ECONOMIC VALUE ADDED STATEMENT

MEANING:

EVA is the Surplus generated by an entity after meeting an equitable charge towards the providers of capital.

USES:

EVA helps to –

- Measure the financial performance.
- Take important managerial decisions.
- Equate managerial incentives with shareholder's interest.
- Improve financial & business literacy throughout the firm.

VALUE ADDED Vs ECONOMIC VALUE ADDED:

Particulars	Value Added	Economic Value Added
Meaning	Wealth that a firm able to create through collective effort of capital, management & employees.	Surplus generated by an entity after meeting an equitable charge towards the providers of capital.
Computation	Market price of firm's output (-)Cost of Bought in materials & services	Operating Profit (-)Taxes paid (-)Capital employed X WACC
Purpose	Analyzing the performance and activity of reporting entity.	Help managers in taking decisions which increase shareholder's wealth.
Focus	Firm's performance & contribution towards various groups.	Firm's ability to create surplus above shareholder's expectations.
Information	Based on internal data.	Uses market information estimates like Cost of Capital, Beta, Risk free Rate of Return etc.
Time value of money	Not considered.	Considered by using WACC.

CONCEPT OF EVA:

- Excess of returns over cost of capital.
- Measures whether operating profit is sufficient enough to cover cost of capital.
- If a company ***EVA is negative*** – Firm is destroying shareholders wealth even though it may be reporting positive and growing EPS or ROCE.
- Shows whether company is creating real value for its shareholders or not.
- **C**apital **A**sset **P**ricing **M**odel (**CAPM**) is used to calculate EVA.
- EVA expressed in terms of Rupee (figures) and not in percentage.

LIMITATIONS OF EVA:

- Not easy to use.
- Too complicated for small business.
- Recommends inexpensive debts in order to reduce cost of capital.
- A passive tool, measures past performance.

FACTORS INVOLVED IN CALCULATING EVA:

- ***Cost of Debt*** = $\frac{\text{Interest on LTB (1 – Tax rate)}}{\text{LTB}}$ X 100.

- ***Cost of Preference Capital*** = $\frac{\text{Preference Dividend}}{\text{Preference Share Capital}}$.

- ***Cost of Equity*** (K_e) = R_f + ***Beta*** (R_m – R_f)
- ***Cost of Retained Earnings*** (K_r)
- ***Beta***
- ***Equity Risk Premium*** = R_m – R_f
- ***Market ROR*** (R_m) =

  $$\frac{\text{Stock exchange index \{at the end of the year – at the beginning of the year\}}}{\text{Stock exchange index at the beginning of the year.}}$$

- ***Overall cost of capital*** =

  $$K_d \times \frac{\text{Debt}}{\text{Total funds}} + K_p \times \frac{\text{PSC}}{\text{Total funds}} + K_e \times \frac{\text{Equity}}{\text{Total funds}}$$

  Total Funds = Debt + Preference Capital + Equity Funds.