

Economic Value Added (EVA) Approach in Russia. Concepts. Approaches. Instruments

Alexei SIRBU¹

Abstract

The measure of the economic value has become a widely debated issue because, nowadays, more and more companies are focusing on creating value for their shareholders. Due to the fact that the traditional methods are not strongly related to the actual value created, the study focuses on finding out if EVA is a more accurate method and more successful than the ones companies currently use. EVA promises an effective way to manage shareholder value. It aligns management's objectives with those of the shareholders', improves accountability and enables better performance analysis. Therefore, it is not surprising that EVA, as a management tool, is in the spotlight.

Keywords: *Economic value added, company efficiency, company value drivers, company value management*

JEL classification: G30; G34.

Introduction

In corporate finance, **Economic Value Added** or **EVA**, a registered trademark of Stern Stewart & Co., is an estimate of a firm's economic profit – being the value created in excess of the required return of the company's investors (being shareholders and debt holders). Quite simply, EVA is the profit earned by the firm less the cost of financing the firm's capital. The idea is that value is created when the return on the firm's economic capital employed is greater than the cost of that capital; see corporate finance: working capital management. This amount can be determined by making adjustments to GAAP accounting. There are potentially over 160 adjustments that could be made but in practice only five or seven key ones are made, depending on the company and the industry it competes in.

Although in concept, these approaches are in a sense nothing more than the traditional, commonsense idea of "profit", the utility of having a separate and more precisely defined term such as EVA is that it makes a clear separation from dubious accounting adjustments that have enabled businesses to report profits while actually approaching insolvency.

¹ Alexei SIRBU, The Bucharest University of Economic Studies, Romania,
E-mail: alexeisyrbu@gmail.com, Telephone: +40723033481, Fax: +40 318178146

1. Economic value added (EVA) approach in Russia

KPMG² - a global network of professional firms providing audit, tax and advisory services, organized a conference at the beginning of 2011 dedicated to the economic value added, as well as to its principles and methodologies. This conference represented an important event in the world of Russian business and thus the need to apply new and modern business management concepts was recognized. Managers of big international consulting companies, like Stern Stewart & Co, were invited to attend this conference, and the presence of Joel Stern – one of the founders of this company – became an unprecedented event for such meetings in Russia.

Stern Stewart & Co (www.sternstewart.com) is one of the leaders of strategic consulting and value-based management. Set up in 1982 in New York, it became the first company in the field of business economy and applied corporate finance. At the end of the 1980's, a new management concept, based on economic value added (EVA), was implemented and patented, and now it is the most widespread concept, applied in numerous companies. Stern Stewart & Co has offices Northern America, Europe, Latin America, Australia, China, India, South Africa, countries from Asia and Africa. Russia has practically become the only country in which almost no analyses based on value and value management consulting services are performed.

The largest part of the presentation at this conference was made by Joel Stern – the one that also created the „economic value added” (EVA) concept, a concept which represents an indicator of company activity efficiency and EVA-based management system.

Further to KPMG's request, in March - May 2010, the Higher School of Economics from Russia (www.cfcenter.ru), in cooperation with the management consulting department, carried out a survey regarding the management practices from the Russian companies and the analysis of the factors which influence the value of these companies. The results of this survey were presented at this conference. Thus, the works of the following participants were presented during the conference:

- Joel and Erik Stern (Stern Stewart & Co): Value concept and its current status. Economic value added – a management concept.
- Howard Polinski (Partner - Management Consulting Department, KPMG in Russia and the CIS) and Irina Ivashkovskaia (Head of Economic and Business Finance department and of the Corporate finance scientific-educational centre within the State University - Higher School of Economics): Results of the survey carried out by KPMG and the Higher School of Economics: analysis of the

² KPMG – a global network of professional firms providing audit, tax and advisory services, operating in 146 countries, with 140,000 people working in member firms around the world. Independent companies – members of the KPMG network, are included in the KPMG International Cooperative („KPMG International”) association, registered in Sweden. Each company is an independent legal person.

economic value added in Russian companies and value management implementation in the Russian business.

The conference program was conceived in such a way that every participant should have the possibility to perceive the value management basic concepts and to take part in the discussions regarding the optimum methods and their implementation on the Russian market.

We present below the main subjects discussed during this conference.

2. Advantages of the economic value added: the point of the view of the person who implemented this concept

Joel Stern is known, first of all, due to his concept regarding the economic value added (EVA), and developed together with his partner - Bennett Stewart. EVA is a simple method, which became quite widespread, both in many companies around the world, and in the academic environment. The essential idea of this concept is that the company should create liquidity flows that generate profit, so that the profit should exceed the necessary profitability rate.

From the management's point of view, the basic issue is to determine the company efficiency, which directly influences shareholders' profit, managers' bonuses, strategy outlining and many others.

