

EVA LITERATURE REVIEW- SEARCHING THE GAPS

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Abstract

In this study, an attempt has been made to identify the gaps in the existing literature on EVA by classifying and analyzing the conclusions of 60 studies conducted in various countries during the period from 1996 to 2012. EVA has been recognized as an important tool of corporate performance measurement. EVA, though has been proved superior to traditional performance measures, is still debatable. Most of the studies have been done in developed countries especially USA. Majority of the studies provide sector specific evidences especially the manufacturing sector. In future, research can be done exploring how EVA can be applied in various other sectors like pharmaceuticals, banking, education, tourism etc. The existing literature also reveals the research gap and it is felt that further detailed study is needed that specifically explores the extent of EVA usage, implementation issues, role of GAAP adjustments, reporting practices of companies in order to broaden the scope of the EVA concept.

Keywords: Economic Value Added (EVA), Traditional Measures, Net Operating Profit after Taxes (NOPAT), Value Creation, Market Value Added (MVA).

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Introduction

Today shareholders' wealth maximization has become a new corporate paradigm. Investors now measure the overall performance of a firm to decide whether to invest in it or not. Value creation and shareholders' wealth maximization depends on the conflicting interests towards a common goal. Performance metrics play a vital role not only in evaluating the firms' current performance but also in achieving high performance and growth in the future. Amongst different approaches to measure performance, it is very important for the company to identify and choose a metric which measures the firm value as much as possible without being biased towards any of the stakeholders.

Most of the currently used performance measures like Return on Net Worth (RONW), Return on Capital Employed (ROCE), Earnings Per Share (EPS) etc. are based on net income, total assets etc. Traditional performance measures fail to assess the true or economic return of a company as they are based on the historical asset values, which in turn are distorted by inflation and other factors. They have been criticized due to their inability to incorporate full cost of capital and therefore accounting income is not a consistent predictor of firms' value and cannot be used to measure corporate performance. This has led to the immense popularity of Value Based Performance measures.

Value based management offers different approaches to performance measurement and metrics. It is a consistent framework that aligns management action and strategic objective with shareholders' value creation. It instills a mindset where everyone in the organization learns to prioritize decisions contributing to the corporate world and focusing on the shareholders' value creation. Value creation is the wealth created for the shareholders through price appreciation and dividends. Value based management helps the company build and maintain the competitive advantage.

Value based performance measures truly reflect the future trends, investors' expectations, impact of inflation and risk level of the firm. They also create a link between value creation and incentive compensation plan for the management. Economic Value Added (EVA), one of the value based performance measures, has gained immense popularity.

Pioneered by US based consulting firm, Stern Stewart and Company in 1982, EVA can be used as a measure of both internal and external performance. EVA figures have been heavily promoted in the UK, Australia, Canada, Brazil, Germany, Mexico, Turkey and France, amongst others and used to provide published rankings of managerial performance (Ferguson, 1997). Some companies have adopted EVA for performance measurement and/or incentive compensation packages.

Concept of EVA

As per Peter Drucker (1995), "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes, as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources...until then it does not create wealth; it destroys it."

EVA has emerged as a critical tool to measure and monitor corporate performance. EVA is the surplus (deficit) that remains after levying a charge against after-tax operating profit for the opportunity cost of all capital- equity as well as debt used to generate that profit. EVA is an estimate of true economic profit or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholder and lenders could get by investing in other securities of comparable risks.

$$\text{EVA} = \text{NOPAT} - (\text{WACC} \times \text{CE})$$

where NOPAT stands for Net operating profit after tax, WACC for Weighted average cost of capital and CE for capital employed.

NOPAT is measured from the Income statement by adding back interest payment and subtracting and adding non-operating income and expenses, respectively to a Net profit figure and after making certain other adjustments, accounting profits gets converted to economic profits. Stern Stewart has identified around 164 adjustments subject to the criteria like materiality, manageability, definitiveness and simplicity.

The total capital employed is the sum of shareholders' funds as well as loan funds. In calculating WACC, cost of debt is taken after tax cost and cost of equity is based on CAPM.

