

CONCEPT OF ECONOMIC VALUE ADDED AND IT'S APPLICATION IN COMMERCIAL BANKS

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Abstract

This paper tries to highlight the concept of Economic value added and its application of commercial banks and then traditional measures vs. Economic value added. An instrument to measure the value creation has been filled with the emergence of a new concept namely, Economic Value Added (EVA). It has been redefined and propagated by U.S. based mostly Stern Stewart & Company. It is an effort to determine the require for a performance evaluate that is well connected to the shareholders wealth and responsive to the measures of the company's managers. The shareholder worth is taken into account as a necessary aware of the company performance The Study accomplishes that Economic Value Added is slowly gaining an increased attention as a financial measure of corporate 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 natured a extraordinary and excellent time ahead.

Keywords: Applications, Concept, Economic Value Added, Performance Measure, Traditional Measures

INTRODUCTION

Economic Value Added was developed in 1982 by a New York consult firm; Stern Stewart & Co to help valuemaximizing behavior in commercial manager .It is a single and value-based measure which was supposed to judge business ways, projects on capital and to increase long-term shareholders capital. The value that has been created or destroyed by the firm throughout the amount is measured by examination profits with the value of capital accustomed manufacture them. Therefore, the managers will commit to pull out value-destructive activities and invest in comes that area unit crucial to shareholder's wealth. This will lead to an raise in the market value of the company. However, EVA sets managerial performance target and associates it to reward systems. The single goal of increasing stockholder price helps to beat the normal live downside, where diverse measures are used for different purposes with unreliable standards and goal. Rewards

are given to managers WHO area unit ready to flip investor's cash and capital into profits expeditiously. EVA was initially defined by Stewart (1991) as the measure that properly account for all the complex trade-offs involved in creating value. It is calculate as the result of the economic value of the investment commit to the company multiply by the extend among the rate of return on capital, defined as r , and the cost of capital, defined as c .

ECONOMIC VALUE ADDED

Economic Value Added is a modern tool usually used as a business performance measurement in the present scenario and there have been a model shift in situation corporate objectives and performance measurement. This shift happens with the change in corporate approach and the arrival of professional management. It is nowadays well-recognized information to the focus of each company entity should be to maximizing shareholders wealth and the behavior of firm to achieve the objectives.

Economic Value Added is a measure of economic profit. It is calculated as the variation among the Net Operating Profit after Tax and the opening cost of invested Capital. This opening cost is determined by the weighted average cost of Debt and Equity Capital ("WACC") and the amount of Capital employed.

RESEARCH OBJECTIVES

1. To study the concept of Economic value added and its application of commercial banks.
2. To study the traditional measures and Economic value added.

