

A study on awareness and adaptability of economic value added concept in indian banking sector

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ABSTRACT

This paper highlights the awareness and applicability of Economic Value Added in Indian Banks on the basis of survey report. Indian Banks listed on the Mumbai Stock Exchange BSE were analyzed. It is further divided into sub-parts which include awareness and use of value-based financial performance, adaptability to Economic Value Added in select Indian Banks, ownership pattern-wise Economic Value Added, and discussion on such time-honoured statistical propensities. The Study concludes that Economic Value Added is slowly gaining an increased attention as a financial measure of business performance of banks. It holds up the researcher's view that the concept of Economic Value Added has been emerging in the brains of the top brass of the corporate world in India and has nurtured a remarkably excellent time ahead.

KEY WORDS: *Economic Value Added, Market Value Added, Cost of Capital.*

Introduction

The fundamental principle of capitalism is that organizations are expected to take financial capital from shareholders and make it worth more. The Success of the firm depends on its proficient management having theoretically sound knowledge of time-honoured tools for planning, decision-making, forecasting and monitoring. Developing new-fangled financial and

management accounting tool is an incredibly contemporary subject matter for both the academicians engaged in business research and financial consultants in practice. During the last few years, the field of finance has become even more prominent. The concept of the Economic Value Added is similar to the traditional accounting concept of Residual Income [RI]. The concept

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emerges in several variations and incarnations including the trade-marked Stern Stewart & Co's EVA with its copious accounting adjustments. Corresponding to Stewart [1991] view, EVA is a residual return measure that subtracts the cost of invested capital from net operating profit after tax.

$$\text{EVA} = \text{NOPAT} - [\text{WACC} \times \text{IC}]$$

Where

NOPAT = Net operating profit after tax

WACC = Weighted Average Cost of Capital

IC = Invested Capital

To compute EVA, Stewart [1994] considers more than 160 adjustments to NOPAT and IC. Most of the adjustments are intended to shifting the traditional accounting closer to 'economic value' accounting in order to encourage managers to perform like owners and to discourage earnings management. The adjustments also improve comparability externally [across firms] and internally [across divisions] by the accounting on a similar basis. Thus, the litmus test behind any decision to raise, invest, or retain a rupee must be to create more value than the investor might have achieved with an otherwise alternative investment opportunity of similar risk. Lay investors tend to focus far too much on size and income-based metrics such as share price, earnings, earnings

growth and earnings per share. Such metrics do not take into account how much additional capital has been poured into the business to generate the additional income. To add wealth, managers focus on Economic Value Added and Market Value Added. MVA is an ideal measure of wealth creation in the long term. EVA tells us how much shareholder wealth the business has created in a given time. Proponents of EVA argue that EVA is a superior measure as compared to other performance measures on four counts :

- It is nearer to the real cash flows of the business entity;
- It is easy to calculate and understand;
- It has a higher correlation to the market value of the firm and
- Its application to employee compensation leads to the alignment of managerial interests with those of the shareholders, thus minimizing the supposedly dysfunctional behaviour of the management.

Objective of the study

- To examine the extent of awareness and adaptability of Economic Value Added Concept of the Indian Banks Listed in BSE-SENSEX.
- To make Suggestions and Recommendations for the use of Economic Value Added as a measure of financial performance to the Banking Sector.

Methodology

Various Studies including this maintain the surfacing of EVA as significant independent variable to MVA for companies in India through secondary data but the studies conducted so far do not suggest about the sensible implementation of EVA in India by the Indian Banking Sector. In simple words, to the best of the knowledge of the researcher, there is no verification through primary information on the awareness and adaptability of value-based financial performance measures in Indian Banks [Both public and private sector banks]. With this reason in mind, the select Indian Banks from BSE-200 have been approached through a well-structured questionnaire for evaluating the realistic face of EVA in India.

To obtain information on the indicators considered most important by Banks, the primary data has been collected through a well-structured questionnaire mailed to all 39 Selected Indian Banks listed at the Mumbai Stock Exchange [BSE] . The questionnaire was also made available upon request of some banks through e-mail, it was specifically designed to obtain information on the preferred financial performance measures on the awareness and adaptability of new value-based performance measures , as well as on the conditions and scope of adaptability of the new performance measures in respective banks.

The broad research task of this paper is to survey and assess how the EVA Model behaves under

different, realistic corporate situation and compares it to the instantaneous behaviour of other traditional financial variables. To embark upon the posed problems suitable cases of banks are looked-for which highlight each of the bits and pieces. The humdrum alternative is to rummage around the theory and practice of EVA in Indian context.

