EVA DISCLOSURE PRACTICES IN CORPORATE ANNUAL REPORTS – THE INDIAN CONTEXT

Dr. R.K.JAIN*

ANSHU JAIN**

Abstract

This paper aims to study the extent to which EVA disclosure is practiced by the Indian Corporate sector. This study is based on the information available for the top Indian corporate houses in Manufacturing, Banking and IT sector, amongst the ET500 companies for FY 2012.

The study also aims at distinguishing the mode of communication used by the companies while sharing EVA with the stakeholders, and traces its application for the decision making. Towards the end of this paper,some thoughts have also been shared towards the pattern existing for the leading companies declaring EVA.

Keywords: Economic Value Added (EVA), Trends of EVA reporting, Extent of disclosure, Medium of disclosure, Applications of EVA.

* Associate Professor, Gargi College, Delhi University, Delhi

** Research Scholar, Mewar University, Chittorgarh, Rajasthan

Introduction

Finance has always been at the epitome of gauging corporate health. Traditionally, managers have always accepted profit maximization as the key indicator for making efficient economic decisions. This thought has seen a large drift during the post liberalization era, with CFO office focusing towards shareholders' wealth maximization This era saw measures such as Earning Per Share(EPS), Return On Investment(ROI), Return On Equity (ROE), Gross/ Net profit margin etc. being adopted to assess the financial performance of the company.

Investors, now-a-days, are more informed and no longer willing to act as fund providers only, but are also concerned with what the company is doing with their money - whether it is creating value for them or not. Similar change is visible with the companies also sharing concern towards delivering values rather than absolute profit. The corporate objective has shifted from profit maximization to value maximization.

As management consultant Peter Drucker (1998) said, "Until a business returns a profit that is greater than its cost of capital, it operates at a loss...The enterprise still returns less to the economy than it devours in resources…Until then it does not create wealth; it destroys it".

It is basically the dissatisfaction with the traditional accounting based performance measures that have spawned a number of alternatives, of which EVA is currently the most prominent one.

EVA is based on the principle that since a company employs equity capital to earn a profit; it must pay for the use of this equity capital.

EVA is an estimate of this true economic profit. It is 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 with comparable risks.

In other words, 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 those profits i.e.

EVA= NOPAT- (WACC x CE)

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

This will produce either a positive or a negative EVA. A positive EVA reflects that the company is increasing its value to its shareholders, whereas a negative EVA reflects diminishing value to its shareholders.

To have a comprehensive view about EVA disclosures in Indian companies, this study is framed to achieve the following objectives:

1. To examine the trends of EVA user companies reporting EVA in their annual published reports.
2. To explore the extent of EVA reporting practices among selected Indian companies.
3. Which medium of communication is adopted by the EVA reporting companies to convey their EVA implementation decision to the stakeholders?
4. What are the areas of corporate decision making where EVA metric is applied?

This has been done by dividing the study in fivesections. Section I describes the scope of the research paper.Section II gives a brief description of the available literature.Section III deals with EVA reporting trends in the Indian corporate sector.Section IV explores the extent of EVA disclosure practices in the annual reports of Indian companies and the applications of this metric in various corporate decision-making areas.Findings and suggestions are given in Section V.

Scope of the paper

The sample population of the study constitutes the Manufacturing, Banking and IT companies from the total population of ET500 Indian companies for FY 2012. To examine the trends and extent of EVA reporting practices among selected Indian companies, the annual report of each company has been examined for the year 2011-12.

Review of Literature

Bhattacharyya and Phani (2000) revealed certain important shortcomings in the EVA statement of Infosys Technologies Ltd regarding the absence of any GAAP-based accounting adjustment and uniformity of Beta variant over a period of four years. Moreover, the study also questioned the subjectivity involved in the estimation of company's market premium and cost of equity and brought to attention the dangerous trend of reporting EVA casually. They suggested that EVA should, at least, be adapted as a corporate philosophy for motivating and educating us to differentiate between value creating and value destructing activities.

Weaver (2001) identified significant inconsistencies in firms' measurement of EVA and its major components. A review of 29 respondents provided the evidence that none of the respondents measured EVA, NOPAT or Invested Capital in the same way. Although all respondents were found to use Capital Asset Pricing Model (CAPM) to calculate cost of capital, divergences occurred related to market risk premium, market versus book weightings and current versus targeted capital structure.

