Outsource inc case essay sample

Finance, Investment

Q1. Explain EVA an MVA and how they are calculated and how they compare with traditional measures of a firm's financial performance.

A1: Economic Value added (EVA) is a financial performance method to calculate the true economic profit of a corporation. EVA can be calculated as Net Operating Profit After Tax minus a charge for the opportunity cost of the capital invested. EVA is an estimate of the amount that earnings differ from the required minimum rate of return for shareholders or lenders. The difference can be both a surplus and a shortage.

EVA has a greater power to explain market value than other traditional accounting measures do.

Q2. What are the advantages and disadvantages of using an EVA to evaluate the firm's performance? Advantages•WACC incorporates a premium for (market's view of) risk. So EVA (unlike ROCE) takes account of risk.

•Tax is more fully reflected by using a post-tax capital charge (WACC) and a notionally taxed PBIT.

•Does not require cash flow estimation and discounting of cash flows. (Nor does ROCE.)•It makes use of the existing accounting and financial reporting systems of companies (as does ROCE).

Disadvantages•Accounting profits and book asset values may be unreliable/irrelevant (as for ROCE).

•Fails to solve short-termism. Managers may still prefer projects with high short-run EVA to longer-term projects whose aggregate wealth-creating capacity may be greater. [Because EVA, like ROCE, is also usually based on a “ snapshot” or short time series of data.]•Is it valid to mix accounting and market measures as EVA does? Q3. Calculate EVA and MVA from Outsource Inc and whether it could be used as an incentive system for its employees.

Ans: Operating Current Assets (OCA)= Current Assets – Short term investments = 438, 685 – 61, 047= $ 377, 638Operating Current Liabilities(OCL) = Current liabilities- Notes payable= 235, 176 – (27, 300 + 45, 050 + 19, 936)= 235, 176 – 92, 286= $ 142, 890Net Operating Working Capital (NOWC) = OCA – OCL= 377, 638 – 142, 890= $ 234, 748Total Net Operating Capital (TOC) = NOWC + Fixed Assets= 234, 748 + 226, 884= $ 461, 632Net operating profit after taxes (NOPAT) = EBIT x (1 – T)= 73, 904 x (1 – 0. 35)= 73, 904 x 0. 65= $ 48, 038Operating Cash Flow (OCF) = NOPAT + depreciation= 48, 038 + 21, 978= $ 70, 016MVA = Stock Price x no: of shares – Total common equity= $ 2 x 219, 884 – 313, 065= 439, 768 – 313, 065= $ 126, 703EVA = NOPAT – Operating Capital x After tax Cost of Capital= 48, 038 – [FA + (OCA – OCL)] x 12. 5%= 48, 038 – (461, 632 x 12. 5%)= 48, 038 – 57, 704= $-9, 666EVA is a critical driver of a company’s stock performance. Since the company suffers negative EVA it cannot be used as an incentive system for its employees.