Awareness and Adaptability to Eva in Indian Banking Sector

An attempt has been made here to bring out the lattice outcome of the survey so conducted through the questionnaire. The results of the survey have been presented by Tables 1 to 7. Table 1 offers the profile of the respondents in Indian Banking Sector which includes both private and public banks listed in BSE. The majority of the respondents who fill up the questionnaire are either General managers (28.2%) or Assistant General Managers (46.2%). The preponderance percentage of the banks selected for the purpose of the survey is mostly more than fifteen year old established organizations and unquestionably all the companies are willing to maximize shareholders wealth.

The Significance of different Variables in the growth of the banks is perceived in a different way by the respondents as evident from Table 2. The table depicts that as many as 33 percentage

respondents consider Net non performing loans as significant variable followed by another 28 % who find the Return on Assets as better indicator of the organizational growth. About 18% feel that Return on owned funds may be the significant variable whereas capital adequacy ratio is given priority by 13% of the respondents. One thing emerged here is that all the respondents consider only four variables as significant and all these variables demand better performance on the part of the banking. It sounds that the efficiency and effectiveness if go up may be observed as significant variable in the growth of the organization and same is expected from a corporate generating positive EVA. Hence, the observations of the respondents authenticate the inevitability of such performance measure

approach in an organization that may truthfully prove to be significant for the persistent escalation.

In the Table 3, the opinion of the respondents regarding the effectiveness of various financial measures for performance evaluation of the banking sector is brought together. It is undoubtedly clear that 9 [23.07%] respondents assign first rank to EVA as the best indicator of performance evaluation of bank followed by Rate of return, Return on owned funds and net operating profit margin. If top five ranks are taken into account, it is observed that 33 [84%] respondents consider EVA among top as the best financial measures followed by ROF [71.79%], Rate of Return [69.23%], Business Per Employee [64.10%], NOPAT [61.54%],Market Share [48.72%], and EPS [28.21%].

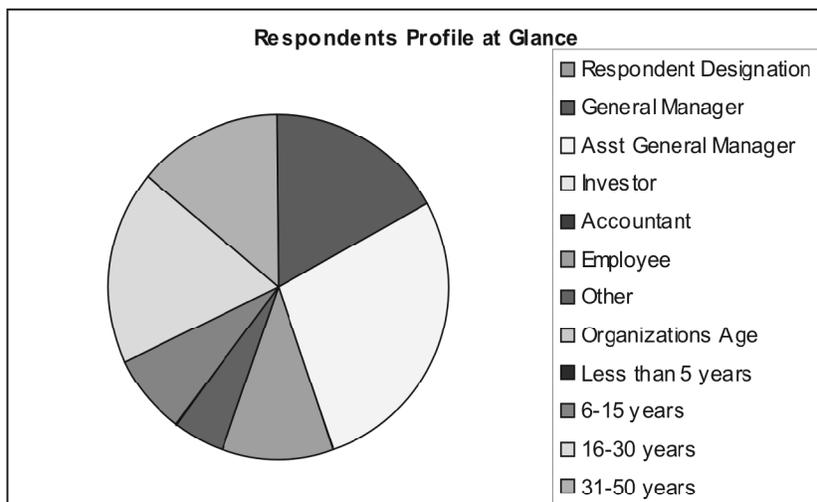


TABLE 1 : Respondents Profile at a Glance

	Score	%
Respondent Designation		
General Manager	11	28.2
Asst General Manager	18	46.2
Investor	0	0
Accountant	0	0
Employee	7	17.9
Other	3	7.7
Organizations Age		
Less than 5 years	0	0
6-15 years	5	12.8
16-30 years	12	30.8
31-50 years	9	23.1
More than 50 years	13	33.3
Financial Objectives		
Maximize Shareholders wealth	39	100
Remain profitable	0	0
Be competitive	0	0
Others [please specify]	0	0

Source : As per our survey

TABLE 2 : Banks Preferences for Performance Parameters

Significant Variables	Score	%
Return on Assets	9	23
Return on Owned Funds	7	18
Net Non-performing Loans [NPL]	13	33
Capital Adequacy	5	13
Cost-Income	2	5
Net Interest Margin	3	8
Others [Please Specify]	0	0

Source : As per our survey

The concept of Economic Value Added is based on the sound economic principle that firm value increases only if it is able to generate surplus over its cost of capital and therefore it is based on strong theoretical foundation. However its calculation involves significant subjectivity and this reduces its

informative value. Moreover it fails to provide better signals to the capital market as compared to conventional accounting measures like Return on Investment, however hard selling of EVA has contributed positively in highlighting the fundamental economic principle, long forgotten by managers.

