ECONOMIC VALUE ADDED: A FINANCIAL FLEXIBILITY TOOL

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Abstract

With increased emphasis on shareholder value addition, there has been an ongoing debate on choosing the right measure of corporate financial performance. There is need for a single measure of financial performance that not only measures corporate financial performance but also works as a financial flexibility tool. The financial performance measure employed by the firm measures the value generated by the firm. This necessitates the firms to choose the right performance tool which can reflect the accurate value added by the firm. We study the role and implications of Economic Value Added as a financial performance measure and further discuss its applicability as a tool for introducing financial flexibility. Flexibility is assessed by measuring the impact of organization's competitiveness and performance. The findings reveal that EVA as a tool enables the corporate to differentiate between value-creating and value-destructing activities and helps managers in taking right decisions which enhances shareholder value. Thus, finally the research makes a case for managers to use EVA as a tool to provide additional information to investors. Interestingly, EVA can also be adapted as a corporate philosophy for motivating and educating employees.

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Introduction

Bahrami (1992) defines flexibility as "a multi-dimensional concept demanding agility and versatility; associated with change, innovation and novelty; coupled with robustness and resilience, implying stability, sustainable advantage and capabilities that may evolve over time". The importance of flexibility in financial management is emphasized by researchers (e.g. Gupta, 1983) as it provides freedom of choice of measures, methods and reporting requirements (Jain and Sushil, 2000).Financial statements such as balance sheet of a company reports the assets and liabilities of the company, reflecting firm's flexibility in terms of fund raising and application for business.

The financial performance measure employed by the firm measures the value generated by the firm for its stakeholders. The right choice of measure is critical and reflects the true value added by the firm. On the contrary, the faulty choice of measure might lead to misleading or inaccurate results (Maditionos et al., 2006).This necessitates a performance measure which goes beyond measuring company's progress, facilitate managers in achieving strategic goals, take correct decisions that increase shareholder's value, motivate employees, guide investors and can reflect market's assessment of company's value (Shah and Rao, 2014). Economic Value Added (henceforth EVA) can be adopted as an integrated financial management tool facilitating better decision making in the long run at all levels, leading to change in management and enhanced firm value (Stern, 1996). EVA is claimed to approximate shareholders' value and has been widely adopted, and hence has been drawing considerable academic and practitioner's interest.

Alfred Marshall (1890) pioneered the notion of economic profit, expressed in terms of real profits besides various operating cost and cost of invested capital. Later in 1991, New York based management consultancy firm Stern Stewart & Co. coined and popularized the concept of EVA. According to them "EVA is the most accurate measure of the economic performance of the company". It attempts to resolve the need for a performance measure that is highly correlated with shareholder wealth and responsive to the actions of the company's managers. Drucker (1995) opines that EVA captures true economic profit and is a vital financial measure reflecting all the facets of enhancing value. EVA is based on the meaning of economic profit taking into consideration the cost of invested capital (Equity and debt) which was absent in the traditional approach (Kyriaziz and Anastassis,

2007). EVA is the financial performance measure that most accurately reflects the company's true profit (Stewart, 1991). Drucker (1995) suggests that EVA's rising attractiveness reflects, among other things the demand for total factor productivity in the contemporary information age. Further Herzberg (1998) reinforced that EVA model focuses on continuous wealth creation instead of wealth distribution (using dividend discount approach).

This paper views EVA from the lens of flexibility in various dimensions and builds a business case for adopting EVA as a powerful tool by the organization. Superiority of EVA is explained in relation to enhancing flexibility in organization. The paper is organized as follows: section I briefly discusses the EVA perspective. Section 2 builds on the various dimensions of flexibility and related research in the area. The third section sets the linkage between EVA and flexibility. Further it discusses the impact of adoption of EVA in enhancing internal and external flexibility of organization. Section 4 concludes with some suggestions on the way forward.

The EVA Perspective

EVA is defined as the surplus available after applying an appropriate charge for the capital employed in the business. EVA is net operating profit after tax (henceforth, NOPAT) adjusted by an appropriate charge for the opportunity cost of all the capital invested in a company; hence it represents profit after tax that exceeds the required minimum return on capital (Shah and Rao, 2014). EVA is calculated after deducting the cost of equity capital and debt from the operating profit. Estimation of EVA involves conversion of accounting profits by adjusting various items in the financial statements. Stern Stewart and Company has suggested 164 adjustments. EVA differs from accounting profits as it adjusts the accounting figures to remove possible distortions caused by generally accepted accounting principles (GAAP) (Stewart 1994, Young and O' Byrne, 2001).