The cost of capital is an important aspect in firms' performance measurement. Traditional performance measures do not consider cost of capital in calculation of profit while EVA takes care of it while calculating NOPAT.

A positive EVA reflects that the company is creating the value to its shareholders, whereas a negative EVA reflects that it is destroying the value to the shareholders.

Objective of the study

A lot of research has been conducted on the concept of EVA all over the world; still there exist gaps among the studies. Some of the studies have proved superiority of EVA to traditional measures but others reject the hypothesis either partially or fully. The present study has been conducted to identify the gaps in the existing literature on EVA by classifying and analyzing the conclusions of the studies reviewed. Also, suggestions have been made for the future research work.

Data

The study is based on the review of the studies conducted on EVA in various countries during the period from 1996 to 2012. 60 Papers (published or unpublished) on EVA have been collected from different national, international journals, conferences and internet.

Methodology

The studies reviewed are classified on the basis of year, country, methodology along with the focus of the study and contribution made by the research.

Different methodologies used by various researchers are classified into two categories- descriptive and empirical. Descriptive papers cover the papers based on the basic fundamentals of EVA description with its usages and implementation process. Studies conducted using databases and case studies are classified as empirical studies.

The focus of the study can be categorized as- EVA as a performance measurement tool; EVA as a corporate philosophy; EVA and stock prices; EVA-MVA relationship; and EVA superiority over traditional performance measures.

Literature on EVA

Over a last decade, various articles dealing with the concept of EVA have been published, but the concept is still debatable. Worthington and West (2001) reviewed the literature on EVA and provided a synoptic survey of EVA's conceptual underpinnings. They concluded that empirical evidences concerning EVA have been mixed. There is strong need for research over a longer time frame to allow greater empirical certainty on the status of EVA as a corporate performance measure. Pal and Sura (2007) reviewed 25 empirical studies published in various journals related to relationship of EVA and stock returns. They only reviewed the results of the studies and did not consider other relevant issues like EVA-MVA relationship, EVA and traditional performance measures, EVA implementation, and EVA as a managerial tool. Till date, no other study has been conducted to cover the issues involved in research about EVA. In the present study, we have covered various issues on EVA by reviewing sixty studies which have been conducted on the concept.

Table-1 (Appendix) shows categorization of the various journals/ articles on the basis of methodologies used, country and year-wise along with the focus of the study and contribution made by the research.

Figure 1 exhibits the description of methodology used by the researchers over a period of time. Out of 60 studies, 45 are based on empirical methodology constituting 75% of the total studies reviewed. Only 25% of the studies have used descriptive methodology.

