

Economic Performance Measure for Creating Shareholder's Value: A Study of Selected Manufacturing Companies in Colombo Stock Exchange

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Abstract

This study intends to analyse the importance of economic performance measure for creating shareholder's value. There is dearth of literature on economic value added in Asian countries including Sri Lanka. To the best of the researcher's knowledge, this research is the first attempt to investigate economic performance on shareholder's value creation in emerging market. This study lies within the positivism methodology and adopts a quantitative approach. Accordingly, secondary data derived from the annual financial reports of selected 10 manufacturing firms during the period of 2010-15, using the CSE's databases. The study reveals that Economic Value Added (EVA) has a negative and less significant relationship with shareholder's value creation. Whilst, it influences on shareholder's value creation more than half percentage. EVA has been able to gain attention of shareholder's value creation. It is able to depict the true profitability the company and more investment by investors, however there have been very little research conducted on EVA and shareholder's value in Sri Lanka. EVA is vital, in that if not properly planned, investment can have disastrous financial and performance implications.

Keywords: Economic value added, Shareholder's value creation, performance measure.

Preface

Continuous innovation in the management techniques of the companies have been one of the challenges in the business environment and improve their effectiveness (De Hart and De Wet 2008). In the field of management accounting and financial management there have been number of new management concept came into existence. One of the key concept that have been considered as superior by (Stewart 1991, Stern 1993, Berber, Pasula and Radosevic. 2012) amongst other management techniques is Economic Value Added (EVA). Shareholders are only concerned about the value of shares of the company and the amount of return in the form of dividend paid. Thus in order to meet the demands of the shareholders of the company, managers needs to increase their abilities and skills to overcome the organizational goals. Thus the main goal of this paper is to discuss on the role of management decisions towards increasing shareholder's wealth and meet organizational goals. One of the key aspects of management decision is in the form of incentives compensations for managers. The issue of rewarding managers in the form of cash bonuses, in the form of stock compensation or stock putting options for top management executives, or restricted stock reward affects company goals (Sigler 2011).

Due to ample of evolution in last decade in the corporate world, managers and investors are seeking for an economic framework which better mirror the value of their company. Many studies were conducted to examine the comparison between the performance of the company as measured by financial ratios and return on assets, Accounting tools which are being used till today are not sufficient and unlikely in facing the challenge arising from efficient capital markets and owners, but if a company assessed its performance with the financial ratios and generate good judgment, but when measured with the concept of economic value added not necessarily produce good judgment, because the calculation of the company's performance through the concept of economic value added elements in the input cost of capital as one of the elements of the calculation of the company's performance and it shows consideration of the risk level of the company. Value based measurement framework, a new economic dimension is required, which could better reflect the opportunities and downsides.

Economic Value Added (EVA) is the financial performance measure that comes closer than any other to capturing the true economic profit of an enterprise. Thus, in modern economics and finance area, EVA holds an important part that has less debate among practitioners. It is the performance measure most directly linked to the creation of shareholders wealth over time. Shareholders are very much choosy for their interest into the business and they like management to come up with very specific solution. By the time, it is established that the very logic of using EVA is to maximize the value for the shareholders. The use of economic value added method makes companies focus more on the business enterprise value creation. Understanding the value is defined as the value of the utility and benefits enjoyed by the stakeholders (employees, investors, owners, customers).

Company has to be very cautious in selecting their measurement tools, as it will affect substantially the management resources and every department of the company. The concept of economic framework is an innovative way to measure the value of a company. This economic measurement system determines companies' worth and performance based on their economic situation not according to accounting numbers produced using traditional accounting rules. According to the past studies, economic frameworks set quality standard in measuring performance. It is now well-recognized fact that the aim of every business entity should be to maximize shareholders wealth and the activities of firm to achieve the objectives.

Statement of The Problem

Many studies were conducted to examine the performance measure of the company by using performance measure mainly financial ratios and assets returns. EVA measurement is one of the emerging areas of research in accounting and finance among researchers all over the world. It gives more participation to create shareholder's value but there is no more awareness on this area for managers as well as investors.

Significance of The Study

Company has to be very cautious in selecting their measurement tools, as it will affect substantially the management resources and every department of the company. The concept of EVA is an innovative way to measure the value of a company. This economic measurement system determines company's worth and performance based on their economic situation not according number produced using traditional accounting rules. According to the past studies, economic frameworks set quality standards in performance measure. This study will help to make appropriate measurement tools for measure the performance in accordance with shareholders value creation.

Objective

The main objective of the study is to find out the impact of EVA on shareholder's value creation and the sub objectives are

- Identify the relationship between EVA and shareholder's value creation
- To provide an understanding to the investors in relation to the economic performance measure and shareholder's value creation.

