



**Knowledge Consortium of Gujarat**  
 Department of Higher Education, Government of Gujarat  
**JOURNAL OF COMMERCE AND MANAGEMENT**  
**ISSN : 2279-025X**

Year-1 | Issue-4 | Continuous issue-4 | January-February 2013

### Economic Value Added (EVA)

#### Introduction:

Economic value added (EVA) has been getting plenty of attention in recent years as a new form of performance measurement. An increasing number of companies are responding to this buzzword EVA and relying heavily upon EVA to evaluate and reward managers from all functional departments. The term EVA has been copyrighted by the consulting firm Stern Stewart & Company in 1994. In corporate finance, Economic Value Added is an estimate of a firm's economic profit – being the value created in excess of the required return of the company's investors (being shareholders and debt holders). This amount can be determined by making adjustments to GAAP accounting. There are potentially over 160 adjustments that could be made but in practice only five or seven key ones are made, depending on the company and the industry it competes in. One of the most useful performance measurements to account for the ways in which business value can be added or lost is Economic Value Added or EVA. Another term for this metric is Economic Profit.

#### Concept of EVA:

EVA is a financial performance measure based on operating income after taxes, the investment in assets required to generate that income, and the cost of the investment in assets (or, weighted average cost of capital). The three elements used in calculating EVA are operating income after tax, investment in assets, and the cost of capital.

As defined by Stern Stewart, EVA is the difference between a company's net operating income after taxes and its cost of capital of both equity and debt.

EVA subtracts the cost of capital from the net operating profits after tax (NOPAT) generated in the business. It is a measure of the residual income from the income statement after accounting for the cost of the balance sheet.

#### The formula to measure EVA is:

$EVA = \text{After tax operating income} - (\text{investment in assets} \times \text{weighted average cost of capital}).$

If the difference amount is positive, the company has earned more after-tax operating income than the cost of the assets employed to generate that income. In other words, the company has created wealth. If the EVA difference amount is negative, the company is consuming capital, rather than generating wealth. A company's goal is to have positive and increasing EVA.

#### Economic Value Added will increase if:

New capital is invested and it earns more than the cost of capital.  
 Capital is divested from the business if it does not cover the cost of capital.  
 NOPAT increases without increasing the capital employed.

#### EVA - Performance Measurement Tool:

Economic Value Added is a performance measurement that links directly with the intrinsic value of the business. The formula for EVA is:

$EVA = (r - c^*) \times \text{Capital employed}$   
 $r = \text{economic rate of return} \ \& \ c^* = \text{cost of capital}$

**EVA example:**

Total capital employed = Rs. 2,000

$c^* = 10\%$

$r = 12.5\%$

$EVA = (12.5\% - 10\%) \times 2,000$

EVA = Rs. 50.00

**Advantages of EVA:**

1. EVA is closely related to NPV. It is closest in spirit to corporate finance theory that argues that the value of the firm will increase if you take positive NPV projects.
2. It avoids the problems associated with approaches that focus on percentage spreads - between ROE and Cost of Equity and ROC and Cost of Capital. These approaches may lead firms with high ROE and ROC to turn away good projects to avoid lowering their percentage spreads.
3. It makes top managers responsible for a measure that they have more control over - the return on capital and the cost of capital are affected by their decisions - rather than one that they feel they cannot control as well - the market price per share.
4. It is influenced by all of the decisions that managers have to make within a firm - the investment decisions and dividend decisions affect the return on capital (the dividend decisions affect it indirectly through the cash balance) and the financing decision affects the cost of capital.

**Comparison With Other Approaches:**

Other approaches along similar lines include Residual Income (RI) and residual cash flow. Although EVA is similar to residual income, under some definitions there may be minor technical differences between EVA and RI. Residual cash flow is another, much older term for economic profit. In all three cases, money cost of capital refers to the amount of money rather than the cost of capital; at the same time, the adjustments to NOPAT are unique to EVA.

Although in concept, these approaches are in a sense nothing more than the traditional, commonsense idea of "profit", the utility of having a separate and more precisely defined term such as EVA is that it makes a clear separation from dubious accounting adjustments that have enabled businesses such as Enron to report profits while actually approaching insolvency. Other measures of shareholder value include:

- Total Shareholder Return
- Market Value Added
- Added Value

**Total Shareholder Return:**

Many businesses have an objective to maximize shareholder wealth. While very few people would disagree that this is a good objective for any business, how this objective should be achieved is much less certain. Firstly, how will returns to shareholders be measured? Generally, returns are represented by returns to shareholders via dividends and increases in the value of the market price of their shares.

