IMPACT OF ECONOMIC VALUE ADDED (EVA) ON FINANCIAL PERFORMANCE

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Abstract

Banking industry in Sri Lanka is very important sector in economy. 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. However mostly private sector banks are effectively than public banks. Bankers now will have to constantly seek to invest in technology and able to be open to strategic alliance, merger, acquisition and restructuring exercises for adding EVA to shareholders wealth all the time. According the data analysis, the result of the research is Economic Value Added impact on financial performance. Financial performance indicators are Return on Equity, Return on Assets, Return on Investment and Liquid assets to liabilities. The study finds Economic value added and financial performance are statistically significant in determining performance. Perhaps most importantly, the study finds positive relationship between Economic value added and financial performance. The study provides bank managers with understanding of activities that would enhance their bank's financial performances. The results of this study imply that it might be necessary for a bank management to take all the required decisions to enhance the financial positions of the bank.

Key words*: Economic Value Added, Return on equity, Liquidity, Financial performance*

Introduction

Present time banks are facing steep competition, technological changes and innovation. So effective management helps to provide better service and expand their activities. The managers make strategic planning for bank performance. Therefore they need Creativity, innovation and intuition. Banking sector is considered to be important source of Financing for most business. Financial performance will lead to improved functions and activities. Banks their internal as well as external environments are becoming more complex. In this dynamic society the managers must be able anticipate changes and their impact and take appropriate measures to deal with these changes.

Recent years have developed a new approach to performance assessment of banks such as Economic Value Added (EVA) and Market Value Added (MVA). The term EVA (Economic Value Added) initially raised by Stern Stewart Management Service in 1989.Later this concept was popularized by G. Bannet Steward, III, Managing Partner of Stern Stewart & CO. in 1991. Since then more than 300 companies in the world to adopt these disciplines.

De Kluyver & Pearce (2006) stated that EVA is a value-based financial performance measure that focuses on economic value creation, which comes from its use of cost of capital that is generally, refers to financial wealth used to start or maintain the business. On the other hand, Market Value Added (MVA) is defined as the difference between the equity market valuation of a listed/quoted company and the sum of the adjusted book value of debt and equity invested in the company. It is equal to the present value of future expected EVA.

This study will evaluate the bank's financial performance on the basis of Economic Value Added(EVA) which is the modern concepts introduced for the purpose of evaluate the performance of banks.

Research Problem

In the banking industry, Millennium of banks has been competition in the market. There are several state and private sector banks in Srilanka. Nowadays banks are computerized and modernized. So, dealing of people with banks is increasing rapidly. Bank's manager tries to increase the value and higher profitability through their high performance. Financial performance of bank indicates the bank's strength, survey and banking activities.

Banks keep the saving of the public and finance to develop the business and trade. Thus the performance of banks has been an issue of major interest for various stakeholders. Such as, Depositors, Regulators, Customers, & Investors. Various tools are used to measure the performance. Even though, researcher assumed that EVA is the new approach tools to measure the performance of the banks based on previous studies. In this situation now the problem is arises.

How to impact the economic value added in private banks financial performance?

Literature Review

The aim of Literature review is to provide valuable insight to the research area as well as review of relevant literature in the area related to the research topic.

Economic value added (EVA) is a performance measure developed by Stern Stewart & Co that attempts to measure the true economic profit produced by a bank. It is frequently also referred to as "economic profit", and provides a measurement of a bank's economic success (or failure) over a period of time. Such a metric is useful for investors who wish to determine how well a company has produced value for its investors, and it can be compared against the company's peers for a quick analysis of how well the bank is operating in its industry. The metric is justified by financial theory and consistent with valuation principles, which are important to any investor's analysis of a bank.

EVA=Net operating profit after tax-(weighted average cost of capital * Total capital employed)

Stewart(1991) argued that earnings per share, and earnings growth are misleading measures of corporate performance and the best practical periodic performance measure is economic value-added. EVA is the financial performance measure that comes closer than any other to capturing the true economic profit of an enterprise. EVA also is the performance measure most directly linked to the creation of shareholder wealth over time.

Bao and Bao (1998) examined the relative informational content of net income, abnormal economic earnings (their definition of EVA) and value added (defined as sales – cost of goods sold – depreciation) using a sample of 166 American companies for the period 1992–93. Their results did not support the argument of superior informational content of the EVA, since they found inconsistent behavior in the abnormal economic earnings variable, which produced a negative sign when the dependent variable was the value of the firm, and then changed to positive when the dependent variable was either the stock price or the stock return. The only variable, which consistently generates positive signs with high explanatory power in all three models, was the value added. In the same category of studies against the validity of the EVA.

