CHAPTER - VII

SUMMARY AND RECOMMENDATIONS

This chapter deals with the summary of the Thesis, suggestions and areas open for further research. Based on the study, some recommendations have been made which if noted could be useful.

7-1) SUMMARY

One outcome of the economic reforms implemented in 1990’s in most of the countries around the world 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.

It is emerging that the global market place is asking for some changes in 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 refined, managers will have the task of providing top management with information that is globally competitive for corporate decision-making.

Capital finance decision is a major decision in any organization. On the basis of financial decisions capital structure is formed. The capital structure of a company consists of debt and equity securities, which contribute, in financing of its assets. In other words, there are two main sources of capital; one is the owned funds and second is the borrowed funds. Owned funds are the shareholders’ monies on which dividend are paid. Dividend payment depends upon the profitability of the company and is not binding. There is no commitment involved in the shareholders
funds. On the other hand, borrowed funds involve fixed commitments; their repayments are secured by a charge created on the assets and interest payments are obligatory irrespective of the profits or losses of the company. Hence, it increases the financial risk of the company. The borrowed funds are relatively cheaper, but entail a certain degree of risk, therefore due care must be exercised while determining the mix of owned and borrowed funds.

The main objective of financial management is maximization of shareholders’ wealth, which means to enhance the market value per equity share. Hence it is necessary to maintain the mix of debt and equity at a level, which would result in improvement of market share price. It means an optimal capital structure can be considered as that particular combination of debt, preference and equity capitals which the company’s cost of capital is at its minimum or alternatively, the value of the company is at its maximum.

Value added indicates the net wealth created by the production of goods or services during a specified period in a corporate; therefore, the concept is superior to the existing methods. No enterprise survives or grows if it fails to generate wealth for ultimate stakeholders. An enterprise may exist without making profit but can not survive without adding value. The enterprise not making profit shall turn into poor health, as it can be found many examples in public sector, but not adding up value may cause it termination over a period of time. For that reason, Economic Value Added is basically a broader financial measure of judging the output of a corporate in particular and the industry in which such corporate works in general to economic growth and development of nation.
Making steady addition to the value of shareholders has turned out to be the new corporate practice in India. Shareholders’ wealth is measured in terms of the returns they receive on their investment. The returns can either be in the form of dividends or it turn depends on the subsequent changes in the market value of the shares. This market value of shares is influenced by a number of factors, which can be company specific, industry specific and macro-economic in nature.

The manager of a firm (as internal user of financial information) and the investors and other parties (as external users) are interested to use an appropriate performance measure in order to assess how managerial actions affect the firm value. This financial performance evaluation measure needs to be accurate, consistent, and globally comparable and should lead to common goal between the owners and managers. EVA is a measure that should be used by top management to evaluate investment centre managers because it considers goal semblance between shareholders and corporate managers.

The corporate procedures have undergone through a deep-seated change in the modern time 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 concentrate on association between financial variables and stock prices or market risk in different way. Therewith the traditional performance measures neglect the expected returns by shareholders.

For this purpose and in order to overcome the limitations of traditional measures of financial performance, Stern Stewart introduced Economic Value Added (EVA) as a measure of business performance in 1990. EVA as an appropriate performance measure incorporates at least three things which are 1) the amount of
capital invested, 2) the return earned on the capital (NOPAT), and 3) the cost of capital employed (WACC).

The EVA analysis, unquestionably, has received much attention in the Western countries both as a management innovation as well as stock market analysis. The recognition of such a technique in Indian context, nevertheless, shows to some extent diverse trends. Majority of companies are still not prepared to put in the EVA technique for evaluating their financial performance because of certain inherent difficulties associated with the computation of EVA.

Again, it is observed by some scholars that in Indian context it may be very difficult exercise to establish the existence of any relationship between different stock price and EVA. Calculation of perfect relationship between different variables is near to unfeasible, as one would not get adequate data points across a uniform period to do so. Secondly, the applicability of something like Capital Asset Pricing Model (CAPM) has been debated in the Indian scenario. Thirdly, computation suffers from some of the problems inherent in EVA itself as well as the quality of underlying data given the poor disclosure standard and the differences in accounting policies of a number of corporates in India. Despite the above discussion, it is expected that EVA because of its potential creates more attraction among Indian corporate sectors in the future.

Here, Indian Automobile Industry has been considered as population under study. Highest growth rate of Capital Employed, Net Worth, and Gross Fixed Assets among manufacturing industries in India for the period of 1996-2004 is the rational reason to select Automobile Industry in order to examine implications of EVA in Indian Industries. There is no primary data and only secondary data has used. The relevant secondary data
have been collected from different sources such as Bombay Stock Exchange Official Directory, Center for Monitoring Indian Economy publications, companies’ websites or the other Internet websites, Annual Reports of the Companies and several libraries in different Institutes and Colleges.

For this research work, Seventeen Indian Automobile firms listed in Bombay Stock Exchange have been selected based on the certain criteria which show a tendency towards relatively profitable firms. The research first attempts to study the effect of capital structure practices of the firms on their EVA. Secondly, it examines whether EVA is the measure which has highest correlation to market value added.