EVA over the years has gained popularity as a reliable measure of corporate performance. In the later years, the concept has received recognition and support from various corporate houses which adopted it as an internal control measure. The selling point of EVA is that it considers economic profit and economic capital in order to know the value created and destroyed by an organization during a particular period. Economic profit and economic capital is calculated by making certain adjustments into the accounting profits. Several United States listed companies like AT and T, Coca Cola, Eli Lilly, Georgia Pacific, Polaroid, Quaker Oats, Sprint, Teledyne and Tenneco have adopted EVA as performance measurement and/or incentive compensation system. These companies experienced considerable enhanced shareholder's wealth. Their developing peers also started adopting EVA to measure financial performance and shareholder value enhancement. Indian companies like Tata Consultancy Services, Infosys Technologies Ltd., Hindustan Unilever Ltd., Dr. Reddy's Laboratories Ltd., Godrej Industries Ltd., and Hero Honda Motors Ltd. extensively base their decisions using the value added measure.

EVA is now considered as a contemporary tool in financial management that has been developed throughout the course of the 20th century by distinguished economists, managers and researchers. EVA is based on the meaning of economic profit taking into consideration the cost of invested capital (equity and debt) which was lacking in the traditional approach (kyriazi and Anastassis, 2007). There is almost settled opinion that EVA is a better measure of market value of the companies as compared to traditional accounting measures (see Stewart, 1991; Grant, 1996; Lehn and Makhija, 1996; Milunovich and Tseui, 1996; O' Byrne, 1996; Uyemura et al., 1996; Kramer and Peters, 2001; De Wet and Hall, 2004; Kim, 2006; Lee and Kim, 2009).

Studies conclude that EVA can provide a valuable measure of wealth creation and can be used to help align managerial decision making with firm preferences (Brewer et al., 1999; Irala 2005). Performance of companies adopting EVA as a base for executive compensation has significantly increased (Stern, 1990; Burkette and Headley, 1997; Todd, 1997; Riceman et al., 2000; Malmi and Ikaheimo, 2003; Lin and Zhilin, 2008). Robertson and Batsakis (1999) found that investors respond favorably to the adoption of an EVA-based compensation plan, and a follow-on effect would be that investors view increase in EVA more favorably than improvements in traditional accounting based performance measures. Durant (1999) describe that EVA is both a measure of value and also a measure of performance. A sustained increase in EVA will bring an increase in the market value of the company. Phani and Bhattacharya (2000) discuss that EVA can be adopted as a corporate philosophy for motivating and educating employees to differentiate between value creating and value destructing activities to direct all efforts in creating shareholder value. Girotra and Yadav (2001) opined that EVA encourages managers to think like owners and, in the process, may impel them to strive for better performance. Sharma et al., (2007) conclude that EVA does not only serve as a good proxy as a valuation of intellectual capital, but can be further used as an objective measure for knowledge management initiatives.

Owing to the deficiency of GAAP in describing a company's real financial position (Clinton and Chen, 1998), Stewart proposes up to 164 adjustments to regain the real picture of a firm's financial performance (Stewart, 1991; Blair, 1997). These adjustments are needed to eliminate financing distortions in a company's NOPAT and capital (e.g.

some accounting items such as costs for research and product development, restructuring charges, and marketing outlays are considered more as capital investments as opposed to expenses) (Stewart, 1991). Consisting of some 120 to 150 possible adjustments, these changes are made on the basis of both empirical and theoretical concerns. First, it is argued that adjustments to accounting numbers are required in order "…to achieve higher correlations between the short term measure (in this case EVA), and share prices, which in turn can lead to more congruent goals for divisional managers and shareholders as well as a more reliable indicator of corporate performance for security analysts and portfolio managers" (Young, 1999). Second, at its root is the argument that not only are accounting earnings an inappropriate proxy for value creation, but that managers who are evaluated and compensated on the basis of earnings "…may take actions that increase earnings but destroy value, or fail to take actions that may reduce earnings but create value" (Young, 1999). He concludes that EVA figure is closer to cash flows and therefore less subject to the distortions of accrual accounting; removing the arbitrary distinction between investments in tangible assets, which are capitalized, and intangible assets, which tend to be written off as incurred; bring off-balance sheet debt into the balance sheets and correct biases caused by accounting depreciation. In most cases, however, not all of these (150-160) adjustments are relevant and only a small number will be performed. For an average firm about 25 adjustments are normally considered, while as few as five to ten are usually implemented (Stewart, 1994; Stern et al., 1995).