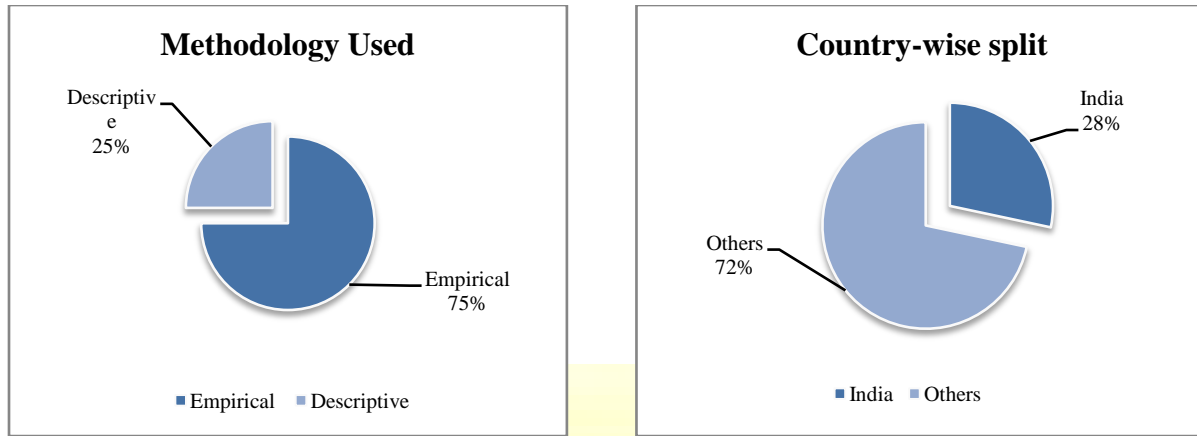
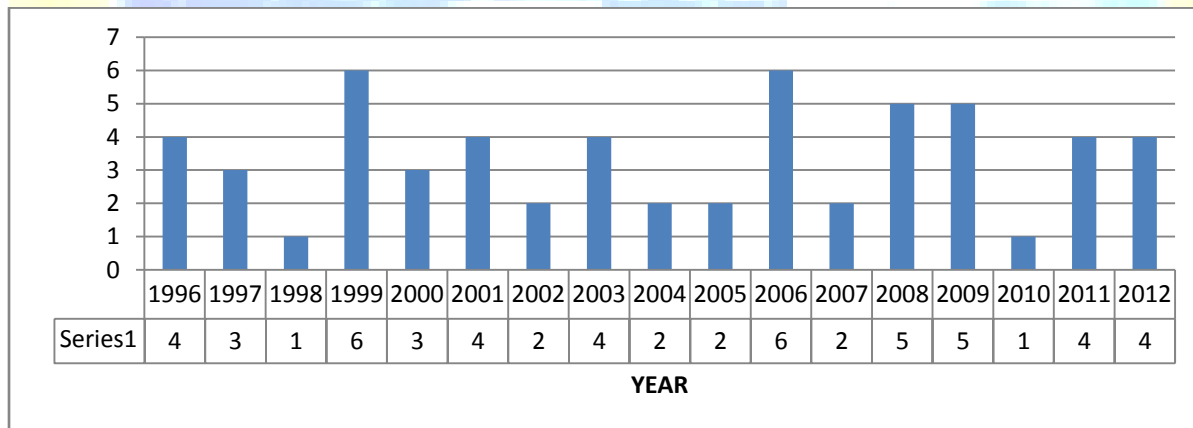


Figure 1: Methodology Used in various studies and Country-wise split

It also depicts that only 28% studies pertain to India and rest 72% belong to all other countries like USA, UK, Malaysia, Iran etc.

Chart 1 summarizes year-wise breakup of the studies conducted on EVA, which form scope of this paper.

Chart 1: Year-wise publication



Literature on EVA has been broadly classified into different themes- EVA as a performance measurement tool; EVA as a corporate philosophy; EVA and stock prices; EVA-MVA relationship; and EVA superiority over traditional performance measures. It is evident from chart 2 that majority of the research (22 out of 60) has been done on EVA as a performance measurement tool. The number of researches focusing on EVA and stock prices is 15 out of 60. There are 14 researches out of 60 which have established superiority of EVA over traditional performance measures. Only six studies have been found to be based on EVA as a corporate philosophy and the least focus is on EVA-MVA relationship. This justifies the need for more studies to be made on these and other related significant aspects of EVA.