The use of standard accounting indicators does not allow an adequate estimate of a company's efficiency, as it does not reflect an adequate evaluation of a company's activity. Alternate methods, initially applied with Stern Stewart & Co too, were based on the models of Discounting Cash Flow (DCF) and Internal Rate of Return (IRR). But, in case such an approach is used, a large part of the company's value is correlated with the post-forecasted period. Moreover, these estimates are static, only evaluating future periods, but EVA also indicates what did the company brought to its shareholders during a certain period of time in the past. Business efficiency estimates are also contradictory. In case we calculate business efficiency by means of the dynamics of the net operational profit (NOPAT), it is necessary to take into account its fluctuations. Profit fast increase can be a consequence both of the higher return on total capital (ROTC), and of some massive new investments (INV) in case of low revenues:

$$1) \quad \frac{NOPAT_{t+1} - NOPAT_t}{NOPAT_t} = ROTC \times \frac{INV}{NOPAT_t},$$

where:

$$2) \quad ROTC = \frac{NOPAT}{TOTAL_CAPITAL},$$

NOPAT (*Net operating profit after tax*) – net operational profit.

Economic value added (EVA) – is an indicator of the economic profit. It is calculated as being the difference between the net operational profit (NOPAT) and the payments for the whole capital invested in the company, adjusted with capital profit, designated as being the equivalent of equity in the EVA concept.

$$3) \quad EVA = NOPAT_{ee} - WACC \times CE_{ee}$$

In case of relative indicators, the calculation formula will be the following:

$$4) \quad EVA = (ROTC - WACC) \times CE_{ee}$$

$NOPAT_{ee}$ – adjusted net operational profit

WACC (Weighted Average Cost of Capital)

CE_{ee} (Capital Employed)

ROTC (return on total capital)

The most important difference between the EVA indicator and other efficiency indicators, like earning per share (EPS), gross profit, interests, wear and depreciation (EBITDA), return on total capital (ROTC), etc. consists of the fact that EVA takes into account all the business costs, both the actual ones and the alternative ones. Thus, this indicator allows the investors to compare the profit obtained from capital investment in the company, taking into account the alternative costs of its resource investment. This is how appears the possibility to have a fair appreciation of the company value, whose increase represents the main target of any corporate strategy.

Moreover, for EVA calculation, adjusted accounting data are used. The role of these adjustments is to emphasize the real volume of resources and their directing strategy, taking into account the specific nature of the company's field of activity, and thus removing the errors cause by the standard accounting calculations.

No matter if we analyse the whole company or just some of its departments, EVA allows the monitoring of value creation at a certain level, value creation at a certain level, taking into account the ratio between its components when the return on total capital (ROTC) is increasing, or of investments, when the department or the whole company brings to its investors a higher profit than the estimated one.

Even if these conditions are transparent, in reality it happens that companies „destroy their value”, showing negative values of EVA: on the American market, these cases represent 60%, and on the Russian market 40% of the analysed companies.

The adjustments applied to EVA indicator calculation are used differently, depending on the business type: production, services, finance, industry, because value is given by the various types of assets, which are not taken into account in the standard accounting calculations.

Thus, in case of oil and gas business, the procedure is the following: the real „drivers” of company value increase in this field (65-80%) are the existing oil and gas reserves, production level, resource accessibility and other data related to natural factors. With a view to correctly determine the strategic methods for efficiency increasing, it is necessary to capitalize the research and innovation expenses.

The EVA upstream and EVA downstream calculations should be based on various supports and needs various adjustments. In the first case, they refer to the capitalization of the expenses related to the operations performed in poor fields. In the second case, adjustments will be made like in the case of production sector companies. It is also necessary to take into consideration the degree of diversification of every company's activity.

One of the aspects of value management applied in the company refers to the bonuses granted to those persons, who, by their decision, influence the business efficiency.

At the basis of the EVA indicator are created the bonus-granting mechanisms for the management of the companies and for the persons in charge for every segment of the business. To set the bonus, it is important to consider the ratio between the obtained income and the risk degree. There is no maximum or minimum limit for this ratio, and this fact is used in the traditional system of bonuses, mainly based on accounting indicators. The use of a single indicator to determine company efficiency and to grant bonuses stimulates the managers to create more value for the investors, as a higher value of the company will determine higher bonuses for them. To keep this motivation for a long period of time, the practice is not to use absolute indicators, but the value indicator modifications in time. This method is efficient especially in case EVA is negative. Moreover, many companies apply the so-called „bonuses bank” method, which consists of bonuses accumulation for a future period of time. These payments are based on the principle of obtaining equal bonuses in case results are the same.

This method represents an incentive for the managers, to obtain as efficient as possible results for the future of the company, but it also eliminates the influence of the negative external factors, which act on the company's activity, namely diminishing the EVA value.