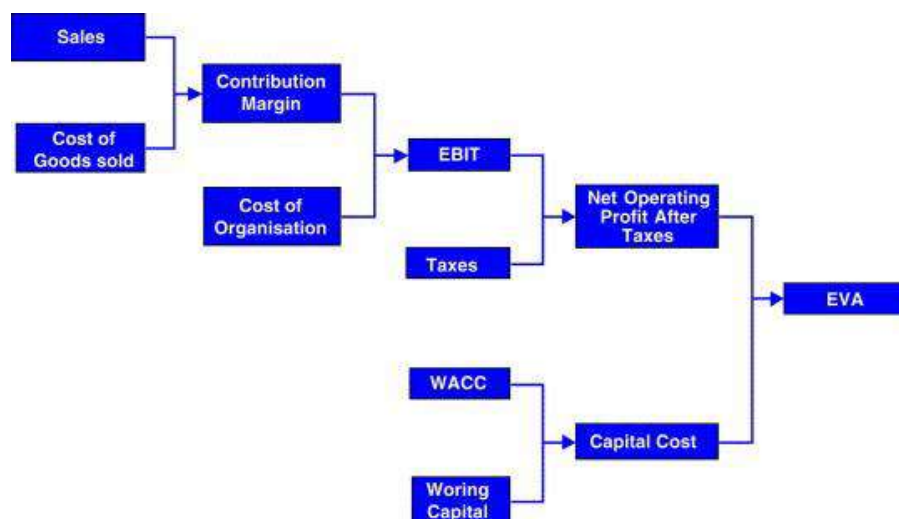
REVIEW OF LITERATURE

Nikhil Chandra Shill (2009) in his study examined, EVA is worth base performance measure which gives significance on value making by the organization for the venders. Profit maximization is an old concept and wealth maximization is aged and value maximization is wisdom. Usability of EVA mostly depends on the standard of accounting data system as ancient data system won't offer decent data to reason true EVA. And he suggested that Economic value added would yield excellent result and his paper may be helpful to know the methodology.

Rao (2009) in his study examined the awareness and applicability of EVA in Indian banks on the basis of survey report. This study concludes the EVA is gradually gaining an increased attention as financial measurements of business performance of banks. It holds up the views that the concept of EVA has been emerging in the brains of the top brass of the company world in India and has remarkable excellent time a head.

CONCEPT OF ECONOMIC VALUE ADDED

Thus, the corporate world's need for a tool to measure value creation has been filled with the emergence of a new concept namely, Economic Value Added (EVA). It has been redefined and commercialized by the U.S. based mostly Stem Stewart & Company. It is an attempt to tenacity the need for a performance measure that is highly correlated to the shareholder's wealth and responsive to the actions of the company's managers. Shareholder worth is taken into account as a necessary life of the company performance. It is an exact indication of the quantum of increased value a business generate for shareholders after accounting for its cost of operation, which contain the rate of funds. The number of company that has adopted EVA worldwide is astonishing. Stem Stewart Management Services (the founders of EVA). Claim that added than four hundred companies universally are using Economic Value Added (EVA). Fortune magazine has designated it as today's most modern economic idea with the underlying scope of getting hotter. The father of managing Guru Peter Ducker has described EVA as a fundamental compute that reflect all the extent by which organization can increase value. Economic Value Added (EVA) is the financial measure to come faster than a few other measures in seizing the accurate economic profit of an enterprise. To complex, value superimposed (EVA) is the same as what economists decision as economic profit. In business, revenue comes from customers and is distributed among the shareholders. Suppliers are paid for their goods and services and employees for their services. Depreciation amount is deducted from revenue as it results in loss of the value of assets. Creditors are paid interest while loan and taxes are paid to the government. Finally, shareholders are also paid a return. The shareholder's return is not the normal dividend payment, although irises the return corresponding through the risk undertakes by them by invest money in the business. It is the earn that the shareholders can have earned by invest in similar risk profile funds i.e. they have to be paid their chance cost of capital. This differentiates EVA from the accounting model as the accounting model does not acknowledge the cost of equity. EVA is thus the residual returns. Since shareholders be the owner of the industry, the residual income adds to their wealth. The present demand for assuming value superimposed (EVA) is predicated on an easy that is it cannot be known whether the enterprise is creating value for their shareholders until it's subtracted from the cost of the capital from income. To the extent EVA is good result; the firm is addition value for its shareholders. But if a firm's EVA is negative, the firm is rescinding cost still while it may be reporting a positive or growing earning per share (EPS) or return on investment (ROI). This means that if a firm wants to have an attractive investment, it has to contain a return that would exceed other investment options with similar risk. Though EVA just retells the basic theory after any activity, it is not presently any other metric for the firm. It is a structure for whole monetary management and compensation system. It can guide every decision a company makes that can a corporate culture and help produce greater wealth for shareholders, customers and themselves.



Economic Value Added (EVA) can be described as:

The most accurate value-based measures of economic performance. A register trade name redefined ad popularized by the US-based Stem Stewart & Company.