In the study at hand, a number of key financial variables have been identified for the purpose of analysis. These variables consist of EVA, MVA, EPS, ROA, ROCE and NOPAT. Computation of these measures has been made for a period of the five years 2001 to 2005.

The role of statistical tools is important in analyzing the data and drawing inferences there from. In order to derive the transparent results from the information collected through secondary data, various statistical tools like mean, standard deviation, variance, correlation and regression tests of hypotheses have been accomplished through EXCEL, SPSS and S-Plus software.

For carrying out the study, the following specific objectives have been set. To find out capital structure of Automobile Industry, to compute and analyze EVA of the sample companies, to rank the selected companies on the basis of well-known Capital Structure Ratios, EVA, EVA to Capital Employed Ratio, EPS, NOPAT, ROA, ROCE and MVA and examine the difference if any, in the ranking; to have an insight into the influence of capital structure on EVA; to study the relationship between shareholders’ wealth (MVA) and
financial variables and to come across the simple most significant explanatory variable and finally to make suggestions and recommendations for the use of EVA as an appropriate measure of financial performance to the Indian Corporate Managers.

The present study intends to review the effect of capital structure on EVA. For this purpose, EVA and EVA to Capital Employed Ratio were as the dependent variable and Total Debt Ratio and Debt-Equity Ratio have been considered as independent variables. It also examines the relationship between shareholders’ wealth and financial variables. Market Value Added (MVA), the measure of shareholder wealth has been considered as the dependent variable. The Economic Value Added (EVA), Earning Per Share (EPS), Net Operating Profit after Tax (NOPAT), Return on Total Assets (ROA), Return on Capital Employed (ROCE) have been considered as independent variables. The analyses have been done by using Panel Data analysis methods and two methods of estimation which are (1) Generalized Estimating Equations (GEE) and (2) Feasible Generalized Least Squares (FGLS) have been used for panel data analysis.

7-2) RECOMMENDATIONS

Today because of high competition among the corporates and scare resources employ by them, it is a serious need to review and modify financial decisions. It should be done in a way that leads an organization to acquire highest return on capital employed. Managers should believe that equity capital is not free of charge and in existence environment shareholders expect a minimum rate of return on their investments. Hence, the investigation and also evaluation of managerial performance and its effect to the firm value is a must. For this purpose, a proper performance measure should employ. The researcher believes EVA has enough potency
to serve in this field and accordingly an attempt is made here to summarize a few recommendations:

1. EVA should be used with care in valuing and identifying stocks that have the potential to outperform the market, but the approach gives analysts valuable insight into value creation. EVA is a reasonable valuation tool for the shares of companies whose prospects can be forecast with reasonable accuracy. It appears to be useful in spotting changes in a company’s ongoing performance that are hidden in EPS numbers.

2. to use EVA as a performance evaluation tool of the managers, the component parts of the EVA like the accurate amount of capital employed, operating profit margin, cost of capital, etc. should be identified and the performance should be measured based on the improvements made in these value drivers. Consistency in calculating the values drivers is a must.

3. The accountancy profession has a key role to encourage the corporate manager for using EVA, but cannot play its role alone. The profession is part of a complex web of regulations and laws, rules and relationships and organizational structures that are all affected by culture and tradition. Only if each element of this web is structured properly in an accepted framework can the profession be expected to provide professional services according to highest standards delivered in the public interest. The standards and guidance represent the minimum requirements though a more comprehensive approach may be adopted. This guidance should help to support the development and implementation of a plan of action to improve standards within corporate financial frameworks.

4. However the recognition of EVA 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.

5. In India, only a few companies are using EVA internally as a performance gauge for refining efficiency that may guide them to enhancement of shareholder value. In view of that, the competent authorities in India like Accounting Standard Board, ICAI, New Delhi, Company Law Board, Ministry of Companies Affairs, Govt. of India, New Delhi, SEBI, should issue wide-ranging guiding principles for the computation of EVA and its practices in financial reporting and accounting disclosures by the corporate world. It would certainly make the Indian companies internationally competitive which is the necessity in the new global order delivered by the economic reforms process. This would also help in restoring the lost-confidence of Indian investors and banking and financial institutions as they might expect transparent working in the corporate world. In simple worlds, the companies who are performing well would be benefited a lot by the winning the market sentiments and others would learn to value the shareholders by making some addition in their financial interest.

6. In order to become EVA more popular among Indian companies, it is expected from ICAI to issue necessary guidelines to the appropriate bodies in the country so that it may become obligatory for Indian companies to disclose their EVA in the financial statements.
7. As the outset, this research was an exploratory effort to study capital structure practices of Indian Automobile Industry and to find out whether the capital structure impacts upon the EVA. Further research of this kind should enlarge our understanding of corporate finance, and increase the knowledge of corporate manager in order to improve firm value by an optimum utilization of fund.

8. In this research the EVA of Indian Automobile Industry was studied. For expansion of using this financial performance measure in developing countries such as India, there is a need to study Economic Value Added of all other major industries also.

9. This study suggests that the relationship between EVA and MVA is statistically significant. Future research might examine which components of EVA contribute to increase or decrease its information content. It would also be interesting to assess the explanatory power of EVA from both a time series perspective and over a large universe of firms.