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Corporate Governance through the EVA Tool: A Good Corporate Performance Driver

Twinkle Prusty

Associate Professor; Faculty of Commerce Banaras Hindu University Varanasi-221005, India

Abstract

The appraisal of the effect of Corporate Governance (CG) to the performance of the firm measured by Economic Value Added (EVA), is the essence of the study from the gaining importance of motivating managers' i.e. enabling good governance for getting rid of destructive activities and investing in those projects that are expected to enhance shareholder value. The implications of the practices of corporate governance on the economic value added, of the sample companies are being explored and assessed to find out whether its conformance will improve corporate performance enthused by valuation reporting, EVA, which is important for investment decision making and consistent internal governance. It necessitates establishing whether the components of corporate governance viz., equitable treatment of shareholders, transparency and disclosure influences the economic value added, an superior performance metric, by raising the consciousness of their relationship thereby, without relying on the bland accounting results flaunted by the corporate.

Keywords: corporate governance, economic value added, value creation

Introduction

Good corporate performance is very much intertwined in good corporate governance which shall ultimately maximize long-term shareholder value in a more ethical manner by ensuring fairness, transparency, integrity and accountability of the management. A well-performed corporate implies well-functioning and well-managed governance principles which leads to corporate excellence in all productive, economic and social pursuits. In the globalized business environment, when companies are driven by market forces and competitive pressures, they are mainly judged by enthused investors with the help of financial indicators namely profits, earning per share, market value per share etc. Moreover, good corporate governance practices as measured by creating enormous wealth through the EVA (Economic Value Added) tool have an impact on the company's trust, credibility and reputation and hence, the ethical dimensions of a company's operations would be reflected by the inclination and incentive to pursue such governance practices. As proclaimed by the Kumar Mangalam Birla Committee Report (2000), it is imperative for the companies to maximize the shareholder's value and wealth. Thus, the quintessence of corporate governance lies in considering the financial aspect, apart from fulfilling the accountability aspect, implying the company as a performing asset. It is required that to achieve the wealth creation function as the objective, the companies must perform within an economic framework that keeps the management accountable for their actions. Many companies try to adopt better corporate governance practices as a way to improve economic dynamism and thus enhance overall economic performance.

Corresponding author's

Email address: *twinkle.prusty@gmail.com*

This paper further dwells upon the following aspects of corporate performance in terms of creation of shareholders wealth as well as managing for a higher stock price:

- Using the EVA tool, as a measure of good corporate performance.
- The superior dimensions of the EVA tool over the traditional measures.
- Some related studies with the observations on the usefulness of EVA, towards value creation.
- Some Indian Corporate Philosophy on EVA Approach.
- Some limitations on using the EVA tool, as a performance measure.
- EVA: Setting up a good corporate governance system.

EVA: A measure of good corporate performance:

Economic value added is a financial measure that gives the true economic profit produced by the company and thus has a direct link with the creation of shareholders' wealth over time. The concept was derived from the work done in 1961 by the Nobel Prize winner economist Franco Modigliani and Merton Miller, formalized by the consultancy firm Stern Stewart(2001) and followed by the accounting firm KPMG International(2004) which has recently won international acceptance as the standard of corporate governance and performance for the reason that business organizations has made a paradigm shift in their focus from `managing earnings' to `managing value' for the shareholders i.e. from EPS/ROE to EVA. Thus the measure of EVA is made in terms of the residual income meaning that, it is the true economic profit calculated as net operating profit after tax minus a charge for the opportunity cost of the capital invested. The calculation of EVA is made as follows:

Net Sales

Operating Expenses

Operating Profit (EBIT)

Taxes

Net operating profit after tax (NOPAT)

Capital charges (Invested capital x cost of capital)

Economic value added (EVA)

From the above formula in the EVA calculation, it can be observed that unlike the accounting profit, expressed as EBIT, Net Income and EPS, which measures only the profitability, EVA on the other hand, overcomes this stage of illusion by explicitly recognizing that the company employing the shareholders capital must bear a charge for the inherent risk that is borne by the later in the process of profit generation by the former. Thus, it has been realized that EVA is a sophisticated tool which produces highly accurate estimates of both capital used and a firms true cost of capital. Unlike the traditional measures like EPS or ROE, the advantage of using EVA is that the decisions can be clearly modeled, monitored and communicated by way of value added to the shareholder's investment.