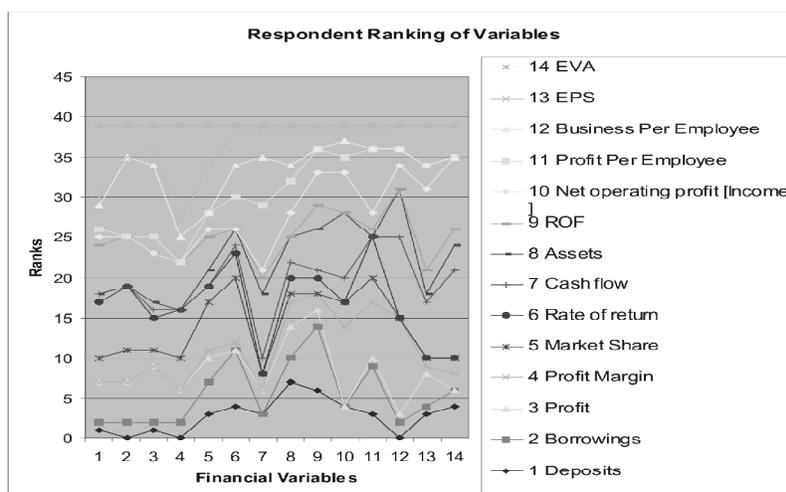
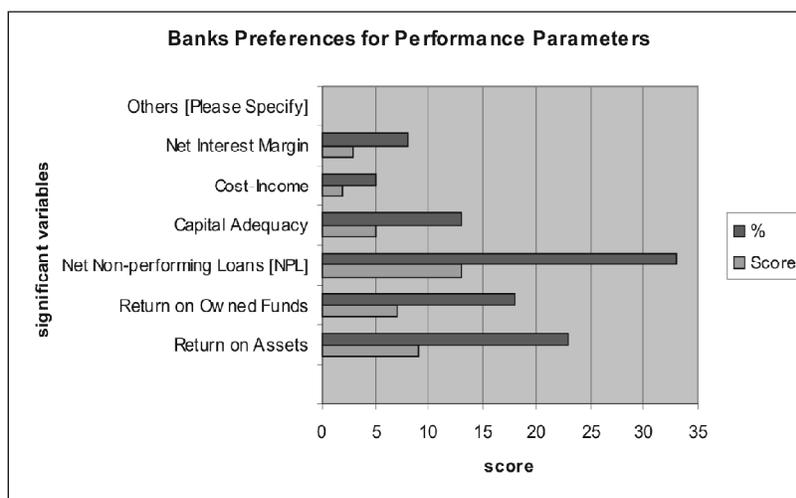


TABLE 3 : Respondents Ranking of Different Financial Variables

S.No	FinancialVariables	1	2	3	4	5	6	7	8	9	10	11	12	13	14	Total
1	Deposits	1	0	1	0	3	4	3	7	6	4	3	0	3	4	39
2	Borrowings	1	2	1	2	4	7	0	3	8	0	6	2	1	2	39
3	Profit	5	5	7	4	3	0	3	4	2	0	1	1	4	0	39
4	Profit Margin	0	0	0	0	1	1	0	3	2	10	7	12	1	2	39
5	Market Share	3	4	2	4	6	8	2	1	0	3	3	0	1	2	39
6	Rate of return	7	8	4	6	2	3	0	2	2	0	5	0	0	0	39
7	Cash flow	1	0	1	0	0	1	2	2	1	3	0	10	7	11	39
8	Assets	0	0	1	0	2	2	8	3	5	8	0	6	1	3	39
9	ROF	6	6	6	6	4	0	2	0	3	0	1	0	3	2	39
10	Net operating profit [Income]	1	0	0	0	1	0	1	3	4	5	2	3	10	9	39
11	Profit Per Employee	1	0	2	0	2	4	8	4	3	2	8	2	3	0	39
12	Business Per Employee	3	10	9	3	0	4	6	2	0	2	0	0	0	0	39
13	EPS	1	0	2	2	6	4	3	4	2	1	2	3	5	4	39
14	EVA	9	4	3	12	5	1	1	1	1	1	1	0	0	0	39
	TOTAL	39	-													

