

“Impact of Economic Value Added on Financial Performance”: Special Reference to Selected Private Banks in Sri Lanka.

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Abstract

Economic Value Added [EVA] is a performance measure developed by Stern Stewart & that attempt to measure the true economic profit produced by a company. A metric is useful for investors who wish to determine how well a company has produced value for its investors. The main objective of this study is to find out the impact of Economic Value Added on Financial Performance in selected private banks in Sri Lanka. To attain this objective, distinctive methodologies which are consistent with the previous research studies have been used. Convenience sampling technique is used to draw the sample from the private banks. Such as Hatton National bank, Commercial bank, Sampath bank, Nations Trust bank, Development Finance Corporation of Ceylon and Seylan bank. Secondary data are collected for the study which consisted annual reports of said banks during the period of 2006-2012 (7 years). Operational hypotheses are formulated which have been tested using correlation and regression analysis. The results revealed that there is a relationship between EVA and financial performance. Mainly, there is a significant relationship between EVA and ROE. In addition Economic Value Added [EVA] has impact on financial performance. This study is beneficial to the academicians, policymakers, practitioners and researchers to formulate the suitable policy in Sri Lanka as well as other similar countries.

Key words: Economic Value Added, Financial Performance, Private Banks.

Background of the Study

Banks occupy a dominant position in the development of a country. Banks cater to the needs of agriculturists, industrialists, traders and to all other sections of the society. It facilitates to accelerate the economic growth of a country and steer the wheels of the economy towards its goal of self reliance in all fields. Present time banks are facing steep competition, technological changes and innovation. So effective management helps to provide better services 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 businesses. 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 to anticipate changes and their impact and take appropriate measures to deal with these changes.

Advancement of the nature of business and management performance has pushed the need of people to build a more effective and structured financial measurement. According to the article of The Chartered Institute of Management Accountants (CIMA), Latest Trends in Corporate Performance Measurement (1992), many companies experienced difficulties in implementing measurement frameworks. The issues from the 1990s are still relevant today related to variables to measure, ways to access data, and so on. Effective performance measurement is believed to be of key importance in ensuring the successful implementation of an organization's strategy. The result of the performance measurement will help the managers to produce effective decision-making processes whether at the operational or strategic level.

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

The concept of EVA is a relatively new approach to assessing corporate performance. Unlike conventional corporate performance measures that require comparative analysis with similar companies in the industry, while the EVA can stand on its own. EVA method is successfully created company is the most relevant factor in the formation of the company that eventually will affect the financial performance. This study evaluates the bank's financial performance on the basis of Economic Value Added (EVA) which is the modern concept introduced for the purpose of evaluate the performance of banks.

Objectives

The main objective of the study is to find out the impact of Economic Value Added on financial performance

Secondary objectives are:

- To reveal the relationship between economic values added and financial performance.
- To make suggestion to increase the value of bank's financial performance.

Review of Literature

Stewart, and Bennett, G. (1994) observed that "EVA is a powerful new management tool that has gained growing international acceptance as the standard of corporate governance. It serves as the centerpiece of a completely integrated frame-work of financial management and incentive compensation." In essence, EVA is a way both to legitimize and to institutionalize the running of a business in accordance with basic micro economics and corporate finance principles. The experience of a long list of adopting companies throughout the world strongly supports the notion that an EVA system, by providing such an integrated decision making framework, can refocus energies and redirect resources to create sustainable value for companies' customers, employees, and shareholders and for management.

The EVA measurement is the net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise or project. It is an estimate of true economic profit, or the amount by which earnings exceed or fall short of the required minimum rate of return investors could get by investing in other securities of comparable risk (Stewart, 1991, and 1994).

You Lee (1995) researched that the use of EVA as a corporate performance measurement tool. His main research finding was that EVA is at best marginally better than measures such as ROA and ROE.

Lehn and Makhija (1996) studied EVA as performance measures and signals for strategic change. They found that both measures correlate positively with stock returns with traditional performance measures like return on assets (ROA), return on equity (ROE) and return on sales (ROS).

Talib and San (1998) stated that for many years, senior managers, investors and analyst have been using conventional measures such as earnings, earnings per share (EPS), P/E ratios or return on equity for setting financial goals, for measuring financial performances and for valuations. Now another method is available for measuring corporate performance that is known as economic value added (EVA).

Pfeiffer (2000) considered mathematically EVA vs. discounted cash flow methods for resolving internal agency problems in decentralized decision-making. Besides the theoretical discussion, understanding is needed about the numerical behavior of the EVA under different conditions and about EVA's numerical relationship to the accounting measures like Return on Investments (ROI), Return on Equity (ROE) and to economic profitability measures like the Internal Rate of Return (IRR).

Girotra et al (2001) emphasized that the importance of the EVA. They compare the EVA with Return on Equity (ROE), Return on Net Worth (RONW), Return on Capital Employed (ROCE) and Earnings per Share (EPS). They argue that EVA is not a tool to create value but it encourages managers to think like owners, and, in the process may impel them to strive for better performance. The study concluded that EVA has been helpful because it forces companies to pay attention to capital employed and especially to excess working capital.