This exerts pressure on the movement of the corporate governance ideals giving impact on overall economic performance, market integrity and the incentives that it creates for market participants and the promotion of transparent and effluent markets.

EVA as mentioned by Maurya (2004), is based on the shareholder’s approach that is concerned with maximizing the wealth of customers, employees, suppliers, society and also the shareholders. The framework of EVA has better reflected value and profitability which can withstand the challenge from the increasing efficient capital markets and owners. As since today industry is shifting from the product centric world of the past to a value centric world of the future, the need of using EVA has got wide acceptance as a key indicator of corporate performance.

According to Hax and Majluf (1984). “It is economic and not accounting profitability, that determines the capability of wealth creation on the part of the firm. It is perfectly possible that a company is in the black, and yet its market value is way below its book value, which means that, from economic point of view, its resources would be more profitable if deployed in an alternative investment of similar risk".

Thus, the Economic Value Added, if adopted as a corporate philosophy can be very useful in improving productivity of a firm measured in terms of creation of shareholder's wealth. This approach of corporate philosophy results in goal congruence and channelizes all efforts of the management and employees towards a common goal. Over the years, the management experts and consultants have been advocating many tools and techniques such as Management Information System (MIS), Business Process Reengineering (BPR), and Enterprise Resource Planning (ERP) etc for improving productivity in physical terms but these tools have failed to distinguish between value creating and value destroying activities because they do not measure the economic surplus being generated by different activities.

Hence, the successful implementation of these tools and techniques across the firm is a long drawn process and the possibility of success has not been very high. In contrast, EVA when used as a tool to measure corporate performance helps to improve the business literacy in understanding the value enhancing capacity of any activity by getting return more than the cost of capital employed for that activity. The one component consideration of the cost of capital sets EVA apart from the other tools and techniques and thereby helps in building the EVA culture in an organization. It can aptly be realized that the use of EVA improves the financial corporate governance as it motivates a manager to get rid of the value destroying activities and to invest only in those projects that are expected to enhance the shareholder value.

From the sample test conducted for 154 companies of India and database obtained from CMIE's prowess during the period 2007-08 to 2011-2012, the following analysis has been made.

