A Study On Awareness and Adaptability of Economic Value Added Concept In Indian Banking Sector

**** R. Satish***
***** Dr. S.S. Rao***

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

EVA = NOPAT – [WACC *IC]
Where
NOPAT = Net operating profit after tax
WACC = Weighted Average Cost of Capital
IC = Invested Capital

To compute EVA, Stern Stewart [1994] considers more than 160 adjustments to NOPAT and IC. Most of the adjustments are intended to shift 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.

RELEVANCE OF EVA COMPARED TO TRADITIONAL PERFORMANCE MEASURES: LITERATURE REVIEW

Parasuram (2000) discussed the EVA position of 14 major public sector banks, 7 new private sector banks, 5 old private sector banks and 2 foreign banks. Among the strength indicators; deposit, return on assets, interest income as a percentage of total assets, interest yield spread as a percentage of total assets and EVA were considered. The study concludes that EVA is an important measure to judge a bank performance in view of the current scenario of banks. EVA has been found to have a high degree of correlation with Return on Assets but not with any of the

***** *Research Scholar*, Sathyabama University, Chennai-119. Email: radhasat@yahoo.com
***Registrar*, Sathyabama University, Chennai-119

other measures. It signifies a fact that banks realize the importance of measuring EVA separately even if they do well in other fields. Thampy and Beheli (2001) studied the economic profits of commercial banks in the public and private sectors during 1990s. The study has been restricted to 12 commercial banks consisting of 4 public and 8 private sector banks. The study shows that the performance of the Indian banks as measured by EVA is not very satisfactory. It also suggests that banks should improve and strengthen their credit assessment technique and monitoring mechanism to bring down the non-performing assets so as to improve the earning capacity. Ashok Banerjee, Deepa Mangala , S.C. Bardia and Manoj Anand are among the leading Indian Researchers who have carried out a range of empirical studies on EVA. However, as a matter of chance and prospect for this team, no study has been conducted at such a colossal extent in the Indian Banking sector. There is no denying the fact that early researchers have made valuable contribution, yet their work had some specific restraints, particularly relating to raw data and its computational course of action.

This paper is an attempt to offer a detailed examination of EVA with specific reference to the envisaged research objectives.

OBJECTIVES 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 for the Banking Sector.

HYPOTHESIS OF THE STUDY

- There is significant difference among awareness and adaptability of EVA between public sector and private sector bank's.
- Banks' preference for performance parameters differ significantly.
- EVA should be used as the most important decision making factor in business decisions.

SCOPE OF THE STUDY

This study helps us whether there is a prima facie case for the awareness and adaptability of EVA as one of the performance measurement tools.

METHODOLOGY

Various Studies including this maintain the surfacing of EVA as a 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 with a well-structured questionnaire for bankers 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 Bombay Stock Exchange [BSE]. The questionnaire was also made available upon request of some bankers 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 from the bankers' perspective.

The broad research task of this paper is to survey and assess how the EVA Model behaves under different, realistic corporate situations 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 the Indian context.

SAMPLE SELECTION

This study has been conducted among Indian Commercial Banks. Listing its shares on a Bombay stock exchange consistently for the past 3 years since 2006-07 was a prerequisite. Considering all these parameters, 39 banks

consisting of 22 public sector banks and 17 private sector banks have been selected for this study. Hence, the study has used a fairly representative classification of sample banks having uniform accounting year.

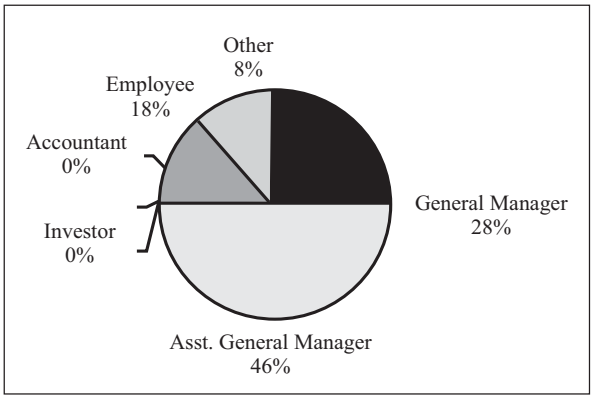
AWARENESS OF AND ADAPTABILITY TO EVA IN THE INDIAN BANKING SECTOR

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 filled up the questionnaire were either General Managers (28.2%) or Assistant General Managers (46.2%). The preponderance percentage of the banks selected for the purpose of the survey are 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 is evident from Table 2. The table depicts that as many as 33 percent respondents consider net non performing loans as a significant variable followed by another 28 % who find the Return on Assets as a 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 that 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 efficiency and effectiveness, if increased, may be observed as significant variable in the growth of the organization and the 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 a 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%].