- * A concept of a variation of residual income.
- * The concept that is nearly the equal as economic profit.
- * It is a measure representative amount of shareholders wealth created or ruined during each year.
- * A framework of widespread financial management

ECONOMIC VALUE ADDED IN BANKS

The above discussion focused on the application of EVA to consolidated bank holding companies, which is important for an overall assessment of the economic performance of an organization from a shareholder viewpoint, the use of EVA for the financial management of banks and other financial institutions involves dealing with more detailed levels of risk assessment and profitability measurement. There are four major adjustments which are ordinary in customizing EVA for banks, they are:

1. Loan loss provision;
2. Taxes;
3. Non-recurring events (such as restructuring charges); and
4. Securities accounting

Loan Loss Provision and Loan Loss Reserve

The major adjustment for most banks relates to the loan loss provision and loan loss reserve. In theory, the advance loss keep should be sufficient to absorb the present value of all future loan losses.

Taxes

The most concerns show characteristic and obstinate differences between their “book tax provisions” and their cash tax payments that give rise to deferred tax balances. Banks are no exception. To the scope that such differences are quasi-permanent for going concerns, deferred taxes should be considered a permanent funding source, i.e., capital.

Non-recurring Events

It has to be measured on a case-by-case basis. A common non-recurring event in banking in recent years is the restructuring charge. To the extent that such a charge represents a disinvestment, the charge must not be consider a reduction of operating profits, but as an adjustment to capital.

Securities Accounting

Under the MVA and EVA, it is conservative to treat capital on a historic basis, not on a current market basis. The rationale is that it would be impractical to attempt to adjust all activities to their current market value. This would add unwarranted volatility to the EVA calculation and negate its effectiveness as the basis for risk assessment or incentive compensation programs. Thus, any adjustment conduct under FAS 115 is separate from all EVA calculations.

ECONOMIC VALUE ADDED V/S TRADITIONAL ACCOUNTING MEASURES

EVA is primarily based is predicated relies on the common accounting-based things like an interest-bearing debt, equity capital, and internet in operating profit. It is different from the normal measures principally by as well as the value of equity.

Among all ancient measures cost on capital is incredibly common and comparatively sensible performance lives. totally different and completely different firms calculate this comes with different formulas and decision it conjointly with different names like come on investment (ROI), come on invested with capital (ROIC), come on capital utilized (ROCE), come on internet assets (RONA), come on assets (ROA), etc. The most disadvantages with of these rates of come is altogether cases that increasing rate of come doesn't essentially maximize the come for shareholders. Mathematically EVA provides precisely the same leads to valuations as Discounted income or Net Price Value (NPV) (Stewart, 1990) that are long ago wide acknowledged as in theory best analysis tools from the stockholders' perspective. Within the company management, it's value basic cognitive process that EVA and NPV go hand in hand as conjointly ROI and IRR. The formers tell U.S. the impacts to shareholders wealth and therefore the letters tell U.S. the speed of come. There's no reason to abandon ROI and IRR. They're superb and illustrative measures that tell U.S. concerning the speed of returns. IRR will perpetually be used together with NPV in investment calculations and ROI will perpetually be used together with EVA in company performance. However, ought to we should always wemust always ne'er aim to maximize IRR and ROI and that we should ne'er base selections on these 2 metrics. IRR and ROI offer U.S. extra data, though all selections may be evaded them. Increasing rate of returns (IRR, ROI) doesn't matter, once the goal is to maximize the returns to shareholders. EVA and NPV ought to be within the commanding role in company management and ROI & IRR ought to have the role of giving extra data.

CONCLUSION

Most of the Banks are still using the traditional accounting system which is known to be unproductive. EVA is an alternative method to the traditional performance measure. It is the most beneficial tool for determining the performance of managers of a bank. Bankers in the competitive administration must increase the shareholders wealth and inspire them for more investment in banks. To achieve this, the bankers have to measure their performance from a shareholder's point of view. Bankers have to follow the wealth maximization as an objective to indicate that they are adding value to shareholder wealth and not deteriorating it. In order to conclude this, bankers need to put on the Economic value added measure.

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