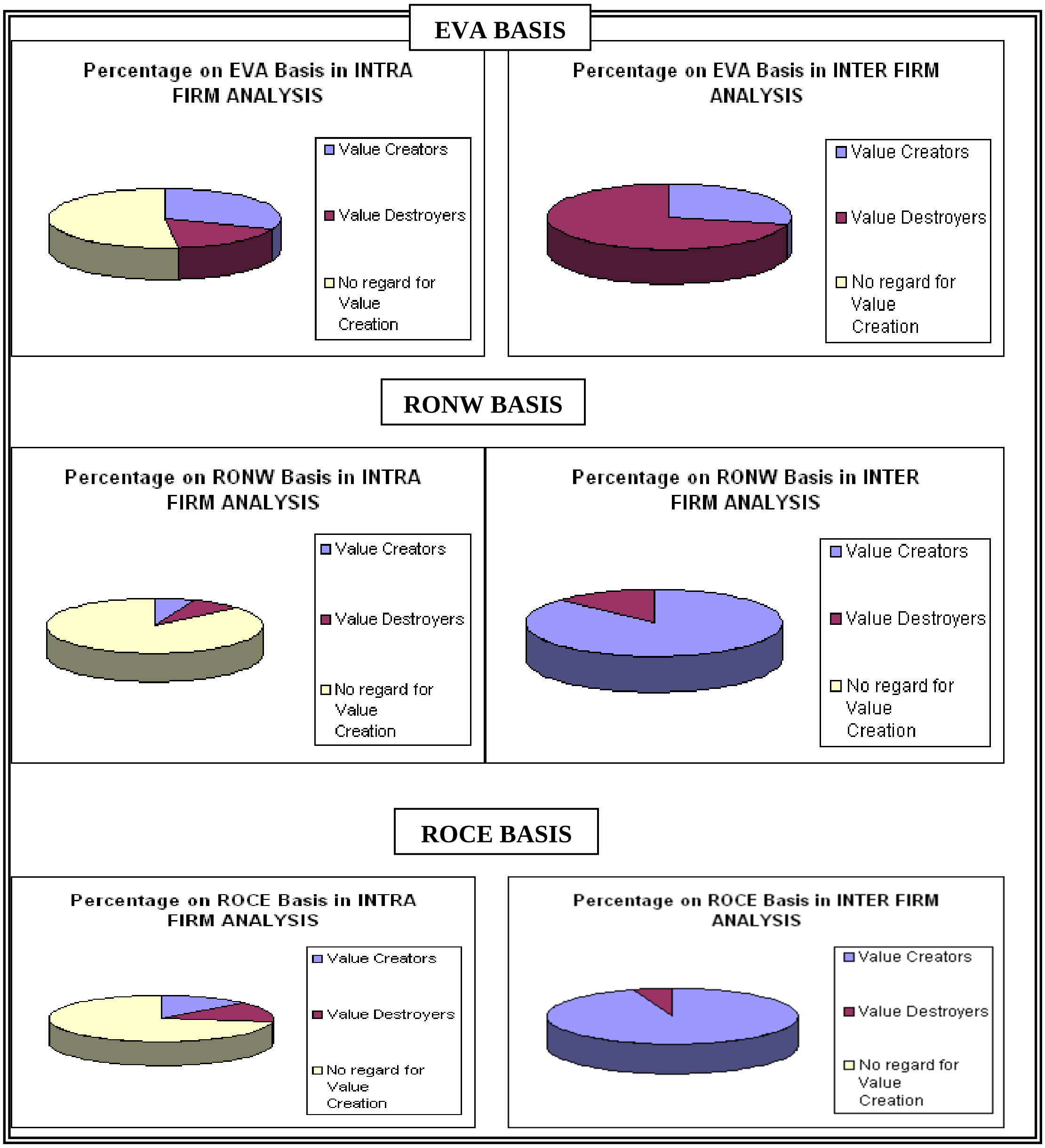
On the basis of EVA it was found that only 31% representing 47 nos. of companies resulted in value addition with the increasing trend. Out of the remaining 69%, 17% i.e. 27 nos. of sample companies destroyed value to shareholders in five years while the balance 52% i.e. 80 companies had no regard for value addition. While inter-firm analysis carried on with average yearly computed values of EVA revealed value in case of 71%, i.e. 110 nos. of companies and only 29% i.e. 44 nos. of companies gained values for their shareholders.

On the basis of RONW (Intra-firm), only 6% representing 9 nos. of companies showed increasing trend of value and out of the remaining 94%, 8% i.e. 13 nos. of companies failed to create value to shareholders and the balance 86% i.e. 132 nos. gave no regard for value addition. While the results of inter-firm analysis showed 87% i.e. 134 nos. of companies added value for their shareholders indicating that these are profitable ones over the study period. Only 13% i.e. 20 nos. of companies resulted in value destruction.

On the basis of ROCE, only 13% representing 20 nos. of companies revealed value addition over the study period and out of the remaining 87%, 14% representing 12 nos. of companies failed to add value to shareholder's wealth and balance 73% i.e. 112 nos. had no regard for value addition. The inter-firm analysis showed (ROCE), 95% i.e. 147 nos. Of companies added value over the study period and just 5% i.e. 7 nos. of sample companies resulted in value erosion.

