Economic Value Added from theory to action

NiloofarPajoohi[1]

[1]Department of Business Management, Rasht Branch, Islamic Azad University, Rasht, Iran

Abstract

For economic decisions, the optimal allocation of limited resources and firm performance, we need the relevant and correct information.
Along times, the output data of the traditional accounting system has taken over this role and it was the most important parameters in the economic decision- making actors of the financial and capital markets. On the one hand, along with the larger economic enterprises and growing commercial markets, the volume of information that is extracted from the accounting systems, has been increased and most users of financial reports are not able to analyze the huge volume of information and are forced to resort to some more important items such as financial statements for making their decisions, on the other hand, the management of the companies affected by the personal motivation and a lot of pressure due to the competitive environment, it may attempt to provide misleading and with adopting certain accounting methods or for company profit encourages for unrealistic investment in the company.
In this article, we are followed this, since the economic value added considering the cost of financing sources, the fraction of the cost of the company profits, the amount of the wealth that company are optioned for shareholders during any period of financial, So it is recognized as the most important criteria for evaluating performance.

Key words: Evaluating performance, Economic Value Added.

1. Introduction

Essentially, the criteria so far are provided in respect to the company vale and the performance of managers can be divided two categories. One category is called as the patterns of economic. In the pattern of the accounting, the value of the company is involved in the various criteria such as Profits, earning per share, profit growth rate, Return on equity, book value, cash flow, dividends profit and stock supply and demand. In the pattern of the economic, the value of the company's share is involved the power of the existing assets and profits and the potential of its investments and margin rate of return and cost of the firm's capital among this, It is claimed that economic value added in the comparison to the accounting profits is less shortcoming and is able to show the real value of the company. (Jahankhani and et.al, 2010, 2)
The economic value added is one of the newest criteria that the stockholder is used to evaluate the performance of the company and giving a reward to the management, the economic added value by considering the all costs of the company's financial resources and the fraction of the cost of capital of the company's profits, the amount of wealth has revealed that the company is optioned for the shareholders during the financial period. In the current situation in Iran is very slow growth rate and investment rate is too low. It is natural that the management and the optimum use of financial resources are important. In this regard, the economic value added is computed by the emphasis on the cost of capital of the financial resources can attend management and investors to the vital issues and can enhanced their efforts to reduce the cost of capital.

2. Describe the dimensions of the economic value added

In today's competitive world, one of the main goals of any individual and the investor enterprises or investee is to make value and to create wealth for shareholders. The capitalists are calling it to increase its capital and maximize it, in this reason; they are looking for investment opportunities that created for them to have more wealth. (Mashayekh and et. al, 2004, 13) With this important of rational decision, It is possible to invest in the investment process, making rational decision and the results from It has a direct relationship with the evaluating of the economic performance of a firm. (Roudposhti, 2007)
Performance evaluation also require firms to identify those indicators that can be classified into two sets of financial and non-financial indicators, financial indicators of performance measurement is preferable due to the features labled as being quantity, being practical, being concrete and tangible that the non-financial criteria. Some financial criteria are more important to evaluate the performance firms including: rate of return on investment (ROI), residual income (RI), rate of return on sells (ROS) and Economic Value Added (EVA). (RahnamyeRoudPoshti, 2007) Among this, EVA is a good criterion for evaluating the performance of the company due to its relationship with the created changes in the shareholders wealth. Based on this index, the value of a company depends on two factors as follows,1) How the company used the capital to earn returns, 2) For using the capital, what is it incurred. Thus, the difference between economic value added and other criteria is that in the determining its, is trying to consider all sources of financing costs. (AnvariRostami and et. Al, 2004)To interpretation, Economic value added is the basic indicators for measuring performance and determining of the firm value. (Jahankhani and et. Al, 1994)The use of the concept of economic value added (EVA) and its scientific applications is emphasized as a control system for measuring performance in organizations. Economic value added is an index that fulfilled to cover these demands, because in this index is focused on how much capital the company to earn returns. Therefore, these returns should be proportional to the rate of capital cost. (Yahyazadeh and et.al, 2010)
EVA shows the total value produced by the company during the period and in this regard that provide information's for measuring, it is similar to the accounting profit. But, because it contains the total capital cost (Cost of debt and equity),It varies benefits. The second advantage resolved some of deformation that has been established by the principles of the accepted accounting, namely, the part that is left open the directors' hand to manipulate the profit, These principles are neutral it. (Talebi and et.al, 2002)
Economic value added is a method of measuring the economic values of a business after considering the cost of capital both debt and equity costs of share owners. Based on accounting standards in computing the traditional indicators of accounting, only the cost of capital is regarded, while in the calculation of EVA, In addition to the cost of dept capital, will be deducted the cost of equity capital. (Nikhbakhtand et.al, 2004, 133)

Economic Value Added equation is that:
EVA = NOPAT –WACC (Capital) (1)
NOPAT = Net operating profit after deducting tax.
WACC = The average weighted of the cost of capital.
Capital = here, capital is meant by total assets minus current liabilities.

2.1 Net operating profit after deducting tax

NOPAT = (EBIT + Adjustment)(1-T) (2)
In the above equation, EBIT is the net operating profit after interest and tax and T is the corporate tax rate and the modifications related to the increasing are in the capital equivalents. Capital equivalents are values that exist in the firm but are not shown in the balance sheet or profits that are not reflected in the statement of the income and loss.

2.2 Capital used

(The residual equivalent of capital + Equity + long-term and short-term debt inclusion to interest) = weighted cost of capital assets used.