Source : As per our survey

TABLE 4 : Respondent's Ranking of Different Financial Variables : Statistical Analysis

Descriptive Statistics

	N	Mean	Std.Deviation	Minimum	Maximum	Mean Rank
Assets	14	2.7857	1.7177	.00	7.00	8.79
Cash Flow	14	2.7857	2.7225	.00	8.00	7.46
EPS	14	2.7857	2.9399	.00	10.00	7.36
EVA	14	2.7857	3.4009	.00	11.00	7.18
Profit	14	2.7857	2.7506	.00	9.00	7.39
Market Share	14	2.7857	2.0069	.00	6.00	8.21
PPE	14	2.7857	2.6941	.00	8.00	7.36
NOPAT	14	2.7857	3.0929	.00	10.00	7.25
Borrowings	14	2.7857	3.4234	.00	10.00	7.04
BPE	14	2.7857	3.9062	.00	12.00	6.43
Return	14	2.7857	2.5474	.00	8.00	8.21
Profit Margin	14	2.7857	3.4681	.00	12.00	6.93
ROF	14	2.7857	2.2931	.00	8.00	8.07
Deposits	14	2.7857	2.8603	.00	9.00	7.32
Test Statistics ^a						
N	14	Chi-Square 4.139		df	13	Asymp. Sig. .990

(a) Friedman Test.

TABLE 5 : EVA's Significance : Respondent's View

	Score	%
Familiarity with EVA		
Unfamiliar	7	18
Somehow	5	13
Familiar	23	59
Very Familiar	4	10
Adaptability of EVA in Banks		
EVA Concept is unknown to our bank	7	18
We collect information about EVA and will decide later	15	39
EVA is already implemented and we are satisfied with it.	0	
EVA is already implemented and is somehow useful to us	0	
EVA is already implemented and we are not satisfied with it	0	
We plan to implement EVA to our bank	17	43
EVA is of no use to us	0	
EVA as the Most Important Decision –making Factor		
Yes	10	26
No	29	74
EVA as True Indicator of Financial Performance		
Yes	8	21
Sometimes	12	31
Cannot Say	17	43
No	2	5
EVA's Worthwhile ness in Future		
Very Worthwhile	8	21
Worthwhile	11	28
Somewhat Worthwhile	10	26
Not very Worthwhile	6	15
Not Worthwhile	4	10
EVA used as a Evaluation Variable		
Short term Financial Performance	2	5.1
Long term Financial Performance	0	0
Management Decision	28	71.8
Any other [please specify]	9	23.1

Source: As per our Survey

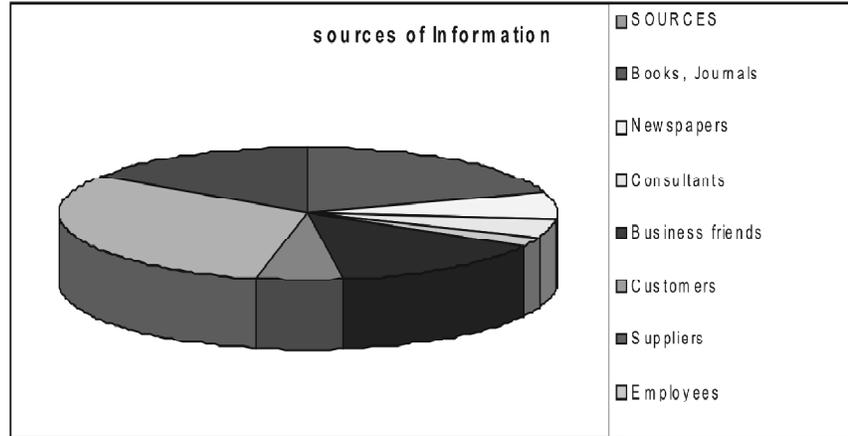
Table 4 depicts the Statistical analysis of these ranks assigned by the respondents. The values show the volatility in EVA and that of Standard deviation. Table 5 also presents the results on the EVA's worthwhile ness in future. Taken together, 74% of the respondents make a clean breast about the good future of EVA in Indian Banking. When called for the use of EVA as valuation variable, the vast majority finds it valuable in the strategic decisions made by the banks and about one-fourth portray that the concept is used by different stakeholders for their particular rationale in decision-making. The overall inference may be drawn from the Table 6 that most of the banks are aware about the concept, they are serious about its implementation in their respective banks, and find EVA as true indicator of financial performance and also foresee the bright future of EVA in India in the times to come.

