Economic value added and shareholder value added accounting essay

Agrawal (2007) defines shareholder value added (SVA) as the term used for the difference between the wealth held by the shareholders at the end of a given year and the wealth they held the previous year. In other words, SVA is the estimated future cash flows that are discounted to present value to calculate the value of the firm continuously. Measuring the current performance is based on comparing these cash flow estimates and period's real cash flow (Rappaport, 1986).

Therefore, SVA represents the economic profits generated by a business above the minimum return required by all providers of capital. Value term is added when the overall net economic cash flow of the business exceeds the economic cost of all the capital employed to produce the operating profit. Hence, SVA integrates financial statements of the business (profit and loss, balance sheet and cash flow) into one meaningful measure.

Economic Value Added (EVA) is best explained by Drucker (1998) as, ' EVA is based upon something we have known for a long time: What we call profits, the money left to service equity, is usually not profit at all. Until a business returns a profit that is greater than its cost of capital, it operates at a loss.' In other words, EVA is a measure that tells what has happened to the wealth of shareholders. Accordingly, earning a return greater than the cost of capital increases value of a company, and earning less destroys the value. EVA is calculated as the excess of net operating profit over the cost of capital including cost of equity.

EVA is the mostly encountered index of measuring economic profit. It is an index of measuring internal and external performance of companies being introduced by Stern Steward American consulting firm. EVA index is relevant in quantifying the capacity of a company of creating value for capital suppliers; capital cost represents the index of the average efficiency expected by investors under similar risk circumstances.

Return on Capital Employed

There are many definitions for the return on capital employed (ROCE), but the widely-used definition, as evidenced by the fact that it is the standard measure produced by DATASTREAM and Standard & Poor's Compustat Service is ROCE equals to EBIT over capital employed. It is measured by comparing the profits made by the firm with the capital used in making the profit and set as a percentage or fraction. Hence, ROCE measures the efficiency of management in the application or use of the organization's funds or resources in a given financial period

Value Based Management

According to Coca-Cola's ' A Guide to Implementing Value-Based Management, 1997,' VBM is defined as ' a set of principles that allows us to manage value at all levels of our business. Value creation becomes not just our company's mission, it becomes the philosophy we work with daily. It becomes the framework for everything we do'.

VBM measures are generally based on comparison between (a) corporate market value & corporate accounting book value and/or (b) on the residual income measure.

VBM provides an integrated management strategy and financial control system designed to mitigate agency conflicts and increase shareholder value. VBM systems attempt to accomplish this goal by providing managers with a set of decision-making tools (metrics) that can identify which alternatives create or destroy value, and often by linking compensation and promotions to shareholder value. VBM provide a mechanism for linking managers' decisions to firm performance outcomes that create shareholder value and provide a means to further align shareholder and managerial interests.

Blue Ocean Strategy

Blue ocean strategy (BOS) is a set of ideas encompassing tools and methodologies to help companies gain a competitive edge by creating uncontested market space or ' Blue Oceans'.

It is based on the view that market boundaries and industry structure are not given and can be reconstructed by the actions and beliefs of industry players. W. Chan Kim and Ren'e Mauborgne, called this as the ' reconstructionist' view. Blue ocean strategies reconstruct market boundaries, thereby freeing companies from head-to-head competition and instead opening new market space to achieve a leap in value for both buyers and for themselves. Identifying a potentially successful strategic move does not require any special capacities, vision or foresight about the future. All new insights come through looking at familiar data from a new perspective. Blue ocean strategy integrates the range of a firm's functional and operational activities. In this sense, blue ocean strategy is more than innovation. It is about strategy that embraces the entire system of a company’s activities.

METHODOLOGIES

Shareholder Value Added

The SVA methodology is an approach to assist management in the decision making process. Its applications include performance monitoring, capital budgeting, output pricing and market valuation of the entity.

SVA = (Present value of cash flow from operations during the forecast period + residual value + marketable securities) ‘ Debt.

The net of the present value of cash flow and the opportunity cost associated with the firm’s capital is a measure of the surplus or additional value provided to the shareholders as a result of the firm’s activities. This formula is expressed in dollar terms for a period

Economic Value Added

The EVA methodology can be applied to create wealth for the owners of businesses from all levels or size of the firms. It is a performance measurement which directly links strategy to value and is therefore the key to wealth creation.