EVA basis is superior in terms of examining shareholders' value addition as compared to RONW & ROCE and also indicates that more profits don't necessarily create more economic value added.

Sample test conducted for 154 companies in India during the period 2007-08 to 2011-12



Source: CMIE's Prowess database

The superior dimensions of the EVA tool over the traditional measures

Although the traditional profit based performance measures such as ROI, EPS, NPV, IRR etc have dominated the area of corporate financial performance measurement but their utility as true indicators of corporate financial performance or as facilitators of shareholder's value creation can hardly achieve success and has proved futile in the corporate value system.

Many researchers and writers have also recognized the superiority of EVA over the traditional performance measures like Stern (1997) & Stewart (2003), Rappaport (1999), Teitelbaum (1997), Bacidore (1997), Banerjee & Jain (1999) etc and placed the EVA tool in new heights as a motivational, compensation-based management system facilitating economic activity and accountability in the performance based management system. Thus, EVA can be considered to be superior to accounting profits as a measure of value creation that can be targeted to be maximized for better results while the traditional measures do not work in such a way.

The several benefits of using EVA over the traditional measures are:

i) The measure of profitability with EPS is susceptible to manipulations in accounting or reported earnings.
ii) The EPS measure can be made up to reflect the financial statements in such a manner as to enhance the company's reputation in the short run and play accounting or management game for the purpose of enabling restructuring, mergers and acquisitions.
iii) The present value of all the future cash flows expected to be earned from any financial asset is ignored in the calculation of reported earnings while in this regard, EVA has been an efficient tool in bearing a dramatically higher correlation to stock price change.
iv) The consideration of the cost of capital which entails the calculation of economic profit has very strong underpinnings in the practice of business ethics as it manages the value creation.
v) The measure of EVA is not constrained by the generally accepted accounting principles (GAAP) which otherwise have impact on EPS with any voluntary adjustments.
vi) The value creation from intangible assets have gained momentum with the onset of knowledge capital which do not appear as positive asset values on financial statements and hence the traditional measures EPS or ROE does not represent them in a meaningful format.
vii) The use of EVA enables to measure value and performance by alignment of the interest of managers and shareholders and thus the managers are more inclined in maximizing shareholder's wealth which is ultimately their goals too.
viii) The resultant effect of measuring value by EPS is that neither business risks nor financial risks are accounted for in annual accounts by which returns cannot be judged unless it, be commensurate with the level of risks and gives unreliable indicator of corporate value.
ix) Furthermore, investment considerations as well as dividend policy matters are excluded in the valuation of EPS which makes the measurement criteria unreliable for determining the economic value of the firms.
x) EVA can be perceived as an important contribution to modern business conscience as it measures the true economic profit that is greater than its cost of capital and indicates whether the enterprise is creating wealth or destroying it. While, on the other hand, EPS gives regard to the return on income after tax only, which doesn't give a true picture of value creation, as in reality the enterprise having a negative EVA may provide the managers more inclination to remain static and not reap better performance in removing any deficiency.
xi) EVA could better assess decisions that affect balance sheet and income statement or tradeoffs between each by charging capital cost against NOPAT.
xii) The need for the increase of EVA has been a useful guide for both strategic and operational decisions by which the knowledge along with the use of capital and assets could efficiently and effectively be made.
xiii) The EVA tool helps to integrate the planning and control functions within an organization.
xiv) EVA works as a powerful decision making tool on a long term perspective as well as links performance to value creation or value destruction in an objective way.

The arguments in favor of the above contentions have also been propounded by various academic researchers like Drucker & Peter (1995), Bowen (1997), Chandra & Dyal (1999), Booth (1997) and Chen & Dodd (1996) through various literatures. Thus the utility of EVA simply does not en by indicating the degree of wealth creation but it also helps the management to assess the likely impact of competing strategies on shareholders wealth with the help of other effective tools like Real Option Analysis, Balanced Score Card, Activity Based Costing etc, thereby earmarked as the best corporate governance system.