TABLE 6: Sources of Information for New tools of corporate

Financial Performance

	Score	%
SOURCES		
Books, Journals	18	20
Newspapers	6	6.7
Consultants	4	4.4
Business friends	0	0
Customers	0	0
Suppliers	0	0
Employees	2	2.2
Internet	13	14.4
Universities	5	5.6
Government Agencies	0	0
Workshops, Conferences , Seminars	28	31.1
Professional Organizations	14	15.6
Others [Please specify]	0	0

Source: As per our survey



In Table 6, the outcome of the sources of information exploited by the banks for taking into deliberation the innovative tools of corporate financial performance is summarized. The Table delineates that majority of the banks rely upon the workshop, conferences, seminars organized by the professional bodies like IBA, CII, FICCI, etc., One-fifth finds the relevant information from the books and journals& about one-seventh of them depend on the information made available websites on Internet. Universities, newspapers, consultants and others account for only about 20%.

TABLE 7: Implementation and Disclosure of EVA

	Score	%
SOURCES		
Plan to implement or already implemented		
Yes	10	25.6
Somehow interested	28	71.8
No	1	2.6
Calculated EVA in Your Annual Report		
Yes [in future]	7	17.9
No	32	82.1

Source: As per our survey

When the respondents accede to the query, as depicted in Table 7, about the implementation of EVA in their respective banks, responses received are rather thrilling. The table views that over one-fourth of the banks are already planned to implement EVA and over 70% of them are somehow interested in implementing it in very near future. On the other hand, only about 18% of the banks interested to disclose their EVA in the annual report in future. The overall results of the table indicate that the corporate world in India, has possibly become conscious on the subject and the worth of the concept in its letter and spirit has been enormously appreciated by the majority of them. It holds up the researchers view that the concept of EVA has been emerging in the brains of the top brass of the corporate world in Indian

Banking and has nurtured a remarkably excellent time ahead. India has found supporters for EVA. It has already earned favour with journalists and leaders in corporate reporting. However most of them do not calculate EVA rigorously, rather they take casual approach in calculating and reporting EVA. The study published by Economic Times neither adjusted book capital to bring it closer to economic capital nor used rigorous model to compute the cost of equity. Perhaps the short cut was adopted by the study to circumvent difficulties in estimating equity and converting book capital into economic capital. Indian companies have started using EVA for improving internal governance. It is expected that EVA will gain popularity more as a management planning and control tool.

TABLE 8 : SUMMARY OF KEY RESPONSES

S.No.	Top Five Variables Preferred by Indian Banks	Familiarity with EVA	EVA as True Indicator of Performance	EVA's Worthwhile-ness in Future	Plan to implement
1	EVA			Very much-21%	
2	Return on Owned Funds	Unfamiliar- 18%	Yes- 21%	Worthwhile-28%	
3	Rate of Return	Somehow-13%	Sometimes-31%	Somewhat- 26%	Yes- 25.6%
4	Business Per Employee	Familiar-59%	Cant say- 43%	Not very worthwhile-15%	Somehow interested-71.8%
5	Net Operating Profit After Tax	Very familiar-10%	No- 5%	Not worthwhile-10%	No- 2.6%

Source: As per our survey

Conclusion

Most of the Public and Private sector banks in our country have already started looking at their portfolio of services offered and what they should do in the future for remaining competitive in the industry. As public sector banks are likely to undergo major consolidation, suddenly for many Indian banks things have changed. One should however consider that the banks objective is to maximize Market Value Added, since it reflects the premium or discount of the market value relatively to the capital invested in the bank. However, the future research might examine which components of Economic Value Added contribute to increase or decrease its information content. It would also be interesting to assess the explanatory power of Economic Value Added from both a time series perspective and over a larger universe of firms. Some finer models, such as industry-specific and sector-specific models based on large number of organisations may provide additional insights. Shareholders Value is gaining an increased attention as a criterion of business performance. For Indian Banks there seems to be enough empirical evidence to support Stern Stewart's claim that EVA is superior to traditional performance measure. First, this research brings into play contemporary apprehensions regarding the performance measures, and it also does take into account the expectations of stakeholders in

the financial valuation of banks. All the respondents have no disagreement on the usefulness of the EVA. However, many of the respondent banks still use traditional accounting measures that are known to be ineffective. Bank managers can understand the intricacies in EVA, but seldom have they succeeded in prevailing on the floor employees and managers on the need to adopt the EVA as a performance indicator in order to achieve better results. We, however feel that all this should not be a barrier to present more reliable results.

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