Academic researchers have argued for the following benefits of employing EVA:

- Goal congruence of managerial and shareholder goals achieved by tying compensation of managers and other employees to EVA measures (Dierks and Patel, 1997);
- Better goal congruence than ROI (Brewer et al., 1999);
- Annual performance measure tied to executive compensation;
- Provision of correct incentives for capital allocations (Booth, 1997);
- Long-term performance is not compromised in favor of short-term results (Booth, 1997).

Provision of significant information value beyond traditional accounting measures of EPS, ROA and ROE (Chen and Dodd, 1997).

Flexibility Perspective

Flexibility is defined by Volberda (1996) as "Flexibility is the degree to which an organization has a variety of managerial capabilities and the speed at which they can be activated, to increase the control capacity of management and improve the controllability of the organization". Thus he looks at flexibility as the interface of two paradox variables namely organization task and managerial task. Key issue related to flexibility is its dimension to impact organizational competitiveness and performance (Sharma et al., 2010). Organizations face both internal and external environment and the associated flexibility also have dimension of internal and external flexibility (Shushil, 2010). Krupski (2006) highlights the two facet character of flexibility as the speed of response and the extent of acclimatization in every constituent of the organization jointly and individually. Flexibility can be seen from the perspective of adaptability, speed, environment, functions, location and strategy.

1. Organizational: Ansoff (1988) divides flexibility as internal flexibility and external flexibility.

2. Adaptability and speed: Jan Eppink (1978) and Krupski (2005) look at flexibility from the lens of adaptability and speed and group it as adaptive, passive, reactive and proactive flexibility.

3. Functions and location: Volberda(1997) discusses on operational, structural and strategic flexibility.

Introduction of newer management concepts like knowledge management, process management, TQM, lean management, organizational leaning and virtual organization in contemporary management style has enhanced the role of flexibility (Ziebicki, 2010). A flexible organization draws its strength from its ability to be conversant with the changes in the environment and to develop at the greater speed than its competitors, to respond quickly to customer feedback and expectations by greatly empowered personnel through faster decision making processes in horizontal organization structure (Brilman, 2002).

Flexibility is multifaceted and we consider two determinants namely organizational flexibility and financial flexibility. Organizational flexibility relates to the organization's ability to face internal and external environment (i.e.)internal and external flexibility. Internal and external flexibility help organizations to cope with unforeseen contingencies and thus bring in inherent stability. Excess of flexibility or lack of flexibility both causes instability. Leeuw et al., (1996) refers to flexibility as the middle path between inflexibility and over reaction. Internal flexibility refers to the capability of the firm to rapidly acclimatize to the demands of the environment whereas external flexibility is the capacity of the firm to dynamically impact the environment. External flexibility of the firm causes the change in the environment and internal flexibility of the firm responds to the change caused in the environment. Eppink (1978) views flexibility as a characteristic of an organization that makes it less vulnerable to unforeseen external changes or puts it in a better position to respond successfully to such a change.

Financial flexibility can be defined as an "exercise of the freedom of choice within the

framework of government's monetary and fiscal policies, capital market regulation, investor's risk returns preferences and corporate strategy, evolving financial processes with versatility, adaptiveness and transparency for better resonance with business environment" (Jain and Sushil, 2000). Financial flexibility implies the organization's ability to create liquidity (see Evans, 1991) or resources that are freely available, not earmarked for the long term (Volberda, 1998). Financial flexibility influences the firm's decision about the structure of operation and where they choose to invest (Singh et al., 2000). Volberda (1998) has highlighted the role of financial flexibility in achieving managerial flexibility. Sanchez (1995) opines that flexibility has a cost as financial constraints restrict company's ability to change swiftly and thus be more flexible. Thus financial flexibility in financial management provides organizations freedom of choice of measures, methods and reporting requirement.