Abdeen and Haight (2002) compared the performance of EVA user companies with EVA non-user Fortune-500 companies for the years 1996 and 1997. Using simple averages, it showed that means of performance regarding profits as percentage of revenue, assets and shareholders' equity were higher in case of EVA users than that of non-users. It was found to be worse for the Earning per Share (EPS), EPS growth and total return to investors. Although their study provided a strong idea about future research in the direction of comparison between EVA users and EVA non-users, it failed to justify its findings with the help of any suitable statistical technique. The study concluded that EVA will become less popular as far as it is used as a measure of value creation and hence should be applied in combination with the long established traditional measures of financial performance.

Sangameshwaran (2002) provided the steps that Tata Consultancy Services (TCS), India's leading software company, has followed to implement EVA. It also stated that how the shareholders' goal of value creation is linked to their employees' performance incentives.

Ghani et al. (2005) found that in the US, firms are steadily adopting EVA as one component of their value management system. The study found that EVA was found in a cross-section of the industries and proxy statement was identified as the most commonly used source of disclosure. Majority of the sample firms tend to use only one metric, that is, EVA and applied it at the corporate level alone. Three-fourths of the sampled firms indicated the use of EVA as incentive compensation tool. Two common modes of compensation using EVA determinants were bonus plan and stock option. They also suggested that along with EVA disclosure, firms should also report their own estimate of cost of equity capital to reduce the valuation error when it is estimated by investors themselves.

Dhamija (2008) discussed the disclosure practices being followed by Indian companies in reporting EVA and incorporated the case analysis of EVA reporting by Hindustan Unilever Ltd.

Kaur and Narang (2008) attempted to analyze and compare the EVA statement as disclosed by Satyam Computer Services Ltd, with the actual EVA created by the company after providing for GAAP-based accounting adjustments given by the founders of EVA concept. They found much divergence between the reported and calculated EVA figures and discussed the need to provide more reliable view of its value addition. They suggested that the companies and accounting professionals should prepare EVA statement scientifically and then publish it in the annual reports.

Vishwanath (2009) discussed the implementation of EVA financial management system at Godrej Consumer Products Ltd (GCPL), a leading FMCG company in India, in 2001. Their study explained three elements of EVA programme followed by GCPL:

(i) EVA centres

(ii) Operational practices of EVA drivers which improve EVA results and

(iii) EVA-based incentive programme for bonus-eligible managers.

Literature on the corporate EVA reporting practices in India is not well developed till date. All the Indian studies dealing with EVA disclosures are company specific. The review of literature clearly depicts the dearth of studies regarding EVA disclosure practices in Indian corporate sector. The sufficient literature on Indian corporate EVA reporting is not available so as to induce the companies to implement and report EVA as a performance measure in their annual reports and hence, a need is felt for further research and studies.

Trend of reporting EVA

The concept of EVA has gained importance over a period of time as a corporate performance measurement tool. EVA generated or destroyed by a company during a period can be measured by comparing profits with the total cost of capital used to earn them, thus aiding managers to withdraw value-destructive activities and invest in projects that are constructive to shareholders' wealth.

Over the long-run, the wealth creation is derived not only by the accounting profits but also by improving EVA. The link between EVA and shareholders' wealth has motivated many leading companies to adopt the EVA discipline. Highly diversified companies like AT&T, Briggs & Stratton, CSX, Coca-Cola, Quaker Oats etc., have set up separate EVA measurement systems throughout their organizations. A number of evidences exist where senior corporate executives world over have followed the EVA phenomenon and reaped the benefits in terms of improved corporate performance and enhancement of shareholders' value.