2.3 WACC

$$WACC = [W_d \times K_d (1\text{-}T)] + (W_e \times K_e) \quad (3)$$

W_d = Weight of current liability on the company's capital structure.
K_d= rate of supplying debt financing costs.
W_e = weight of common stock and other reserves in the company's capital structure.
K_e = rate of expenditure financed by common stocks and other reserves.

3. Theory and Models

Economic value added introduced by stewart in 1989 as the most important criteria for performance evaluation. Interest is calculated on the basis of economic value added after deducting all costs including capital.Although economic value added is a new concept but its theoretical basis is not new. The company should benefit over the cost of capital, long ago it has been of interest to the economists. Years ago, famous economists such as Marshall believed that what is commonly called profit, fee remains for service quality, usually not profitable. When a company does not have to create return over the cost of capital, it has losses. In the twentieth century, this concept was introduced under different titles, one of which is residual profit.

The residual profit is the profit margin of operating and capital costs, the difference of the residual profit with economic value added in the part of medications. Because in the calculation of residual profit, modification will not be done. According to Kang and et.al , economic value added first introduced formally in the 1965s called residual profit, after introducing residual profit, many companies used it to evaluate the performance. Among these companies was General Motors. General motors (GE) also used residual profit for performance evaluation of decentralized units. Therefore, Economic value added is not a new concept and there have been long known as residual income.

In the calculation of earning, only the cost of financing is regarded through debt and directors of funds provided by shareholders will assume no cost. But the concept of economic value added, cost of financing is regarded b the shareholders. Because money into the company was not entered itself and this money does have any cost. In other words, Economic value added is the estimation of the firm's economic profits and it varies with accounting profit. Economic value added caused that the accounting profit be closer to the economic profit and it is easier for shareholders to measure the creation by the company.

According to weaver, economic value added is the lost loops of shareholders efficiency, economic efficiency and financial efficiency. (Mahdavi and et.al, 2007, 140)

Today, in the scientific and academic circles is also as much attention to the EVA, and has written several books and articles in the field of value based management system and its operational approach namely EVA. Fortune magazine, the concept of EVA is introduced as the real key to wealth creation or in the other writings is called as a new ways to trade. Also, It can see the works in the professional circles and policy making of accounting, AICPA, financial reporting committee proposes to use a committee called Jenikis in 1994 in order to improve the financial reporting and taking more appropriate decisions than EVA for the internal and external reporting.

4. Discussion

Give the fundamental changes in the conditions governing the activities of commercial firms and the emergence of the phenomenon of economic globalization, business unit managers are faced with new challenges which is the most important movement of capitals.

Economic value added is a measure of performance evaluation that reveals the firms economic reality of this measure can be used for estimating the business units and determining the value of stocks.

Given the current situation in Iran, that economic growth and investment rates are low. Emphasizing the need for optimal use of financial resources is very essential and in this regard, the economic value added that is emphasized inpatients cost of capital and optimal use of resources financial, will play a major role.

5. Results

As noted, many researchers, stewart was at their head, always believed that economic value added is strong and efficient measure in the description of the company's performance. Since economic value added emphasis on the effectiveness of management decisions in a certain period and in addition to also indicate. Promising actions and activities of sector management for future share holders.in general , these measures can help managers to consider total cost of financing and efficiency of company's investment has walked in order to improve the internal performance of companies there by managers can adapt themselves to the external conditions and increase the wealth of their share holders. Economic value added is raised by itssupporter's .as.an important and effective evaluation criteria this criterion tries to accurately measure the value created by the company and there by could provide the basis for performance evaluation of investment managers and investors.

References:

1-Jahankhani, Ali & Sohrabi, Jamshid(2009), “Analyze the deviation of economic value added and impact of inflation on the financial characteristics of this deviation ",Tahghighat Mali, 1-20.

2-Mashayekh, shahnaz, Bashiri manesh, Nazanin(1994),” Performance measure of economic value aded in the Tehran Stock Exchange”, Hesabdar, 12-55.

3- Rahnamaye roudposhti, Fereydoon,(2006), “Review and assess the functioning of the economic value added and market value added to assess the economic performance of companies”, Pajoheshnameh Eghtesadi, 157-175.

4-Anvari rostami, Ali ashghar,Tehrani, Reza,Seraji, Hasan(2003),” The relationship between economic value added, profit before interest and taxes, cash flow operating activities with the stock market value of companies listed in Tehran Stock Exchange”, Baresihaye Hesabdari & Hesabrasi, 3-21.

5-Jahankhani, Ali,Sajadi, Asghar(1994),” Application of the concept of economic value in financial decisions”, Tahghighat Mali, 68-86.

6-Yayazadehfar, Mahmoud, Shams,Shahabodin,Larimi, Seyed Jafar(2010),” The relationship between economic value and profitability ratios and market value added”, Baresihaye Hesabdari & Hesabrasi, 113-128.

7-Nikbakht, Mohammadreza, Peykani, Mohsen(2009),” The relationship between capital structure and performance evaluation criteria”, Tahghighat Mali, 89-104.

8-Mehrani, Sasan, Rasaian, Amir(2009),” The relationship between financial leverage and the market value of companies listed in Tehran Stock Exchange”, Hesabdari Mali, 79-91.

9-Warr, Richard S (2005),"An empirical study of inflation distortions to EVA ", Journal of Economics and Business, 119-137.
10-Tully (1998),**"**Helsinki school of Economic, Financial **"**, 2-8.