EVA = Net Operating Profit after Taxes (NOPAT) ‘ (Capital*WACC)

NOPAT is an operating performance measure after taking account of taxation, but before any financing costs. Interest is totally excluded from NOPAT as it appears implicitly in the capital charge.

Capital costs include both the cost of debt finance and the cost of equity finance. The cost of these sources of finance is reflected by the return required by the funds provider. This capital cost is referred to as the Weighted Average Cost of Capital

Economic Value Added will increase if:

‘ New capital is invested and it earns more than the cost of capital.

‘ Capital is divested from the business if it does not cover the cost of capital.

‘ NOPAT increases without increasing the capital employed.

Return on Capital Employed

The ROCE methodology indicates how well the management has used the investment made by owners and creditors into the business. It is commonly used as a basis for various managerial decisions.

ROCE = EBIT/ (Total Assets – Current Liabilities)

The ROCE ratio can be found for a number of years so as to find a trend as to whether the profitability of the company is improving or otherwise.

Value Based Management

VBM methodology provides an integrated framework for making strategic and operating decisions. By aligning internal business processes, strategies, and corporate governance and investor communications, VBM provide a common discipline, a consistent culture, and a singular focus on value for all business activities.

There are many ways to measure and implement VBM in the business. Four approaches have been widely used in practice. One is fundamental value analysis (FVA). Two is returns to shareholder (RTS). Three is economic profit. Four is the relationship between the market value of the firm’s financial instruments and the book value of the firm’s operating assets (MVA, the q-ratio, and the market-to-book ratio). Planning and control analyses of the structure of income, costs, and investments are also employed in implementing the four approaches.

In implementation, each approach to value based management (VBM) starts with strategic planning processes, ties performance to incentive compensation, requires top management involvement, as well as information and training programs for employees.

The four approaches to VBM also take into account other stakeholders such as employees, consumers and community. VBM must also evaluate changing economic, cultural, and political environments. The strategic planning process analyzes long term trends, cyclical economic changes, competitive forces, and effective development of managerial capabilities and other resources.

Blue Ocean Strategy

To create a blue ocean market, there are several frameworks and tools to be applied in the business. First approach is the strategy canvas which is both a diagnostic and an action framework for building a compelling blue ocean strategy. It serves two purposes. First, it captures the current state of play in the known market space. This allows managers to understand where the competition is currently investing; the factors the industry currently competes on in products, service, and delivery; and what customers receive from the existing competitive offerings on the market.

Second approach is the Four Actions Framework which is the value innovation analysis. This approach asks four key questions to challenge an industry’s strategic logic and business model. The first question forces a company to consider eliminating factors that company in an industry have long competed on. The second question forces a company to determine whether products or services have been over-designed in the race to match and beat the competition. The third question pushes a company to uncover and eliminate the compromises an industry forces customer to make. The fourth question helps a company to discover entirely new sources of value for buyers and to create new demand and shift the strategic pricing of the industry. All the four questions allow a company to systematically explore how it can reconstruct buyer value elements across alternative industries to offer buyers an entirely new experience, while simultaneously keeping its cost structure low.

Third approach is the Eliminate-Reduce-Raise-Create Grid. The grid pushes companies not only to ask all four questions in the four actions framework but also to act on all four to create a new value curve. By driving companies to fill in the grid with the actions of eliminating and reducing as well as raising and creating, the grid gives companies four immediate benefits; it pushes them to simultaneously pursue differentiation and low costs to break the value/cost trade-off, immediately flags companies that are focused only on raising and creating and thereby lifting their cost structure and often over-engineering products and service, is easily understood by managers at any level, creating a high level of engagement in its application and because completing the grid is a challenging task, it drives companies to robustly scrutinize every factor the industry competes on, making them discover the range of implicit assumptions they make unconsciously in competing.

APPLICATIONS AND PRACTICES BY CORPORATE ENTITIES

Shareholder Value Added

The use of SVA gives an insight into the investment performance of the business by clearly identifying the opportunity cost of the investment, being the cost of capital, and comparing this to the return generated from the business.

SVA can be applied to all the segments within a firm. Accordingly, it is primarily used by managers to evaluate the performance of divisions or branches.

