creation is depended on management’s performance. In order to measure the performance companies’ management, several tools are used by accountants, financial managers, investors, annalists, and other users.

As it is mentioned in the previous section, some of the measurement tools that have been used to evaluate the performance of a company are Earning Per Share (EPS), Return On Capital Employed (ROCE), Return On Net Worth (RONW), Net Profit Margin (NPM), Operate Profit Margin (OPM), Residual Income (RI) and Return on Investment (ROI).
These measures are simple to compute and the formula gives a figure that determines how the managers of a particular unit are performing.

But these simple measures suffer from substantial weaknesses, which are as under:

1. Income manipulation may be possible since income and investments or assets base, has not been defined to ensure consistency;
2. Manipulation may result if different units make different accounting choice;
3. Income is based on accrual accounting which does not consider cash flow or time value of measure;
4. In an effort to improve performance, managers may be motivated to keep old assets and not replace them, which other wise would have been most beneficial for the organization;
5. These measures focuses attention on how well the units perform but no effort is made to determine how well the unit performs in relation to the companies wide objectives;
6. These measures consider only cost of debts but not the entire cost of capital.

In an effort to overcome these weakness Economic Value Added (EVA) measure have been developed.
EVA as a measure of performance has been a part of the economist’s tools. In its most fundamental form, EVA is the simple notion of residual income. i.e. for investors to earn an adequate rate of return and that return must be large enough to compensate the risk. The required return is a capital charge for both debt and equity.

EVA is conversion of accounting information to economic reality that can be readily understood by non-financial managers. EVA is a measure of corporate performance that differs from others by including a charge profits against cost of all the capital employed. Many corporate managers have forgotten the basic principle of true profit, because they have been conditioned to focus on conventional accounting profits, which include a deduction for interest payments on debts, but have no provision at all for the cost of equity capital. True profit is after tax operating profits minus the appropriate capital charge for both debt and equity. This is a number that economists refer to as residual income, which means exactly what is implies. It is the residue left over after all costs have been covered. Economists also refer to this as economic profit or Economic Value Added.

EVA is much more than just a measure of performance. It is the framework for a complete financial management and incentive compensation system that can guide every decision a company makes from the Board Room to the shop floor.
EVA can transform a corporate culture, which can improve the working lives of everyone in the organization by making them more successful.

It has brought about a revolution in the accounting concepts that can help any corporation, public or private, in any industry and produces superior results for the shareholders and the employees.

EVA helps the managers of companies create hundreds of billions of rupees in shareholders’ wealth that wouldn’t otherwise have existed. Therefore a company that has more EVA creates more wealth for its shareholders. Normally new investors prefer to buy shares of companies, which has positive EVA. It has been proven to work virtually everywhere because it is the right approach for all companies, in all times and in all environments.

EVA has been recognized as an excellent measure of operational performance which is applicable virtually to all industries because:

1. It has the strongest correlation with the market value creation of any profitability measures;
2. It can be used as the basis for all financial decision-making and strategy formulation;
3. It is effective as the focus of powerful incentive compensation programs;
4. It is an effective vehicle for both internal and external communications;
5. EVA represents the net value added by the operations of a business over a given period of time usually a year.

The mechanism of EVA is very simple. By applying the methodology of EVA if the result is positive, the firm in question has created value over the period and if the EVA is negative, it will be termed as value destroyed. A company having consistently high EVA implies that it has been successful in creating value for the business. It has effectively utilized the resources in the most profitable manner. On the other hand, a company having oscillating EVA or consistently negative EVA indicates that there is something wrong with the company.

An essential concept that is closely related to EVA and wealth creation is Market Value Added (MVA), indeed Wealth creation is determined not by the market value of a company but by the difference between the market value and the capital of the company. The difference between market value (of both equity and debt) and total capital is Market Value Added (MVA).

MVA measures the value added to shareholders’ investments. It is the difference between the current market value of all capital elements and the historically rupees amount of capital invested in a company: MVA provides the stock market’s assessment of management’s efficiency in using capital. A positive MVA indicates that a company is building value for its shareholders; whereas a negative MVA indicates that shareholder
value is being destroyed. Maximizing MVA is consistent with management’s goal to maximize shareholder’s wealth.