Table 1: The level of profitability and value creation-a comparison

Companies	ONGC	RIL	IOC	HLL	VSNL	MTNL	ITC	GAS	WIPRO	BPCL
NOPAT (Rs in crores) in year 2011-12	6198	3243	2885	1640	1407	1301	1190	1186	866	850
EVA (Rs. In crores) in year 2011-12	17	-318	355	1003	339	1089	591	180	235	139

Source: Reports and annual accounts of various companies

Review of related studies

Studies regarding the usefulness of EVA towards value creation and the corporate performances have been summarized as below.

- Bacidore (1997) observed that EVA performs quite well in terms of its correlation with shareholder value creation while the Refined EVA (REVA) is a theoretically superior measure for assessing the firms operating performance.
- Nicholas (2000) observed that EVA is more than just an internal business performance measure or a basis for determining incentive pay.
- Salmi *et al.* (2001) evaluated and compared EVA with the traditional profitability measures within a controlled simulation framework.
- Stern (1997) observed that EVA is the financial performance measure that comes closer than any other to capture the true economic profit of an enterprise.
- Mayfield (1997) observed that the shareholder value is enhanced by investing in all those projects which give a positive NPV and by harvesting all those existing products and projects whose return on capital is less than encouraging management and employees to create long term value.
- Booth (1997) observed that economic profit should be a part of company's performance measurement framework.
- Teitelbaum (1997) observed that EVA is a performance measure, an analytical tool and a management discipline.
- Bhattacharya and Phani (2000) observed that EVA is a superior performance measure both for corporate reporting in U.S.A and other advanced economies.

The Indian corporate philosophy on EVA approach

The companies that adopt the EVA tool by identifying it as a measure of performance to relate to value creation and that the managers can directly observe and see the influence of their actions over it. In operational terms, the companies focus on the measurement and maximization of EVA for shareholder value creation which is considered to be more relevant rather than the conventional measures such as earnings capitalization, market capitalization and present value of estimated future cash flows.

Oil and Natural Gas Corporation: Value creation (by EVA) can be achieved through the focused internal efficiencies.

- The Coca Cola Co.: Business managers need to increase shareholder value through EVA only.
- Indian Oil Corporation: EVA methodology can cultivate high standards of business ethics and Total Quality Management for a strong corporate identity and brand equity.
- AT & T Corp.: EVA, the lead indicator of a performance measurement system gives humane value added and customer value added.

- IBM: Outsourcing IT often lead to short-term increases in EVA – by a study with Stern Stewart.
- Wipro: Value drivers necessary for global talent markets and global products.
- Infosys: Value creation is greater than what is received from customers – EVA, an efficient measurement tool for achieving excellence.
- Marico: Consideration of capital is very essential to know value creation.
- TCS: EVA'S link to compensation is important and has been implemented.
- Godrej: EVA's used as structural performance-linked variable remuneration along with, as a financial tool.
- Dr. Reddy's Laboratories: EVA used as a criteria to grant rewards such as variable pay, stock options and performance bonuses.
- HLL : EVA, need to measure the performance of each of its divisions

Source: From the financial reports of the above companies

Table 2: Indian company's response to EVA in the year 2011 & 2012

Year	HLL	ITC	Dr. Reddy's Lab	Infosys	Wipro	Nestle India	CIPLA	Satyam Comp. Services	Ranbaxy Lab	RIL
2011 (Rs. In Crores)	765	420	36	224	111	69	43	160	-97	328
2012 (Rs. In Crores)	1003	591	350	242	235	100	71	33	-94	-318

Source: Reports and annual accounts of the various companies

Limitations on using EVA tool as a financial performance measures

1. The inconsistency in adopting the methodology to compute the cost of capital to report on EVA and the various related assumptions may not be useful to compare the performance with the other companies.