EVA as a Financial Flexibility Tool

An appropriate capital structure is very critical for any organization. The literature on financial flexibility has looked at the capital structure of the organization. The firm's ability to access and restructure finance at a low cost is representation of its financial flexibility. The capital structure decisions are vital for an organization to maximize returns and compete in global environment. EVA concept has resulted in freedom of choice of performance measure to the organizations and thus brings in flexibility to the organization. EVA draws its superiority over other traditional measures by considering the cost of equity capital. This helps the management and the employees in understanding the true value of equity capital and not treating it as a cost free source of funds. In that sense it becomes more apt in big companies as they don't have strong owners but EVA pushes managers to behave like one. Considering opportunity cost of equity is the most distinguished feature of EVA. EVA thus results into better decision making as maximizing returns after deducting cost of equity, pushes managers to take better investment decisions as against traditional measures. EVA implementation at all levels entails identification of activities as value generating and value destroying activities and the decisions are glanced through this lens; ensuring managers acting as owners. This brings in a long term perspective for the employees and managers and not just focusing on cutting costs but also focusing on cutting excess capital. Managers and employees allocate the capital on the basis of the rate of return to match up or exceed minimum acceptable performance levels set after considering opportunity cost of equity capital. More and more corporate are choosing to introduce EVA linked flexible bonus system and thus ensure that managers and employees act like owners. Employees are paid bonus if they have added value to the organization, by earning at par or higher than the cost of capital employed. EVA implementation involves training of employees and it develops the mindset of ownership throughout the organization.

EVA is innately flexible and it brings flexibility in both dimensions; one at the operational level and other financial level. In other words it brings in operational flexibility as well as financial flexibility. At operational level it removes rigidity and brings in much desired flexibility. EVA can be used as one matrix that can fit all - like performance measurement tool, strategic tool, bonus to employees, value driver and comparative performance assessment tool for activities, divisions, departments or businesses. The culture of ownership and evaluation of every activity from the paradigm of value creation pushes managers harder and provides them an opportunity to constantly evaluate existing options and exploring newer options. These results in shareholder value creation and increased business. At financial level EVA provides flexibility to the organization by providing choice of performance measure and availability of capital. Simerly and Li (2000) provide supportive evidence for the proposition that competitive environments moderate the relationship between capital structure and economic performance. Adoption of EVA ensures that managers and employees are driven to add value for the organization and hence every investment opportunity is constantly evaluated by considering opportunity cost of equity capital. EVA hence acts like benchmarking and seemingly avoids investment in activities that yield negative EVA. Singh and Hodder (2000) views financial flexibility as a crucial influence on the organization's operation structure and its investments. EVA system ensures deployment of capital in value driven activities and thus ensure the excess capital is available to the finance manager. This brings in financial flexibility to the organization. While a firm's financial flexibility depends on external financing costs that may reflect firm characteristics such as size, it is also a result of strategic decisions made by the firm related to capital structure, liquidity, and investment. Chief finance officers' leverage choices are also primarily driven in by financial flexibility (Bancel and Mittoo, 2004; Brounen et al., 2004; Graham and Harvey, 2001; Pinegar and Wilbricht, 1989).

Conclusion

EVA concept is not fully verified and inspite of mixed reviews, it co-exists as a powerful corporate performance measure. There is no measure that is perfect and so is the case with EVA. Though EVA is recognized as a superior performance measure as compared to traditional measures, it also has its own drawbacks. Questions are raised about its simplicity, applicability and transparency. Constraints inherent in

calculation of EVA and availability of information to the public make it more complex to apply. The secrecy about the accounting adjustments lead to lack of standardization in formula for calculation of EVA. This result into various variants of EVA which are distorted EVA. In spite of these drawbacks, EVA has been getting both academicians and practitioners' attention. It gains its popularity from the success stories of the organizations that have grown immensely due to the adoption of EVA. Adoption of EVA itself hints at flexibility of the organization, sending positive signals to the investor and allows competing in global environment. Shah et al., (2014) concluded that EVA provides additional information and can be adapted as a corporate strategy for motivating employees. They found empirical evidence of the positively significant influence of EVA on shareholders' value among Indian corporate. EVA leads to synergy in the interest of manager and shareholders and further helps to conquer manager's risk aversion by paying more attention to capital cost and long term strategy. This reduces gap between manager and shareholders and creates more value for the organization as the projects generating shareholder value are adopted. EVA thus acts as a tool that brings flexibility in the organization.

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