MVA is the ultimate goal in the wealth creation game. A company with higher MVA creates more wealth. The financial objective of every company should be to create as much as shareholder’s wealth and as much MVA as possible. The best way to increase the EVA is by efficient internal management performance.

1.3 BACKGROUND

In the earlier years EVA was a new metric recognized by economist since the 1770’s and it was called Residual Income. Alfred Marshall\(^1\) has defined Residual Income as a total net profit minus the interest on invested capital. Later other economists contributed to this concept. In 1917 and 1924 economists included the concept of Residual Income in accounting theory and further reappeared in management accounting literature in the 1960s. Before 1970s Residual Income or the new concept “EVA” did not get wide publicity and it did not end up to be the prime performance measure in number of companies. A global consulting firm established in 1982 by Joel M stern and Bennett Stewart\(^2\). They have put EVA on the world map in 1989 by publishing an article in the fortune magazine. Indeed EVA is the registered trademark of Stern

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1 Alfred Marshall (1842-1924) Professor of Political Economy at the University of Cambridge from 1885 to 1908.

2 Joel M, Stern and Bennett Stewart have been the managing partner of Stern Stewart & Co. Since it’s founding in 1982. Stern Stewart & Co. 1345 Avenue of the Americas, New York, NY 10105
Stewart and Company’s for measuring managerial performance and economic value.


Crant (1996)\(^8\) observed that EVA is better correlated with shareholder wealth than other traditional parameters like ROCE, RONW, and EPS. On the predictive power of EVA in explaining shareholder wealth Dillon and Owers (1997)\(^9\) views EVA as a measure of value created that compares the return from operations with the cost of


financing those operations. Stern, Stewart, (1995) define EVA as the internal measure that management can decentralize throughout the company to be used as a basis for a completely integrated financial management system. Uyemura, Kantor, and Pettit (1996) state that EVA differs from traditional accounting measures such as ROE and ROA. In that it charges for the use of capital and it adjusts reported earnings and minimizes accounting distortions. O'Hanlon and Peasnell (1996)\textsuperscript{10} assert that EVA provides a valuable framework for converting wrong accounting numbers into correct estimates of value. However, there are adverse finding too.

Chen and Dodd (1996)\textsuperscript{11} found that return on assets (ROA) explained stock returns better than EVA.

Recently the number of financial economists has taken increasing interest in the subject and number of financial consultants has developed successful practices in EVA. Furthermore, the spreading of EVA as a corporate performance measurement tool does not seem to be on a weakening trend. On the contrary the number of companies adopting EVA is increasing rapidly. Corporations in the US started disclosing EVA information from the beginning of 1990s. Since then the number of companies adopted EVA has increased. More than 300 companies, with

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\item \textsuperscript{10} J. O’Hanlon and K. Peasnell, 1998, Wall Street’s contribution to management accounting: the Stern Stewart EVA, financial management system, Management Accounting Research, 9, 421-444.
\item \textsuperscript{11} Chen, S. and J. Dodd, 1997. Economic Value Added EVA: An Empirical Examination of a New Corporate Performance Measure, Journal of Business Finance and Accounting, Fall, PP.318-333
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revenue approaching a trillion dollar a year, have implement EVA framework for financial management and incentive compensation. Over the past few years the shift of companies in developed countries towards the importance of EVA, can be directly attributed to an unprecedented increase.

In contrast to EVA development in the USA and another developed countries there has been very little systematic, empirical research on the importance of EVA information in India. A review of several Indian journals reveals that there are very few articles and manuscripts published on EVA reporting. However, some Indian companies have recognized this new aspect. Particularly, after the liberalization on foreign holding in Indian companies, the concept of shareholder value is gaining ground.

Some companies like Hindustan Lever, NIIT, Infosy, Technologies Hyderabad based Dr Reddy Elaborators have already made EVA a part of their published annual reports and others like Ranbaxy Laboratories, Samtel India Ltd. have started calculating EVA as an internal report.

Though study relating to EVA analysis would appear to be a totally new theme for research in India, while collecting information about review of literature pertaining to this topic.

As a result, the relevance and utility of EVA, to the economic decision-making, users, particularly investors and shareholders is yet to
be demonstrated empirically in this country. So it presents an immense scope.

Against this background of the EVA at the national and international level, this study has been undertaken. This study basically undertakes the shareholders and other users of the EVA.