Chen and Dodd (1998), who found, by using a sample of 566 American companies for the period 1983–92, that EVA did not have an incremental informational content in explaining the variability of stock returns, when compared to operating income and simple residual income. However, in the same study the variable of residual income appeared to have a marginally higher explanatory power than operating income.

Worthington and West (2001) reviewed the literature on EVA and provided a synoptic survey of EVA's conceptual underpinnings. They concluded that empirical evidences concerning EVA have been mixed. There is strong need for research over a longer time frame to allow greater empirical certainty on the status of EVA as a corporate performance measure.

Stern Stewart and Co (1982) intended that this study was to identify any added value or added advantage in EVA compare to conventional methods such as percentage increase in net tangible assets, profit margin, return on assets (ROA) and return on equity (ROE) as a performance measurement.

Fernandez (2001), said that using a representative sample of American and European firms, and based on data provided by Stern Stewart & Company, analyzes the correlation between the MVA (Market Value Added) and the EVA , NOPAT (Net Operating Profit After Taxes), and WACC (Weighted Average Cost of Capital). Fernandez observes a low (and sometimes negative) correlation between EVA and MVA, and concludes that NOPAT and WACC present higher levels of correlation with MVA (which is the best indicator of shareholder wealth).

Objectives Of The Study

The main objective of the study will be to make a comparative performance analysis of two of state Banks. Such as, bank of Ceylon and peoples bank. Two of private banks. Such as Commercial bank and Hatton national bank on the basis of economic value added and market Value added. Assess their real performance as well as value addition to the various components of banks and the society. Specific objectives are

- To reveal the relationship between economic values added on financial performance.
- To find out the impact of economic value added on financial performance.
- To assess the financial performance in private banks.
- To make suggestion to increase value of bank's financial performance.

Data Collection

The secondary data were used to this study. These were obtained from the annual reports of respective banks. Further, scholarly articles from academic journals, relevant text books on the subject and the internet search engines were also used. Specifically, the financial statements of the banks in the sample were collected for the period 2006-2010 and a balanced panel of six banks emerged for the study.

Sampling Design

Convenience sampling technique is used to draw the sample from private banks. Such as Hatton national bank, Commercial bank, Sampath bank, Nations Trust Bank, Development Finance Corporation of Ceylon, which are situated in Sri Lanka. Five financial year (2006-2010) data is collected of each bank for this study.

Methodology

The quantitative research approach is employed to find out the findings of the research study. Since numerical and secondary data is used, quantitative approach is considered to be a suitable approach for the study. According to Leavy (2004, p.37), "statistical analyses are used to describe an account for the observed variability in the data". This involves the process of analyzing the data that has been collected. Thus the purpose of statistics is to summarize and answer questions that were obtained in the research. The upper level of statistical significance for hypotheses testing was set at 5%. All statistical test results were computed at the 2-tailed level of significance. Statistical analysis involves both descriptive and inferential statistics. The hypothesis are

H1 - There is a positive relationship between economic value added and Return on equity.

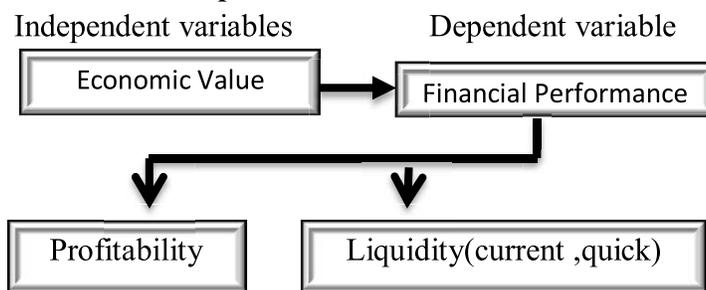H2 - There is an impact of economic value added on financial performance.

H2$_{a:}$ There is an impact of economic value added on Return on Equity.

H2$_{b:}$ There is an impact of economic value added on Return on Assets

H2$_{c:}$ There is an impact of economic value added on Return on Investment.

H2$_{d:}$ There is an impact of economic value added on Liquid assets to liabilities.

Conceptualization Model

Independent variables   Dependent variable

| Economic Value | → | Financial Performance |

| Profitability | | Liquidity(current ,quick) |

Reliability And Validity Of The Data

Secondary data for the study have drawn from audit accounts (i.e., comparative income statements and comparative balance sheets) of the concerned banks: therefore, these data may be considered reliable for the purpose of the study. Necessary checking and cross checking have done while scanning information and data from the secondary sources. All these efforts have made in order to generate validity data for the present study. Hence researcher satisfied content validity.