Popa et al (2009) argued that EVA can be an important tool that bankers can use to measure and improve the financial performance of their bank. They emphasize the advantages of EVA by comparing to other performance indicators. Since EVA takes the interest of the bank's shareholders into consideration, the use of EVA by bank management may lead to different decisions than if management relied solely on other measures. They investigate the Romanian Banking systems to compare the advantages of EVA to other measures of bank performance such as return on assets (ROA), return on equity (ROE), net banking income and the efficiency ratio, which do not consider the cost of equity capital employed.

EVA may be distinguished from other financial performance measures such as net profit and earnings per share (EPS), as it determines the profits remaining after the capital costs of a company – both debt and equity – have been deducted from the operating profit (McClure , 2011).

Variety of authors said that there is a significant relationship between Economic Value Added and Financial Performance and also there is an impact of EVA on financial performance. Based on the empirical studies, following conceptual model is formulated by the researcher.

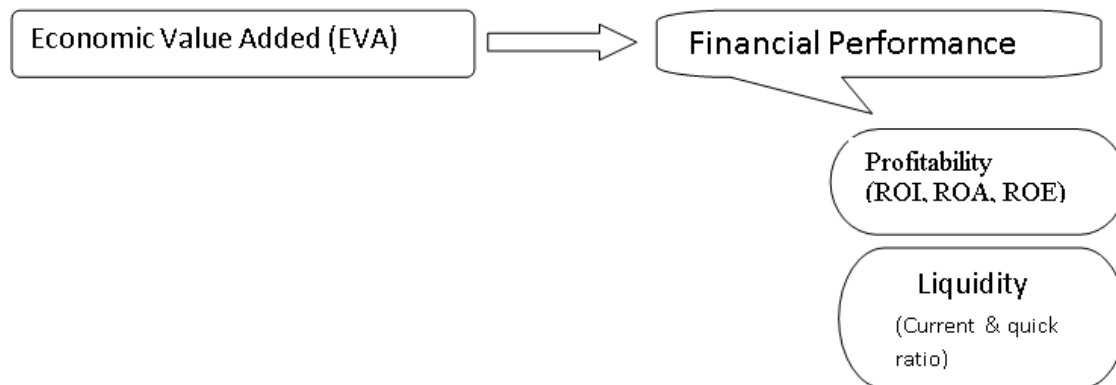


Figure 1: Conceptualization

Hypotheses

Following hypotheses are formulated to find out the impact of economic value added on financial performance and relationship among them.

H1: There is a significant positive relationship between economic value added and financial performance.

H_{1a}: There is a significant positive relationship between Economic Value Added and Return on Equity.

H_{1b}: There is a significant positive relationship between Economic Value Added and Return on Assets.

H_{1c}: There is a significant positive relationship between Economic Value Added and Return on Investment.

H_{1d}: There is a significant positive relationship between Economic Value Added and Liquid assets to liabilities.

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

H_{2a}: There is an impact of economic value added on Return on Equity.

H_{2b}: There is an impact of economic value added on Return on Assets

H_{2c}: There is an impact of economic value added on Return on Investment.

H_{2d}: There is an impact of economic value added on Liquid assets to liabilities.

Methodology

Data Collection

Secondary data which are collected from the annual reports of banks have been utilized in this study. Further, textbooks, journals and internet search engines were utilized for this study.

Sample

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 and Seylan bank, which are situated in Sri Lanka. Seven financial year (2006-2012) data is collected of each bank for this study.

Data analysis method

Various statistical methods have been employed to compare the data. Inferential statistics involves in drawing conclusions about a population based only on sample data. It includes Correlation analysis and regression analysis. Correlation analysis is used to find out the significant relationship between Economic Value added and financial performance. Regression analysis is used to find out the significant impact of Economic Value added on financial performance. (SPSS- 16 version has been utilized in this study).

Operationalisation

Table No 01: Operationalisation

Concept	Variables	Indicators	Measurements
Economic Value Added	EVA	NOPAT	Ratios
		WACC	
		Invested Capital	
Financial Performance	Profitability	Return on Equity	Ratios
		Return on Assets	
		Return on Investment	
	Liquidity	Current ratio	Ratios
		Quick ratio	

Where:

NOPAT: Net Operating Profit After Tax

WACC: Weighted Average Cost of Capital

EVA: Economic Value Added

Results and Interpretation

Correlation Analysis

The purpose of correlation analysis is to find out the significant relationship between Economic Value added and financial performance. Table No 02 presents the results of the correlation analysis.