Figure 1: Profile of the Respondents – A Glance



EVA FOR INDIAN BANKS

While the banking reforms swept the financial sector in the last decade, many Indian banks are discovering that the key to their long-term growth does not lie in products and services alone but in assets that can never be replicated. One of the most fateful errors bankers usually commit relates to their belief that merely reducing NPAs and thereby maximizing profit would solve "the problem of the banking industry". Not only is this belief still held by most bankers in India, who are therefore, professionally unacquainted with the changing profile of their shareholders and the capital market – the captains still possess a myopic view of the industry.

TABLE 1 : Profile of The Respondents 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
Years of Operation of the Organization		
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: Preferences of Banks 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 a 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.

Figure 2: Bank Preferences For Performance Parameters

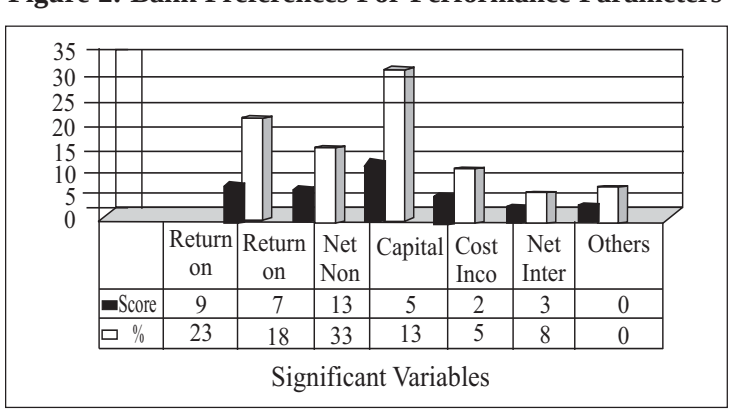


TABLE 3: Respondents' Ranking of Different Financial Variables

S.no	Financial Variables	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	39	39	39	39	39	39	39	39	39	39	39	39	39	-

Source : As per our survey

TABLE 4: Respondents' 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.						

The Friedman test is a non-parametric equivalent of a one-sample repeated measure design or a two-way analysis of variance with one observation per cell. Friedman tests the null hypothesis that k related variables come from the same population. For each case, the k variables are ranked from 1 to k. The test statistic is based on these ranks.

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 a True Indicator of Financial Performance		
Yes	8	21
Sometimes	12	31
Cannot Say	17	43
No	2	5
EVA's Worth in Future		
Extremely Worthy	8	21
Worthy	11	28
Somewhat Worthy	10	26
Not very Worthy	6	15
Not Worthy	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

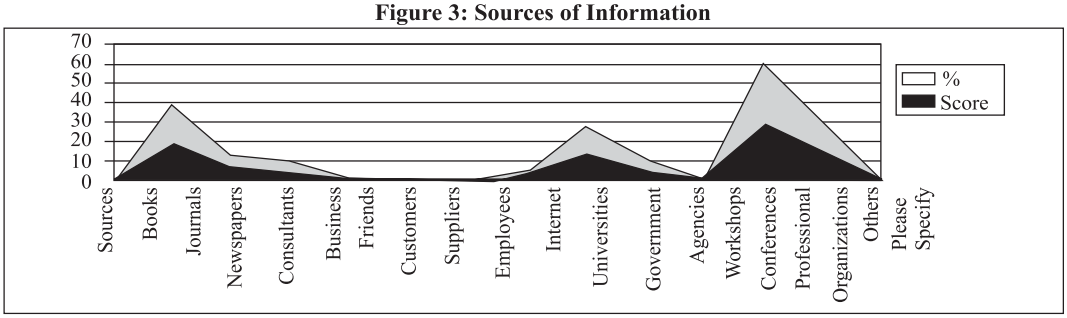
Table 4 depicts the statistical analysis of these ranks assigned by the respondents. The values show the volatility in EVA and that of Standard deviation. Table 5 also presents the results on the EVA's worth in the future. Taken together, 74% of the respondents make a clean breast about the good future of EVA in Indian Banking. When called for the use of EVA as a 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 a 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

Figure 3: Sources of Information



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 workshops, conferences and seminars organized by the professional bodies like IBA, CII, FICCI, etc., One-fifth find the relevant information from the books and journals and about one-seventh of them depend on the information made available on websites. Universities, newspapers, consultants and others account for only about 20%.

TABLE 7: Implementation and Disclosure of EVA

	Score	%
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 depicts that over one-fourth of the banks have already planned to implement EVA and over 70% of them are some how interested in implementing it in very near future. On the other hand, only about 18 % of the banks are 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 of 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 a casual approach in calculating and reporting EVA. A study published by The Economic Times neither adjusted book capital to bring it closer to economic capital nor used a 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 more popularity 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 Worth in Future	Plan to Implement
1	EVA			Extremely Worthy -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 worthy - 15%	Somehow interested- 71.8%
5	Net Operating Profit After Tax	Very familiar-10%	No- 5%	Not Worthy - 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 in 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 organizations 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 measures. 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 EVA as a performance indicator in order to achieve better results.

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