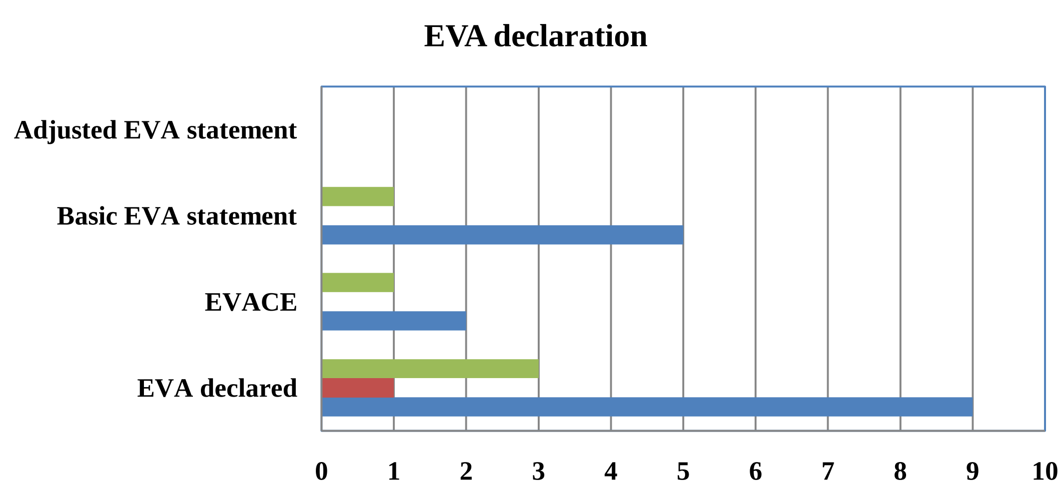
In Indian corporate world, the significance of EVA has also been recognized, though at a slow pace as compared to the corporate sectors in other countries because EVA computations and its disclosure are not mandatory for a company as per the listing requirements. Only a few companies like Hindustan Unilever Ltd, Infosys Technologies Ltd, Hero MotocorpLtd., and

Godrej Ltd. etc. measure their value creation in terms of EVA. Some of the Indian companies have reported the EVA statements in their annual published accounts. EVA reporting has less significance in the Indian context due to accounting distortions and poor disclosure practices.

A thorough examination of the annual reports revealed that most of the sample companies referred the shareholders' value enhancement through the introduction of value added products/services/operations or through profitable growth.

India is gaining supporters of EVA and also getting favour from the leading corporates.The approach followed by some of the highly regarded Indian companies to report EVA externally has been taken as a ground to depict the trend of reporting EVA.

The study of 256 companies of Manufacturing, Banking and IT sector amongst ET500 companies for the financial year 2012 found that only 13 companies report EVA as a corporate performance measure in their annual published reports.



	EVA declared	EVACE	Basic EVA statement	Adjusted EVA statement
IT	3	1	1	0
Banking	1	0	0	0
Manufacturing	9	2	5	0

Source: Computed

Figure 1: EVA declaration by the companies in study

As analyzed in figure 1, out of total 188 manufacturing companies only 9 companies such as, Larsen Toubro Ltd., Hero Motocorp Ltd., Dr. Reddy Lab. Ltd., Hindustan Unilever Limited, Godrej Consumer Products Ltd., Associated Cement Company Limited, etc. have disclosed

EVA. Only 2 companies showed EVA as a percentage of capital employed. There are 5 companies which presented basic EVA statement. No company made any adjustments to calculate EVA.

In Banking sector, only J&K Bank (out of 38), with casual approach, presented EVA in their annual report, but without any basic or adjusted EVA statements.

As far as IT sector is concerned, only 3 companies (Infosys, Tata Consultancy Services, OFSS) out of total 30, declared EVA but without any adjustments. Out of these three companies, Infosys is the only one which showed EVA as a percentage of capital employed along with the basic EVA statement.

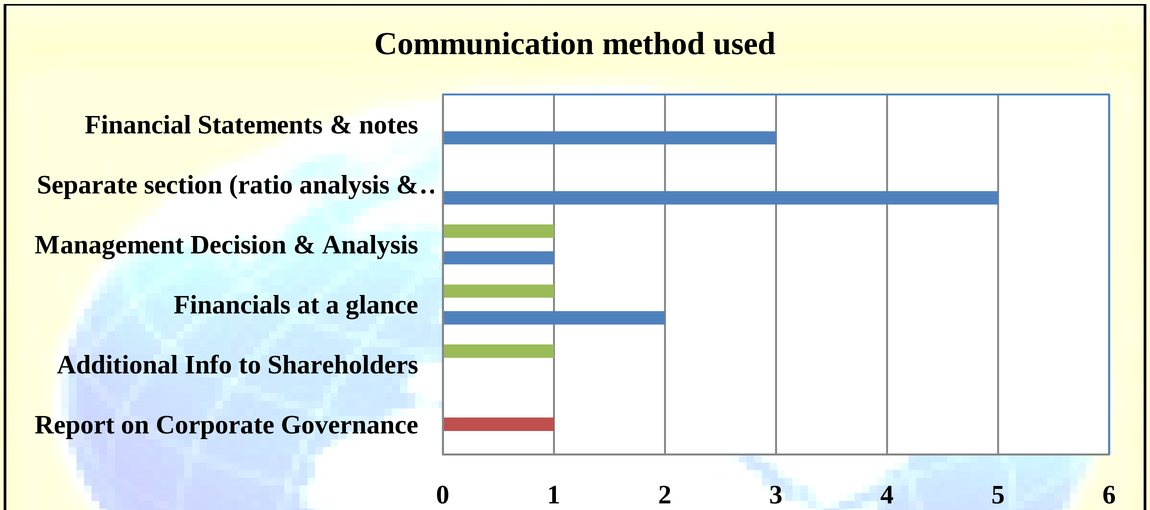
A perusal of the EVA statements published by the companies in their annual reports for the year 2011-12 reveals that:

i. EVA computation is highly subjective i.e. the disclosure of the assumptions on the basis of which EVA is computed is not made. This reduces the informative value of EVA. e.g. the cost of equity is estimated by using Capital Assets Price Model (CAPM) but the basis of taking different beta variant for all the different years is not clear.
ii. The assumptions on which risk premium has been estimated for different years have not been mentioned anywhere.
iii. No adjustments have been made for converting the accounting profit into economic profit.
iv. Ambiguity has been observed in EVA disclosures specifically with respect to WACC computations. How the cost of debt has been computed is not clear?
v. Nowhere, the computation basis has been given for NOPAT.

Extent of EVA Usage and disclosure practices in Annual Reports of Indian Companies

As EVA disclosures are not mandatory for the Indian companies, only a few companies are there which specifically mention the use of EVA as a measure of corporate financial performance and decision making in their annual reports. As per analysis based on figure 2, the study reveals that the Indian companies use different methods to disclose EVA figures and its implementation. Some of the Indian companies like Hero Honda, BHEL, HUL, and Infosys etc. make a separate section in their annual reports to report the EVA performance. The others prefer to disclose EVA figures along with their traditional financial performance measures through financial highlights' charts for 5 -10 years. However, in few cases, Management Discussion & Analysis Report has been used forEVA disclosure. Besides these, Directors' report, Corporate Governance report, Additional information to shareholders etc. are used for EVA disclosure. However, the study found that EVA reporting companies, although, disclose EVA but with more emphasis onthe traditional performance measures.

The motive behind the EVA calculation and disclosure is its ability to measure the true economic performance of the entity. The study found that the most common usages of EVA in Indian companies are financial performance measurement, measurement of shareholders' value enhancement, incentive payment and reward system.



	Report on Corporate Governance	Additional Info to Shareholders	Financials at a glance	Management Decision & Analysis	Separate section (ratio analysis & EVA statement)	Financial Statements & notes
IT		1	1	1		
Banking	1					
Manufacturing			2	1	5	3

Source: Computed

Figure 2: Analysis of the communication method used

The study also found a casual approach of the Indian companies in reporting EVA performance in their annual reports and hence may not be so fruitful for the users. No system or technique will bear fruits until it is well implemented under a certain set of principles and has the support of all the concerned parties. Hence, in order to have a clear perception of underlying economies of business and to enable managers to take better decisions, EVA framework should be backed by mandatory requirements.

Conclusion

Though the Indian corporate sector is taking a keen interest to adopt EVA as a new corporate performance measurement tool as well as to design the compensation, the study found that among the India's largest companies: Manufacturing, Banking and IT companies (total 256 companies) out of ET500 companies, just 13 companies specifically mention the use of EVA as a measure of corporate performance, shareholders' value enhancement and decision making. Companies like Infosys, HUL, Hero Honda, Godrej etc. have started disclosing EVA in their annual reports. This indicates that the trap of the traditional performance measures is breaking down but still people are skeptical about the success of EVA measures. The companies are still using traditional performance measures even after the implementation of EVA. EVA is not being used much as a measure of financial performance and shareholders' value enhancement because of:

(i) The unsatisfactory disclosure of EVA and low level of transparency in its measurement.

(ii) Difficulties experienced in breaking the resistance of middle and lower level employees to adapt the new culture.

(iii) Existence of significant inconsistencies and irregularities in the measurement of EVA and its major components by the EVA reporting companies.