Correlation Analysis

Correlation is concern describing the strength of relationship between two variables. In this study the correlation co-efficient analysis is under taken to find out the relationship between EVA and Financial performance.

Table 1 Correlation among EVA and Financial Performance

	EVA	ROE	ROA	ROI	Liquidity
EVA-Pearson Sig(2tailed)	1	.813* .049	.095 .857	.621 .188	-.357 .487
ROE-Pearson Sig(2tailed)	.813* .049	1	.025 .962	.314 .545	-.482 .333
ROA-Pearson Sig(2tailed)	.095 .857	.025 .962	1	.069 .896	.846* .034
ROI-Pearson Sig(2tailed)	.621 .188	.314 .545	.069 .896	1	-.153 .772
Liquidity- Pears Sig(2tailed)	-.357 .487	-.482 .333	.846* .034	-.153 .772	1

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

Above table demonstrates it can be observed that there is a strong positive relationship between Economic Value Added and Return on Equity. The correlation value is 0.813* and which is significant at 0.05 levels (2-tailed). Researcher observed that there is a weak positive relationship between Economic Value Added and Return on Assets. The correlation value is 0.095 and which is insignificant at 0.05 levels (2-tailed). Economic Value Added and Return on Investment have positive relationship between them. That correlation value is 0.621. At the same time, observed that the weak negative relationship between Economic Value Added and Liquid assets to liabilities. The correlation value is -.357.

Regression Analysis

Regression analysis is used to find out the value of dependent variable based on the value of independent variable. Here dependent variable is determined by independent variable such as EVA.

Table: 2 Regression for Economic Value Added

Variables	Unstandardized Coefficients-B		R Square	Significant	
	Constant	EVA		Constant	EVA
ROE	12.335	.002	.661	.001	.049
ROA	1.299	4.62	.009	.033	.857
ROI	-.273	.002	.386	.898	.188
Liquidity	48.670	-.009	.127	.074	.487

Above table illustrates the unstandardized coefficients and R square of the Economic Value Added. The R^2 value is 0.661. This means EVA has impact on Return on Equity by 66.1%. The remaining 33.9% is influenced by other factors. The R^2 value is impact of Economic Value Added on Return on Assets. The R^2 value is 0.009. This means has impact on Return on Assets by 9%. The remaining 91% is influenced by other factors. The R^2 value is 0.386. This means EVA is contributed to determine Return on Assets by 38.6%. The remaining 61.4% is influenced by other factors. The R^2 value is 0.127. This means EVA is contributed to determine Liquid assets to liabilities by 12.7%. The remaining 87.3% is influenced by other factors.

Hypotheses Testing

H_1: There is a positive relationship between Economic Value Added and Return on Equity.

The correlation value is 0.813* and which is significant at 0.05 levels (2-tailed).so that there is a strong positive relationship between Economic Value Added and Return on Equity. Hence, H1 is accepted.

$H2$: There is an impact of economic value added on financial performance.

$H2_a$: There is an impact of economic value added on Return on Equity.

The R^2 value is computed to identify the impact of Economic Value Added on Return on Equity. The R^2 value is 0.661. This means EVA is contributed to determine Return on Equity by 66.1%. The remaining 33.9% is influenced by other factors. Hence, $H2_a$ is accepted

$H2_b$: There is an impact of economic value added on Return on Assets

The R^2 value is computed to identify the impact of Economic Value Added on Return on Assets. The R^2 value is 0.009. This means EVA is contributed to determine Return on Assets by 9%. The remaining 91% is influenced by other factors. Hence, $H2_b$ is accepted.

$H2_c$: There is an impact of economic value added on Return on Investment.

The R^2 value is computed to identify the impact of Economic Value Added on Return on Investment. The R^2 value is 0.386. This means EVA is contributed to determine Return on Assets by 38.6%. The remaining 61.4% is influenced by other factors. Hence, $H2_c$ is accepted.

$H2_d$: There is an impact of economic value added on Liquid assets to liabilities.

The R^2 value is computed to identify the impact of Economic Value Added on Liquid assets to liabilities. The R^2 value is 0.127. This means EVA is contributed to determine Liquid assets to liabilities by 12.7%. The remaining 87.3% is influenced by other factors. Hence, $H2_d$ is accepted.

Conclusion

Some initial studies indicate that, EVA has greatest power to explain market value than other traditional accounting measures. Such as ROE, ROA, ROI & Liquidity. These findings that support traditional accounting indicators are superior to EVA in explaining changes in market value. EVA has been proven excellent performance measure to motivate management in any company and financial performance. Theoretically definitive performance measure and EVA adopting companies' superior performance compared with peer non- EVA adopting companies.

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