For many years, managers and shareholders have believed that growth in annual earnings per share and increases in return on equity were the best measures for maximizing shareholder wealth. However, more recently there has been a growing awareness that these conventional accounting measures are not reliably linked to increasing the value of the company's shares. This occurs because earnings do not reflect changes in risk and inflation, nor do they take account of the cost of additional capital invested to finance growth. The value of company's shares will only increase if management can earn a rate of return on new investments which is greater than the rate investors expect to earn by investing in alternative, equally risky companies. Since the concept of "maximizing shareholder wealth" was developed in the 1970's, more and more enlightened managers are focusing

on strategies which maximize economic returns for shareholders, as measured by dividends plus the increase in the company's share price. One way of viewing the "shareholder value" approach is to value the business using Economic Value Added as a valuation methodology.

### **Market Value Added (MVA):**

The market value of a business at a point in time is an approximation of the fair value of the business's entire debt and equity capitalization. This can be arrived at by taking the number of shares and multiplying by the share price and adding the book value of long and short term loans net of any cash deposits. Theoretically, market value at a point in time is equal to the total capital employed plus or minus the net present value of all future Economic Value Added. Therefore, market value is maximized by maximizing the present value of future Economic Value Added. Consequently, if we prepare a projection of annual Economic Value Added into the future and discount these projections to the present value, at the cost of capital, we get an estimation of market value that management has added to or subtracted from the total capital employed in the business. This present value of all future Economic Value Added is theoretically equal to market value added, MVA. Therefore the market value of a business is:

Market value = MVA + capital employed.

### **Advantages of Market Value Added (MVA):**

By forecasting Economic Value Added for each year it shows how much value will be added to the capital employed each year. It is the only method that can clearly connect capital budgeting and strategic investment decisions with a methodology for subsequent evaluation of actual performance. By forecasting Economic Value Added amounts it automatically produces a series of targets for management to achieve in order to justify the valuation. It can be readily communicated to and understood by operational management.

Through the computation of Economic Value Added amounts Economic Value Added creates a meaningful performance measurement which can be used to judge subsequent performance. For a project to be favorably considered, market value added must be positive. On the other hand free cash flow may fluctuate from positive to negative and back again over the life of the project. Economic Value Added focuses management's attention on the fundamental three ways to create value. These are:-

- Improve profits without making a further investment in additional capital.
- Only invest in projects where earnings exceed the cost of capital.
- Disinvest from projects where the savings on the capital cost exceeds earnings foregone.

Discounting the benefits of these strategies in free cash flow terms makes them difficult to understand. Because Economic Value Added is a powerful overall measurement of management's performance, it is an ideal method for setting corporate goals, management incentives and the payment of performance bonuses. This cannot be achieved with cash flow. It links planning to performance and performance to value.

### **Conclusion:**

The creation of wealth can be achieved in the real world through the use of economic profit / economic value added as a performance measurement linking strategy to value. The managers of many well known international corporations have succeeded in substantially increasing the value of their business entities by using this valuable tool. The dynamics of using Economic Value Added and market value added have a very powerful application in every business entity, irrespective of size or industry. The Economic Value Added methodology can be applied to create wealth for the owners of businesses from the size of the corner store to that of the multinational corporations.

### **REFERENCES :**

1. G. Bennett Stewart III (1991). The Quest for Value. HarperCollins.
2. Erik Stern. The Value Mindset. Wiley.

3. Joel Stern and John Shiely. The EVA Challenge. Wiley.
4. Al Ehrbar. EVA, the Real Key to Creating Wealth. Wiley.
5. Stern Stewart & Co.: The EVA Company. Menu: "About EVA; EVA Companies."
6. Stern Stewart Management Services. 1993. The Stern Stewart Performance 1000 Database Package: Introduction and Documentation. New York, NY: Stern Stewart Management Services.

\*\*\*\*\*

Prof. S. J. Parmar  
Department of Commerce & Business Administration  
Saurashtra University  
Rajkot 360005.

Copyright © 2012 - 2016 KCG. All Rights Reserved. | Powered By : Knowledge Consortium of Gujarat (KCG)