Chart 2: Focus of the study

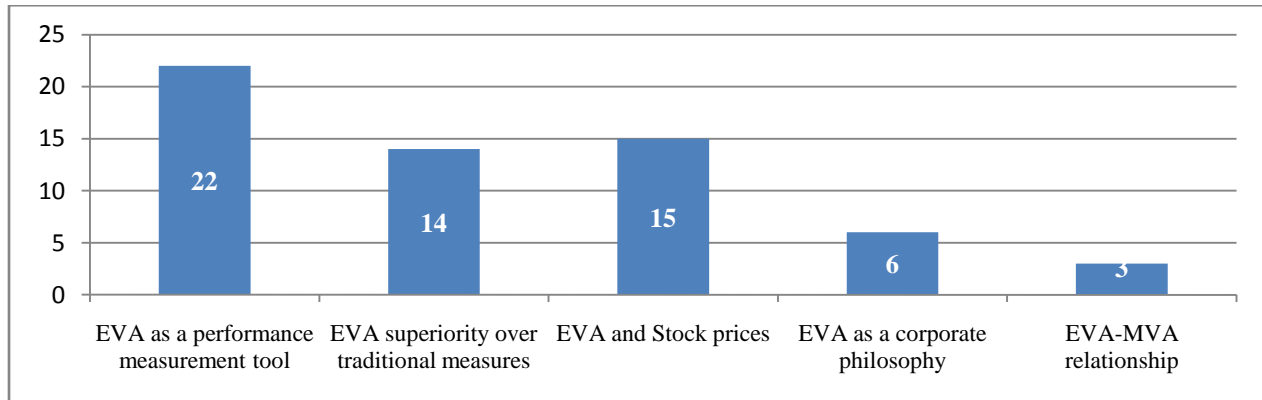
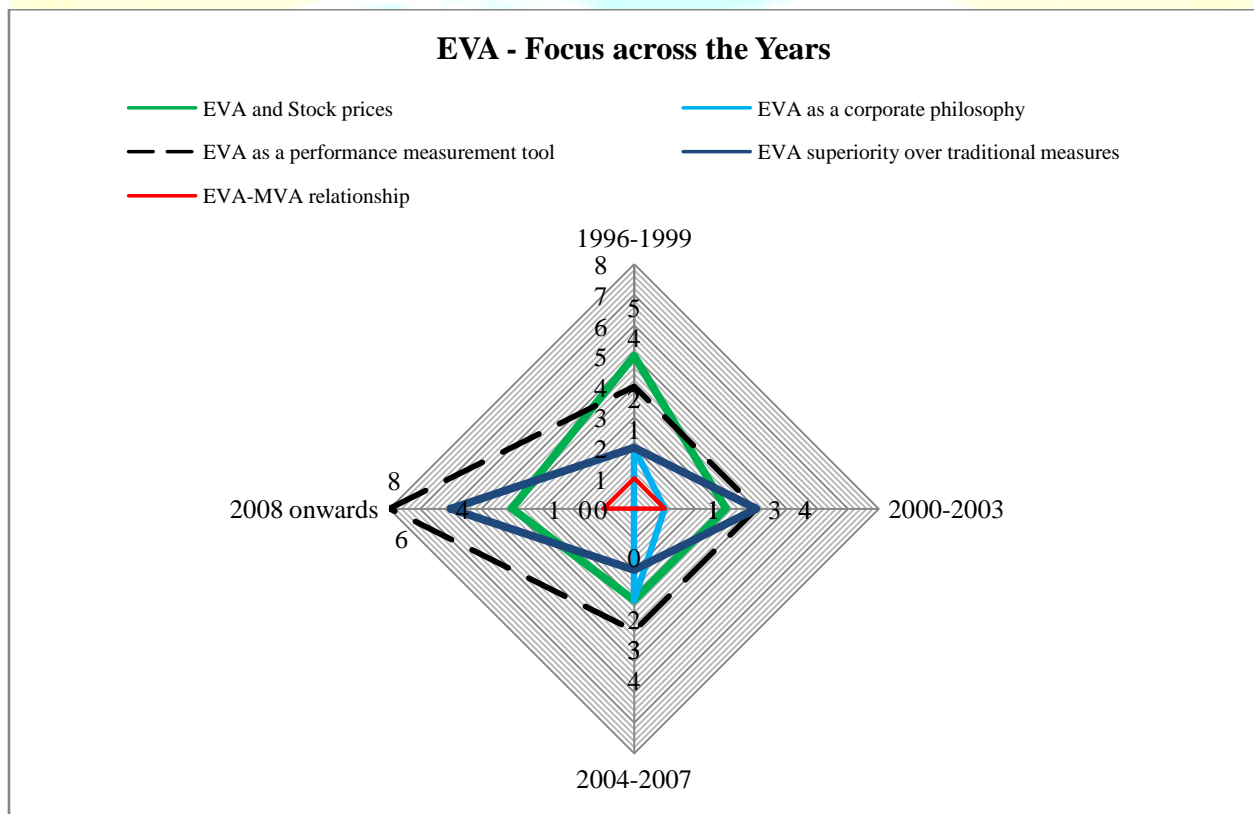


Chart 3: Focus of the study across the years



Further analysis of these studies across multiple years reveals that highest focus of the authors has always been on EVA being a performance measurement tool. Whereas, little focus is there for EVA & MVA relationship and EVA as corporate philosophy based articles.