Most of the companies reporting EVA do not provide for the adjustments required to be done while computing EVA. Moreover, Indian companies also avoid EVA disclosures due to its complex methodology that involve higher expenses on EVA consultancy. All these problems to a large extent can be overcome by developing the understanding of the EVA concept to the people at large. This can be done by arranging workshops and training sessions. Also, by improving communication levels and ensuring them that EVA is not a new mean to take away their share in the corporate pie rather by adopting it something can be added to their big share if they are contributing to add value to the shareholders' wealth. There is a need to make EVA reporting mandatory in Indian corporate sector. Also, separate accounting standards for EVA computation and reporting should be established to reap benefits in terms of shareholders' value enhancement.

References

- Abdeen, A.M. and G.T. Haight (2002). "A fresh look at economic value added: Empirical study of the fortune fivehundred companies", *The Journal of Applied Business Research*, 18(2): pp. 1–10.
- Ahmed, K. and D. Nicholls (1994). "The impact of non-financial company characteristics on mandatory disclosure compliance in developing countries: The case of Bangladesh", *The International Journal of Accounting*, 29(1), pp. 62–77.
- Bardia, S.C (2002). "Economic value added: Overall consideration", *The Economic Challenger*, 15(4), pp. 46–50.
- Bhattacharya, A.K. and B.V. Phani(2000). "Economic value added—A general perspective", *Social Science Research Network*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=545444
- Biddle, G.C., R.M. Bowen and J.S. Wallace (1998). "Does EVA beat earnings? Evidence on associations with stock returns and firm values", available at SSRN: http://ssrn.com/abstract=2948 or DOI: 10.2139/ ssrn.29482006. 'BT-500 India's most valuable companies', Special Issue, 19(November), pp. 118–38.
- Byrne, O. and F. Stephen(1996). "EVA and market value", *Journal of Applied Corporate Finance*, 9(1): 116–26.
- Byrnes, N. and D. Henry (2001). "Confused about earnings?", *Business Week Online*, 26 November, available at http://www.businessweek.com/magazine/content/01_48/b3759001.htm
- Dhamija, S. (2008). "EVA reporting practices in the annual reports of Indian companies: A case study of Hindustan Unilever Limited", *The Accounting World*, October 2008.
- Dodd, J.L. and J. Johns(1999). "EVA reconsidered", *Business and Economic Review*, April–June, pp. 13–18.
- Ghani, W.I., A. Tezel, J.M. Ragan and A.J. Stagliano(2005). "Disclosure of EVA use in corporate financial reports: A descriptive analysis", *The Journal of Applied Business Research*, 21(1), pp. 81–92.
- Kaur, M. and S. Narang(2008). "Economic value added reporting and financial performance: A study of Satyam Computer Services Ltd.", *ICFAI Journal of Accounting Research*, 7(2),pp. 40–52.

- Kramer, Jonathan K. and G. Pushner(1997). “An empirical analysis of economic value added as a proxy for market value added”, *Financial Practice and Education*, 7(1),pp. 41–49.
- Misra, A. and K. Kaur(2004). “Linkages between economic Value Added and Share Prices: An Empirical Study of Indian Corporate Sector”, available at http://www.kiml.ac.in/ conference/abstracts/16.pdf.
- Ramana, D.V. (2007). “Economic value added and other accounting performance indicators: An empirical analysis from Indian companies”, *The ICFAI Journal of Accounting Research*, Vol. 6(2), pp. 7–20.
- Sangameshwaran, P. (2002). “Courting EVA, the TCS way”, *Economic Value Added-Concepts and Cases*, The ICFAI University, Hyderabad, India, ICFAI Press, pp. 177–84.
- Shammari, B.A. (2008). “Voluntary disclosure in Kuwait Corporate Annual Reports”, *Review of Business Research*, available at http://findarticles.com/p/articles/mi_6776/is_1_8/ai_n28552085.
- Stewart, G. Bennet(1994). “EVA fact and fantasy”, *Journal of Applied Corporate Finance*, April, pp. 71–84.
- Vishwanath, R. (2009). “EVA financial management at Godrej Consumer Products Ltd”, available at SSRN: http://ssrn.com/abstract=1354422.
- Wallace, J. (1998). “EVA financial systems: Management perspectives”, *Advances in Management Accounting*, Vol. 6, pp. 1–15.
- Weaver, S.C. (2001). “Measuring economic value added: A survey of the practices of EVA proponents”, *Journal of Applied Finance*, Vol. 11(1), pp. 50–60.