2. The use of EVA has been used very casually for external reporting purposes only.
3. The information on EVA approach in terms of shareholder value creation does not form part of the annual reports which are audited; rather they are reflected as the unaudited additional information that is given to the shareholders.
4. The use of EVA alone may not explain appropriately the changes in a firm's value under the conditions of value depending on future expected cash flows.
5. EVA based on historic cost data may be distorted due to inflation to estimate the actual profitability.
6. EVA which is dependent on the cost of capital calculations favors large firms but low return investments.
7. EVA could be artificially low in case of new assets where depreciation is charged to lower the profits and the vice versa.

In this regard, the noted researchers and academicians like Chandra and Dyal (1999), Chen & Dodd (1996), Biddle *et al.*, (1997), Mayfield (1997) and O'Hanlon & Peasnell (1996) have also observed that EVA is not a complete performance measure due to some of the aforementioned limitations in its adoption and thus may not prevent the managers from engaging in dysfunctional behavior. However, like other financial measures, the limitations that are observed could be minimized by supplementing EVA with other measures and efforts of the top management is indispensable to empower the lower level managers and employees in implementing such a valuable long term vibrant measure which can actually add value to the corporate shareholder wealth.

EVA: Setting up of a good corporate governance system

The creation of value, as understood by the Global ethical business people is in regard to create value through integrated and sustainable relationships with the primary corporate constituencies of shareholders, lenders, customers, employees, suppliers and the communities in which the firm does business. The value created many not always reflect in financial statements, as they may also be from the non-financial assets and it is to be realized by the companies as an integral part of fully understanding the performance of their business. Companies are under pressure from the investors to report all the value drivers of their performances which includes the various intangibles too, such as the intellectual capital, requiring transparency in their measuring and reporting also. Much of the discussions about value creation through already existing corporate governance standards with well-developed regulatory and financial reporting framework couldn't hold back the American and London corporate by an unprecedented string of corporate collapses from early to recent times – Maxwell, BCCI and Polypeck in UK and followed after 20 years are Worldcom, Xerox, Enron, to name a few.

Hence, the genesis of corporate governance must be imbedded in a free market economy and excessive governmental regulations sticking to the structural form impedes the value creation process and always leads to unethical corporate practices.

There is so much of widespread of the values of corporate governance that can increase the business's market capitalization, but hardly there is increase in the number of corporate who look upon their performance as a form of worship by dedicating it to their inner Hi C (Higher Consciousness) and allowing it to act through them and letting the overall handling of economic value added to begin and to improve. If only more corporate could accept the economic truth of value creation, and carry this knowledge from their inception, then the people of the world could finally be at peace with one another and no business will ever be condemned to Hell.

The spirit of demonstrating the best practices of corporate governance will be awakened only by realizing the measureless benefits that is manifested in the primary mission of creating value and providing service to others. This requires the heart energy to understand the acute seriousness for the economic and social transformation and strive for corporate excellence. Wherever corporate live or work, they can make a difference and hence it is up to each of their corporate management to accept this fact and act accordingly as the corporate values are directed from within only when they seek guidance from their self. Thus, the ultimate truth underlying in the principles of corporate governance is the sheer regulation of the self and the conscience to attain highest satisfaction and value while creating value with satisfaction for others i.e. for those whose precious resources are employed that could be used elsewhere in a better way.

Conclusion

The study has observed that good corporate governance will improve corporate performance by adopting EVA reporting which is important for investment decision making and internal governance. It necessitates establishing whether the components of corporate governance viz., equitable treatment of shareholders, transparency and disclosure influences the economic value added for consistent internal governance and value creating of companies. It calls for a professional exercise by the corporate to make considerable progress in raising awareness of the value of good corporate governance by way of establishing relationship between corporate governance and economic value added, an superior performance metric of reporting the shareholder's value creation. It shall also focus on the importance of corporate governance in the economic framework for shareholder's wealth creation and whether the route to achieve excellence by the corporate have been tailored in the best practices of corporate governance of which EVA is the perfect measurement tool and an integrated management philosophy.

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