The analysis of the available literature reveals that EVA as a corporate performance measurement tool is superior to the traditional measures of performance. There is a positive

correlation between EVA and the value of the firm. EVA has greater explanatory power for the market value of a firm than other traditional performance measures. However, there are certain studies concluding that an increase in EVA does not mean that the firm is creating value, as the shareholders' value creation has very little to do with EVA and it does not outperform other performance measurement tools. Further, the studies have also remarked that the implementation process of EVA involves complexity and inconsistencies. Also, EVA is suitable for capital intensive organizations as it is costly and not suitable for all types of organizations.

Various studies have been conducted to examine the correlation between EVA and stock prices. Most of the studies concluded that EVA is highly correlated with the stock prices of a company though traditional measures are not empirically less related to stock returns than return on EVA. However, there are some studies which do not support the claim that EVA provides better stock returns. It has been concluded that traditional performance measures outperform EVA, as stock returns are more closely related with RONW, ROCE and EPS. One of the studies has provided the evidence of strong correlation between EVA and MVA while the other study claims that the traditional measures have better correlation with MVA than EVA.

The studies conducted with a focus on EVA as a corporate philosophy revealed that EVA is positively and significantly related to incentive based compensation plans. EVA based compensation plans drive managers to employ a firm's assets more productively and efficiently. Using EVA, a company can establish a good risk management culture to create competitive advantage and improve shareholders' value. Also, EVA can be used to motivate employees and educate them to differentiate between value creating and destructing activities. However, some researchers claim that traditional performance measures are better than EVA not only to motivate managers to increase the corporate value but also for the compensation plans.

From the analysis of the literature reviewed, there arises a need to assess the importance of EVA as a corporate philosophy besides understanding the basic but relevant issues related to EVA.

Conclusions and Suggestions

In the present study, an attempt has been made to review the existing literature on the concept of EVA. As evident from the study, EVA has been recognized as a significant tool of corporate performance measurement. Still, the superiority of EVA over the traditional performance

measures is debatable. Although there is a plethora of research literature on EVA, most of the studies have been done for the corporate world of the developed countries especially USA. In India, very limited research has been done related to EVA. Majority of the studies, 75%, are empirical in nature while 25% are descriptive studies.

Most of the studies focus on the superiority of EVA over the traditional performance measures; and EVA and stock returns. But, there are many other relevant areas which need to be focused while studying the concept of EVA.

The most debatable aspect of EVA is its GAAP related adjustments. Stern Stewart has suggested 164 adjustments for the calculation of adjusted NOPAT while calculating EVA. There are some controversies regarding these adjustments. Some argue that removal of certain accruals through these adjustments decrease the informational value of EVA, instead of increasing.

Most of the studies provide sector specific evidence, especially in the manufacturing sector. In future, research can be done exploring how EVA can be applied in various other sectors like pharmaceuticals, banking, education, tourism etc.

The existing literature also reveals the research gap and it is felt that further detailed study is needed that specifically explores the extent of EVA usage, implementation issues, role of GAAP adjustments, reporting practices of companies in order to broaden the scope of the EVA concept.