Literature Review

Shrikant, K., Panigrahi, Y., Zainuddin, A and Azzlina (2014), founded that there is a positive and significant relationship between EVA and shareholder's wealth maximization, but EVA was not reported by the companies and is not been used by investors for their investment decisions. And also they suggested that mostly the managers produce EVA, the more impact on shareholders' wealth maximization and its creation, Thus it is recommended for the managers to focus more attention to the criteria of EVA in evaluating shareholder's value on importance of economic value added for the shareholders wealth maximization. Further, Pandey (2005) mentioned that economic profitability is the concept of EVA for measuring shareholder's value, based on that there is a strong association between economic profitability and shareholder value.

There is a study related with shareholders and justifying the conflicts between managers and shareholders. This numerous studies have been investigated towards importance of EVA as a value based measure (Jensen, 1986). Another study concluded three findings, such as adjustment can be made as per the economic value numbers for shareholders, Firms have been pushed to adopt EVA concept not only in higher level but also with lower level including managers and employees working for the shareholder's value creation and EVA provides the measurement system that helps shareholders to understand performance appraisals and compensation for managerial performance. (D. Young, 1997)

According to previous researchers Stewart (1991), Young and O'byrne (2001) confirmed that EVA is superior performance measure among the financial performance measurement tools for explaining shareholder's wealth. In addition, Geysers & Liebenberg (2003) Suggested that Economic Value Added is an effective performance measure as well as reliable indicator of long term shareholders wealth maximization based on the study of creating a new valuation tool for South African agricultural co-operatives to find out the capabilities of Economic Value Added

(EVA) for shareholder's wealth creation in terms of regulated and deregulated agribusinesses and cooperatives business. Ben Nacauer and Goaided (1999) investigated the determinants of value creation among listed Tunisian companies. Their results indicate that firm values are positively and significantly correlated with profitability

CSV is a measure that was first developed by (Rappaport, 1986). Recent management trend have focused on the importance of shareholder wealth creation as the goal of any business enterprise. The ability of the business to create shareholder wealth is increasingly seen as the key indicator of management and business performance. Total return to shareholders is one of the shareholder value measures and most direct measures of the return received by shareholders (Powers, 2010).

Shareholder value analysis provides a framework for linking management decision and strategies to value creation. Shareholder value analysis insists the managers to take decision

that can create value for the shareholders. The management is required to pay attention to such value for shareholders while taking investment and financing decisions. Shareholder value analysis helps the management to concentrate on activities which create value to the shareholders rather than short term profitability. Managers should identify value drivers which lead to increase shareholder's value. Shareholder's investment in the business is totally excluded in traditional financial measures and is ignored inappropriately to handle many business decisions that are tradeoffs between profit margin and capital utilization.

Hypothesis

H1: EVA is impact on shareholder's value creation

H2: There is a Significance relationship between EVA and shareholder's value creation.

Conceptual Model

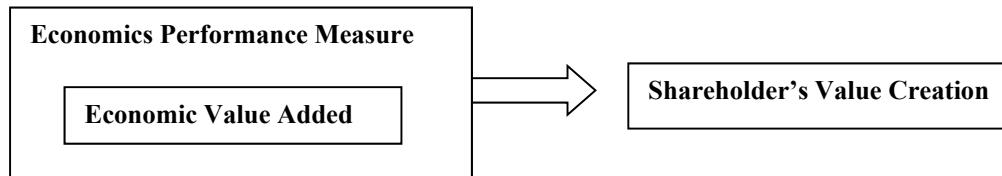


Figure 1: Conceptual Model

Methodology and Data Analysis

Data Collection and Sampling Techniques

The secondary data has been collected from published annual reports of respected company. Convenience sampling technique was used to select sample companies from population. Sample of companies used in the study included 10 companies that went manufacturing Sectors in Colombo Stock Exchange covering a period of Six years ranging from 2010 to 2015. Companies included in the study were as follows:

1. Abans Electricals Public Limited Company
2. ACL Cables Public Limited Company
3. ACL Plastic Public Limited Company
4. ACME Printing and Packaging Public Limited Company
5. Blue Diamonds Jewelry worldwide Public Limited Company
6. Kalani Gables Public Limited Company
7. Laxabana Batteries Public Limited Company
8. Piramal Glass Ceylon Public Limited Company
9. Print Care Public Limited Company
10. Richard Pieries Exports Public Limited Company

The financial statements must have a fiscal year ending December 31 and have been audited and does not use financial statements as of March as per the financial statements are not audited in March 2016. And financial reports interest expense is not zero as sample. This is to avoid the influence of the partial calculation of financial ratios.