Practices

AFS Consulting (2004) did a research on SVA performance with the Malaysian Banking Industry. The result shows that Maybank Berhad (MBB) and Hong Leong Bank Berhad (HLBB) emerge as banking institutions that create the best shareholder wealth or value among the local banks. While MBB and HLBB have enormous potential to be the leading domestic bank competing with foreign banks, both banks are still lagging behind in shareholder value creation compared to the incumbent foreign banks, which operate in a highly restrictive and controlled environment.

Economic Value Added

EVA can be used for the purposes like setting the organizational goals, performance measurement, determining bonuses, communication with shareholders and investors, motivation of managers, capital budgeting, corporate valuation and analyzing equity securities.

Practices

The study done by Issham Ismail on the performance of GLCs (Government-Linked Companies) and non-GLCs in Malaysia using EVA found that the outcomes of the study indicate a negative relationship between the size of the companies and the EVA values. The larger companies tend to have lower EVA values. In Malaysia, the GLCs are generally larger in size as compared to non-GLCS. Therefore, companies with government as their stakeholders tend to exhibit lower EVA scores than the companies without government stakeholders.

It is believed that the Malaysian government prefers investing in public amenities companies to protect public interest, evidenced by their active role in Telekom, POS and TNB. These types of companies do not have higher value than their competitors, where the competitors are usually profit-oriented organization.

This outcome further emphasizes that companies that have both the characteristics, large sized and government-linked, tend to have lower EVA values. It also leads to findings that an expansion of size government holding companies tends to increase the cost of capital in greater proportion to the any returns it generates.

Return on Capital Employed

ROCE is used to prove the value the business gains from its assets and liabilities, a business which owns lots of land but has little profit will have a smaller ROCE to a business which owns little land but makes the same profit. It basically can be used to show how much a business is gaining for its assets, or how much it is losing for its liabilities.

Practices

Norman Kahl and Jawad Shaikh (2003) analyzed ROCE trends over time for twelve major telecommunication service providers. The sample size represents nearly two-thirds of the US and nearly three-quarters of the Western European telecom services market. The result shows a significant regional difference exist, with ROCE at around 9% in the US and -8% in Europe. The negative European ROCE can only partially be explained by the enormous write-offs made in 2001 and 2002. Other finding is that past and present initiatives of the industry have mainly focused on revenue generation and operational efficiency; but less focus on asset utilization. This shows that by consistently leveraging all three drivers of ROCE (revenue generation, operational efficiency, and asset management), companies are able to get back on track and may even gain a sustainable leap versus their competitors.

Value Based Management

VBM emphasizes long-term cash flows analysis and risk analysis in all aspects of managerial decision making, such as evaluating individual projects and determining the economic value of the overall strategy of the business.

The VBM approach is ultimately aimed at the goal of structuring and managing a company in a way that will create more value for its owners. Bromwich (1998) observes the need for measuring tools, applicable to different organizational levels, such as corporate and business unit level, while Ottoson and Weissenrieder (1996) emphasize the need for measurement systems that can be used for internal and external communication.

Practices

Harley E. Ryan, Jr. and Emery A. Trahan (2007) examine the performance of 84 firms that adopt value-based management (VBM) systems during the period 1984-1997. The result shows that the typical firm significantly improves residual income after adopting VBM. This improvement persists for the five post adoption years studied. They also found a negative relation between tying compensation to VBM and post-adoption performance.

Furthermore, firms reduce capital expenditures following VBM adoption, but that the reductions in spending do not differ based on the firms' growth opportunities. Overall, the evidence suggests that VBM improves economic performance and the efficient use of capital.

Blue Ocean Strategy

The frameworks and tools introduced by Kim and Renee (2006) are essential analytics that can be applied to allow companies to break from the competition and open up blue oceans of uncontested market space.

Practices

According to The Star Online dated July 16, 2007 titled ' Blue Ocean Strategy for Corporate Malaysia', Harvard Business School Professor D. Quinn Mills, states that there were many companies worldwide that are adopting BOS either knowingly or unknowingly. In addition, companies that know how to apply BOS to access a bigger market would reap significant benefits in terms of earnings. On questions regarding the Malaysian companies adopting BOS, he said: ' We believe the strategy is still fairly new to local companies. However, it is likely that many CEOs are aware of BOS but have yet to fully understand and apply the strategy to their companies'. He also cited Air Asia as an example of a successful company that had identified a Blue Ocean and created a business model to capture and untapped and un-served market in the travel industry. Mills also said BOS was especially important for a country like Malaysia with a small population and market.