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APPENDIX

Table 1: Available literature at a glance

S.No.	Author	year	Country	Methodology	Focus on EVA as	Contribution made
1	Vijayakumar A	2012	India	Empirical	performance measurement tool	EVA is a better predictor of market value of firm as compared to traditional measures.
2	Alam & Nizamuddin	2012	India	Descriptive	Superiority of EVA over traditional measures	managerial tool is stronger than others.
3	Anand, Garg & Arora	1999	India	Descriptive	performance measurement tool	EVA is a better measure of business performance in terms of shareholders' value creation & competitive advantage of a firm.
4	Asad, Naveed & Attatur-Rehman	2010	Pakistan	Empirical	EVA and Stock prices	EVA contributes negatively to stock returns as compared to other variables in Pakistan Stock Market.
5	Bacidore	1997		Empirical	EVA and Stock prices	EVA performs quite well in terms of its correlation with shareholders' value creation, but Revised Economic Value Added (REVA) is theoretically superior.
6	Bandyopadhyay&saha	2007	India	Empirical	corporate philosophy	Through EVA banks can establish a good risk management culture to create competitive advantage & improve shareholders' value.
7	Banerjee	1999	India	Empirical	Superiority of EVA over traditional measures	EVA is superior over traditional measures of performance.
8	Bao & Bao	1998	USA	Empirical	EVA superiority over traditional measures	EVA is a significant factor in market returns and its explanatory power is higher than that of accounting earnings.
9	Bhatnagar & Shekhar	2001	India	Empirical	Superiority of EVA over traditional measures	EVA is superior over traditional measures of performance.
10	Byrne	1996		Empirical	EVA and Stock prices	EVA has greater explanatory power for market value of a firm than other measures.
11	Chandra	2009	Bangladesh	Descriptive	performance measurement tool	EVA is stronger than traditional performance measures.
12	Chen & Dodd	1997	USA	Empirical	EVA and Stock prices	EVA is highly correlated with stock returns than other measures.
13	Evans	1999	Australia	Descriptive	corporate philosophy	EVA is positively & significantly related to incentive based compensation.
14	Ferguson	2005		Empirical	performance measurement tool	EVA is a reliable guide to the firm's value and can be used to have better predictions of future earnings.
15	Fernandez	2003	Spain	Empirical	performance measurement tool	Increase in EVA does not mean that firm is making value as the shareholders' value creation has very little to do with EVA.
16	Fraker	2006		Empirical	performance measurement tool	EVA is an important tool to measure and improve financial performance of the banks.
17	Gabriela, Caragea	2009	Romania	Descriptive	performance measurement tool	EVA is a better tool to measure performance of the banks.
18	Geyser & Lienbenberg	2003	South Africa	Empirical	performance measurement tool	EVA is a reliable indicator of growth in value of the enterprise in future (for Agri-business & Co-ops in South Africa).

19	Goldberg	1999		Descriptive	corporate philosophy	Residual income measures are better than EVA to motivate managers increase the corporate value & for compensation plans.
20	Grant	1996		Empirical	performance measurement tool	There is a positive correlation between EVA & the value of the firm.
21	Gregory & Ronald	2003	Alabama	Empirical	performance measurement tool	EVA better measures value creation in Farm Businesses than other measures.
22	Houque, Mahfuzul, Mahmuda & Chandra	2008	Dhaka	Empirical	Superiority of EVA over traditional measures	EVA is superior over traditional measures for small manufacturing companies.
23	Irala	2005	India	Descriptive	corporate philosophy	EVA based compensation plans drive managers employ a firm's assets more productively. EVA helps in reducing the difference in the interests of the managers & shareholders.
24	Ismail	2006		Empirical	EVA and Stock prices	Traditional measures outperform EVA in explaining stock returns.
25	Kaur & Narang	2009	India	Empirical	EVA and Stock prices	EVA influences the market value of shares.
26	Keef & Roush	2003		Empirical	EVA and Stock prices	There is no relationship between EVA & stock prices of a firm.
27	Keys, Mumin & Mackey	2001	USA	Descriptive	performance measurement tool	EVA is not better than other performance measurement tools. EVA process involves complexity and inconsistencies.
28	Kim	2009		Empirical	Superiority of EVA over traditional measures	REVA and MVA are more useful than traditional measures of performance.
29	Kramer & Pushner	2001	USA	Empirical	EVA-MVA relationship	Marginal cost of using proxy for MVA is not justified by any marginal benefits.
30	Kramer, Jonathan & George	1997	USA	Empirical	performance measurement tool	EVA is not better than other performance measurement tools. Market is more focused on the profit than EVA.
31	Kyriazis & Anastassis	2007	Greece	Empirical	Superiority of EVA over traditional measures	Net Operating Income is more valuable than EVA.
32	Lefkowitz	1999	USA	Empirical	EVA and Stock prices	EVA is better correlated with stock returns as compared to traditional performance measures.
33	Leh & Makhija	1996	USA	Empirical	EVA and Stock prices	EVA is highly correlated to stock returns.
34	Lin & Zhilin	2008	China	Empirical	performance measurement tool	Company's Capital structure, Profitability, Size, Growth ability, Management ability have a positive influence on EVA.
35	Maditinos, Sevic & Theriou	2006	Greece	Empirical	EVA and Stock prices	Stock returns are more closely associated with EPS than EVA.
36	Mehdi & Imam	2011	Iran	Empirical	Superiority of EVA over traditional measures	Traditional measures outperform EVA, as stock returns are more closely related with RONW, ROCE and EPS.
37	Milunovich & Tsuei	1996		Empirical	EVA-MVA relationship	EVA is better correlated with MVA than other measures in Computer industry.
38	Mishra & Kanwal	2008	India	Empirical	EVA and Stock prices	Use of EVA can boost the share prices by increasing NOPAT or by cutting down cost of capital.
39	Mishra & Kanwal	2008	India	Empirical	Superiority of EVA over traditional	EVA is the most significant variable, better than traditional measures in determining the share prices.