Variable Measurement Economic Value Added

Economic value added is a performance indicator that is reflected through the company's profits from the company after considering the cost of the invested capital. Economic value added is the result of a reduction in the total capital cost to operating profit after tax. The cost of equity capital can be either cost of debt and cost of equity. Economic value added is able to calculate the true economic profit (true economic profit) of a company in a given year and are very different when compared to the accounting profit. The steps to calculate the economic value added (Rokhayati, quoted in Widjaja, 2001):

Tools of Analysis

Correlation and regression analysis is used to draw conclusion and

$$EVA = NOPAT - (COC \times CE)$$

$$SVC = \text{Equity market Value} \times (\text{Shareholders return} - K_e)$$

Where,

EVA = Economic Value Added

NOPAT = Net Operating profit after Tax

COC = Cost of Capital

CE = Capital Employed

SVC = Shareholder's Value Creation

K_e = Cost of Equity

EVA criteria that performs well and does well must meet the following criteria:

- When the economic value added > 0 , a process of value-added enterprises, it means either the company's financial performance.
- When the economic value added $= 0$, it shows the position of the company to break even.
- And if the economic value added < 0 , means that the total cost of capital is greater than the operating profit after tax earned, so that the company's financial performance is not good.

Research Model

$$SVC = \beta_0 + \beta_1 (EVA)_{it}$$

Here, SVC is shareholder value creation, and EVA economic value added.

Finding and Discussions

Researcher's hypothesis aims to test the performance measurement tool of economic value added impact and relationship to shareholder's value creation for selected manufacturing companies listed in Colombo stock exchange for the year 2010 to 2015.

Correlation Analysis

Table 1: Descriptive Statistics

	Mean	Std. Deviation	N
EVA	8.94E7	1.738E8	60
SVC	-.69000	1.085138	60

Table: 1 shows the descriptive Statistics of the independent and dependent variable. This variable reflects with the dependent variable shareholder's value creation (SVC). The variables also refer to the level of acceptability and understanding of SVC and adopted by shareholders as measurement tool. Mean of independent variable Economic value added was found to be positive as 8.94 while dependent variable SVC negative value. Overall deviation of the variables is near 1. This result supports to prior research examined in terms of economic value measurement tool and shareholder's value creation.

Table 2: Correlations

		EVA	SVC
EVA	Pearson Correlation	1	-.288*
	Sig. (2-tailed)		.025
	N	60	60
SVC	Pearson Correlation	-.288*	1
	Sig. (2-tailed)	.025	
	N	60	60

*. Correlation is significant at the 0.05 level (2-tailed).

Table: 2, describes the result of correlation between dependent variable and independent variable. The relationship between EVA and SVC was found to be significant at 5% significant level ($p < 0.05$), but based on the Pearson correlation coefficient 28.8% significant relationship between variables was found it is very less percentage. Further it shows the relationship between EVA and SVC. So finally there is significant relationship between EVA and SVC is accepted at 5% significant level.

Regression Analysis

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.288 ^a	.83	.67	1.047946

a. Predictors: (Constant), EVA

The model is significant with adjusted R² of 0.67. this mean economic value added is impact by 67% towards shareholder's value creation for selected manufacturing companies in Colombo stock exchange.

Table 4: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.529	.152		-3.471	.001
	EVA	-1.800E-9	.000	-.288	-2.294	.025

a. Dependent Variable: SVC

Taking a closer look, Table 4, revealed that Shareholder's value creation is influenced by Economic value added in this study and it is negatively performed. From the above table, the p value of EVA is 0.025 and lower than 0.05. Thus H1: EVA is impact on shareholder's value creation is accepted while rejecting null hypothesis 5% significant level ($0.25 < 0.05$).

Conclusion and Recommendations

EVA is used in this study to estimate performance of manufacturing sectors in Sri Lanka and undertaken to investigate relationship and influence EVA on shareholder's value creation. Results and their analysis are portraying the actual picture for the period of 2010 to 2015. Based on the result economic value added is less significantly related but there is influencing more than half percentage on shareholder's value creation.

Economic measures are more accurate to create and maximize shareholder's value. The findings shows significant support but unfortunately EVA was not reported by the companies and is not been used by investors for their investment decisions. Thus it is recommended for the managers to focus more attention to the criteria of EVA in evaluating shareholders value creation. The companies operating in Sri Lanka are still depending on traditional performance measures but economic performance measure is playing vital role when companied with other variables. So highly recommended to observe or adapt for new and emerging trend. This research has been investigated in the selected Manufacturing companies listed in the Colombo Stock Exchange. Further research can be tested separately in different industries and sector in order to make this issue practical and validate the result depicted from this study and also can be test comparison between traditional and economic performance measures and also can add another economic performance measurement tools in order to make validate research in future.

There are different aspects to calculate the financial measurement tools utilized in this study, thus it is suggested to use other formulas and methods in order to confirm the relationship for the variables.

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