Table No 02: Correlation Analysis

	EVA	ROI	ROA	ROE	Liquidity
EVA Pearson	1	.749	0.326	0.813*	-0.316
Sig(2-tailed)		0.087	0.529	0.049	0.542
ROI Pearson	0.749	1	0.235	0.430	-0.091
Sig(2-tailed)	0.087		0.653	0.395	0.865
ROA Pearson	0.326	0.235	1	0.225	0.736
Sig(2-tailed)	0.529	0.653		0.669	0.094
ROE Pearson	0.813*	0.430	0.225	1	-0.475
Sig(2-tailed)	0.049	0.395	0.669		0.341
Liquidity Pearson	-0.316	-0.091	0.738	-0.475	1
Sig(2-tailed)	0.542	0.865	0.094	0.341	

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

Table 02 shows the correlation value of 0.749 which is insignificant at 0.05 levels, and it can be clearly pointed out that, there is a positive relationship between Economic Value Added and Return on investment. There is a weak positive relationship between Economic Value Added and Return on assets. Those are at insignificant level ($P > 0.05$). 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 ($P < 0.05$). At the same time, observed that the Economic Value Added and liquid assets to liabilities have negative relationship between them.

Regression Analysis

The purpose of regression analysis is to find out the significant impact of Economic Value Added on financial performance. Table No 03 presents the results of the Regression analysis in which, Economic Value Added is considered as independent variable. And financial performance is considered as dependent variable.

Table No 03: Regression analysis

Variables	Unstandardized Coefficients-B		R Square	Significant in EVA
	Constant	EVA		
ROE	-3588.20	336.35	.661	.049
ROA	328.71	898.75	.106	.529
ROI	934.39	343.27	.561	.087
Liquidity	2090.98	-13.79	.100	.542

Table no 3 illustrates that the EVA has higher impact on Return on Equity by 66.1%. The remaining 33.9% is influenced by other factors. Model of the return on equity is

$$Y = -3588.20 + 336.35X_1$$

The R² value is 0.561. This means EVA is contributed to determine Return on Assets by 56.1%. The remaining 43.9% is influenced by other factors. On the other hand, Model of the return on investment is

$$Y = 934.39 + 343.27X_1$$

EVA has low impact on ROA and liquidity by 10.6% and 10.0% respectively.

Hypotheses Testing

Where researcher observed that, whether there is a relationship between variables or not, Based on P value. At the same time, whether there is an impact or not, based on significant value.

Table No 04: Hypotheses Testing

No	Hypotheses	Results	Tools
H1	There is a significant positive relationship between economic value added and financial performance	Partial Accepted	Correlation
H _{1a} :	There is a significant positive relationship between Economic Value Added and Return on Equity.	Accepted	Correlation
H _{1b} :	There is a significant positive relationship between Economic Value Added and Return on Assets.	Rejected	Correlation
H _{1c} :	There is a significant positive relationship between Economic Value Added and Return on Investment.	Rejected	Correlation
H _{1d} :	There is a significant positive relationship between Economic Value Added and Liquid assets to liabilities.	Rejected	Correlation
H2:	There is an impact of economic value added on financial performance.	Partial Accepted	Regression
H _{2a} :	There is an impact of economic value added on Return on Equity.	Accepted	Regression
H _{2b} :	There is an impact of economic value added on Return on Assets	Rejected	Regression
H _{2c} :	There is an impact of economic value added on Return on Investment.	Rejected	Regression
H _{2d} :	There is an impact of economic value added on Liquid assets to liabilities.	Rejected	Regression

Conclusion

Based on the overall study findings, there is no significant positive relationship between value EVA and ROI, ROA and liquid assets to liabilities. But, There is a strong positive relationship between EVA and ROE (r = 0.813*). High value leads to higher financial performance. Hence, we can conclude that there is a relationship between EVA and financial performance. Private Banks have high financial indicators. Such Financial indicators are EVA, ROE, ROA, ROI and Liquidity. Based on the regression analysis, we found that, only ROE is influenced significantly. In contrast, other dependent variables as ROA, ROI and Liquidity are not influenced by EVA significantly. Basically, EVA is highly focused by the equity base. Due to that, ROE is highly influenced by the EVA.

Some of the reasons are better management, operational efficiency, and skilled staff. Private Banks maintains proper accounts, records, books and does well than state banks. In the support way, Lehn and Makhija (1996) studied EVA as performance measures and signals for strategic change. They found that both measures correlate positively with stock returns with traditional performance measures like return on assets (ROA), return on equity (ROE) and return on sales (ROS). And also EVA has impact on financial performance.

Recommendations

The following suggestions are put forwarded to increase the financial performance and value of banks. Banks invest the money any useful ways and different locations in order to get maximum return on investment and reduce risk. So return is higher than cost of capital. Increased EVA leads to higher financial performance.

Analysis shows that, management of the bank must use the fund for loan maximum, but recovery of the loan should carefully dealt by them. Which is major problem in Sri Lanka' banks. Representatives can be appointed from different places for visiting and collecting loans from customers. Providing commission or bonus based on the amount of recovery may be motivated them in quick recovery which will benefits to the banks.

Nowadays some banks face the liquidity problems. So banks must have buffer cash to resolve the immediate liquidity problems. 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.

Finally, 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.

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