3. The management system in Russian business and the ways of implementing the value management concept

Between March and May 2010, KPMG, in cooperation with Corporate finance centre within the Higher School of Economics, prepared a survey, which included a poll among the managers of Russian companies regarding the management methods used in their companies.

The results obtained from this survey showed that the value-based management is not very well known and applied on the Russian market. The value-based management is applied in just one quarter of the interviewed companies, and in 60% are found only some elements of the value-based approach (mostly in case of investment project decisions). In 17% of the companies this approach is not applied at all.

One of the main problems underlined by the managers in the creation of the value-based management system is the difficulty to allocate company targets to every branch or department, and also the difficulty to determine the management

methods for a certain type of activity. Thus, at present, various accounting indicators are taken into consideration to determine company activity efficiency, like: net profit and dynamics of obtained revenues. The fact that the value concept is not taken into account determines the use of various efficiency criteria for every element of the management system, and thus strategic targets are set mainly in terms of market share or net profit, and the net profit or the number of new attracted clients are used to stimulate the employees. This way, the lack of a single indicator which should show the creation of the fundamental value may lead to conflicts of interests between different departments of the company, therefore in this case exist a risk of diminishing the company activity efficiency.

However, in Russian companies there are some objective supports the value management system may be implemented upon. Some of them are: the application of the value-based criteria for the evaluation of the investment plans (using the following indicators: NPV – net present value and IRR – internal rate of return), the existence of divided organizational structure, which allows the defining of the „value centres” and large enough systems for centralizing the necessary data.

In reality, the implementation of the value management (in part or in whole), for the Russian companies is necessary in order to improve managerial decision quality (an opinion supported by 63% of the interviewed companies) and to increase the net profit of the company (declare 25% of the companies). But market capitalization increase or higher returns of the invested capital and investment decision quality were mentioned in only 13% of the cases.

4. Economic profit drivers in Russian companies

The determining of the key factors for the economic profit, as measurements of company activity strategic efficiency is absolutely necessary in order to create an efficient value management system. The second part of the survey carried out by KPMG and the Corporate finance centre was oriented towards determining those factors based on econometric analysis. These studies were started by the Corporate finance centre as far back as 2006. During this whole period of time, studies were performed in the following fields: research regarding the level of the economic profit compared to market capitalization, based on the data of the telecommunication companies from the countries with developing capital markets (Ivashkovskaya, 2010); the influence of the corporate management on the strategic efficiency of the company, calculated as the economic profit, in case of big Russian companies (Ivashkovskaya, 2009); analysis of Russian companies’ stability and growth level, based on the economic profit (Ivashkovskaya, Jivotova, 2009).

Research methodology is based on the simplified formula of the economic profit, which, in its calculation, takes into account just the interests of the company shareholders. Economic profit is calculated based on profitability spread: the difference between the actual profitability to equity (the ratio between the net profit and the invested equity) and the profitability requested by the investors (K_e), as

shown in formula (5). For this work, accounting data were used without adjustments:

$$5) \text{ Spread} = \frac{NI}{E} - Ke.$$

To determine economic profit between 2007 – 2009, the results of 68 big Russian companies (from all the fields of activity from the Russian economy) were analysed. The review was based on 2 models, one focused on financial and industrial variables, and the second one – on variables which characterize the financial architecture of the company.

The results of the performed analyses allowed the outlining of some conclusions. The obtained interdependence between the economic profit spread and the financial factors indicates a positive influence on operational profitability, income level increase degree, business risks, which reflect the company operational indicators volatility in time, the presence of foreign investors among shareholders. Some other influences are those of the activity field type factors, capital structure and size.

The second model, directed to determining the role of company financial architecture factor in value creation, allowed the detecting of an interdependence between the spread indicator and the percentage of shares held by the first 3 major shareholders, the percentage held by independent directors, and the size of the company capital. As a negative factor was mentioned the existence of institutional investors among the company owners and the number of the Board members. Capital structure also remained insignificant.

Mostly, both methods lead to a result: the obtained values of R^2 represent 29% and 42%, respectively.

Therefore, for the Russian companies, the value-based management remains a new enough practice. At the same time, this approach represents for investors a mechanism which will allow the increase of the fundamental value of their business, thus increasing the level of their income. The EVA concept represents one of the most widespread methods of determining economic profit, based on the value management applied in the company. Although it is not complicated to calculate this indicator, it allows the evaluation of the fundamental value and represents an index of company activity fluctuation and efficiency during each period of its existence.

The companies' own potential to improve innovation is limited. Therefore, the Russian government policy measures should be proactive and focused. However, the creation in a company of the value-based management system and the selection of the economic profit calculation method should also take into account the internal characteristics of the company – elements which considerably influence strategic efficiency.

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