					measures	
40	Nazarieh	2000	Tehran	Empirical	Superiority of EVA over traditional measures	EVA is a better criterion in evaluating the effectiveness of non-metal mineral company's performance than EPS.
41	Noravash	2004		Empirical	performance measurement tool	EVA is a better criterion to predict operating profit and shareholders' value creation than other measures.
42	Palliam	2006		Empirical	Superiority of EVA over traditional measures	EVA is unreliable & questionable to deliver superior results than traditional measures.
43	Patel & Patel	2012	India	Empirical	EVA and Stock prices	EVA does not have any impact on share prices of Indian Private sector Banks.
44	Phani & Bhattacharya	2000	India	Descriptive	corporate philosophy	EVA can be used to motivate employees and educate them to differentiate between value creating and destructing activities.
45	Poll, Booyse, Pienaar & Buchner	2011	South Africa	Descriptive	performance measurement tool	EVA is suitable for capital intensive organisations. It is costly & not suitable for all types of organisations.
46	Rakshit	2006	India	Descriptive	corporate philosophy	Company can take appropriate decisions related to the choice of strategy, capital allocation & goal setting on the basis of EVA.
47	Reddy, Rajesh & Reddy	2011	India	Empirical	Superiority of EVA over traditional measures	EVA is best measure of shareholders' value creation (case study of HUL).
48	Salmi, Timo & Virtanen	2001		Empirical	EVA superiority over traditional measures	EVA is more unstable than traditional Return on Investment measure.
49	Samady, Khotanlu & Nooryan		Iran	Descriptive	performance measurement tool	EVA is a good performance measurement tool.
50	Swain, Mishra, Jaysimha & Vijayalakshmi	2002	India	Empirical	Superiority of EVA over traditional measures	EVA does not outperform other financial measures in Indian Pharmaceutical Industry.
51	Tebogo	2011	Botswana	Descriptive	performance measurement tool	EVA is superior to traditional measures of performance.
52	Turvey, Lake, Duren & Sparling	2000	Canada	Empirical	EVA and Stock prices	There is no relationship between EVA & stock market performance of Agriculture Business Firms.
53	Vakilian, Vadie & Husseini	2009		Empirical	performance measurement tool	There is no significant relationship between EVA and EPS. Residual Income is better than EVA to evaluate firm's performance.
54	Verma	2002	India	Empirical	EVA and Stock prices	EVA, a better tool to measure Indian Banks' performance, should be used to enhance stock prices by maximising shareholders' value.
55	Walker	1999		Descriptive	performance measurement tool	EVA is a mean to represent that capital is efficiently and effectively allocated in the firm.
56	Wet	2008		Empirical	EVA-MVA relationship	EVA is more correlated with MVA than other variables.
57	Wood			Descriptive	performance measurement tool	EVA is more than just an internal business performance measure or a basis for determining incentive pay.
58	Worthington & West	2004	Australia	Empirical	EVA and Stock prices	Stock returns are more closely associated with EVA than traditional performance measures.

59	Yahaya, Mat Kila & Mahmood	2006	Malaysia	Empirical	performance measurement tool	Positive EVA enhances shareholders' value & vice-versa in Real Estate Corporations in Malaysia.
60	Zabiulla	2012	India	Empirical	performance measurement tool	EVA better represents market value of firm as compared to traditional measures.

Source: compiled by Author

