ISSN No: 2348-4845
International Journal & Magazine of Engineering, Technology, Management and Research
A Peer Reviewed Open Access International Journal

A Study on Evaluation of Financial Performance of IT Companies in India

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ABSTRACT:
Economic Value Added (EVA) is a financial performance method to calculate the true economic profit of a corporation as well as to calculate net operating after taxes profit minus a charge for the opportunity cost of the capital invested. EVA is an estimate of the amount by which earnings exceed or fall of the required minimum rate of return for shareholders or lenders at comparable risk.

Unlike Market-based measures, such as MVA, EVA can be calculated at divisional level. EVA is a flow and can be used for performance evaluation over time. Besides accounting profit, such as EBIT, Net Income and EPS, EVA is Economic and is based on the idea that a business must cover both the operating costs and the capital costs. The present research paper is based on secondary data with the value based metrics calculations.

Key words:
EVA, MVA, EBIT, SVA and Opportunity cost.

INTRODUCTION:
Financial performance refers to that degree at which financial objectives are being or has been accomplished. It is a process of measuring the results of the firm's policies and operations in monetary terms besides, measuring firm's overall financial health over a given period of time and also to be used to compare similar firms across the same industry or to compare industries or sectors in aggregation [1].

The analysis of financial statement is a process of evaluating the relationship between component parts of financial statements to obtain a better understanding of the firm's position and performance. In order to overcome the limitations of ratios, they found the exact method known as the Value Addition metrics such as EVA, SVA and MVA [2].

ECONOMIC VALUE ADDED (EVA):
The acronym EVA stands for Economic Value Added, a patented word by the New York – based consulting firm, Stern Stewart & Co. and it conveys a new measure of corporate performance. The concept is drawing increased attention since it has emerged as a critical tool to measure and monitor corporate performance today, as the industry is shifting from the product – centric world of the past to a value-centric world of the future [3]. EVA estimates a particular type of economic profit, which has been part of mainstream economic thinking for more than a century. This concept states that in order to assess whether a company earns genuine profits, it is not only necessary that the company earns sufficient profits to cover the firms operating costs, but they should also cover the cost of capital, that is, the cost of borrowed money in the business as well as the owner's fund deployed in the business. Only then, the owner of the business can claim to have earned a profit. In other words, EVA is a surplus or deficit that remains after levying a charge against after-tax operating profits for the opportunity cost of all capital-equity as well as debt used to generate those profits, i.e.,

EVA= NOPAT – (CAPITAL EMPLOYED*WACC)
or = (ROCE-WACC)*CE
Where,
ROCE = Return On Capital Employed
NOPAT = Net Operating Profit 8after Taxes
WACC = Weighted Average Cost of Capital
CE = Capital Employed

Shareholder Value Added (SVA)
Shareholder Value Added [4] is also one of the emerging metric of financial performance.

Cite this article as: Mr.S.Pratap & Dr.J.Revathy, "A Study on Evaluation of Financial Performance of It Companies in India", International Journal & Magazine of Engineering, Technology, Management and Research, Volume 5 Issue 1, 2018, Page 100-103.

ISSN No: 2348-4845
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SVA is the difference between the Return on Equity and Cost of Equity is multiplied by Equity Capital Invested.
SVA= (ROE-COE) * ECI
Where,
SVA= Shareholder Value Added
ROE = Return on Equity = Return on Net worth = PAT/ Net worth *100
COE = Cost of Equity
ECI = Equity Capital Invested

Market Value Added (MVA)

Market Value Added [5] is the difference between the Market Value and Book Value of the equity. In modern approach MVA is the present value of the future stream of EVA.
MVA = (Debt +Equity value) – Total Capital
MVA = Firm value – Total Capital
MVA = PV of expected future of EVA
MVA = MV-BV
Where,
MVA = Market Value Added
MV=Market Value of the firm
BV= Book Value of the firm
To show, whether the MVA is driven by EVA or not, is done through the coefficient of correlation techniques as well as regression analysis. The data analysis is based on empirical analysis through simple EVA calculations; SVA calculations and MVA calculations are also computed and used to find out the relationship with EVA.

REVIEW OF LITERATURE:

Stewart (1994)1 has expended that EVA is a powerful new management tool that has gained worldwide recognition as the standard tool of corporate performance. EVA presents an integrated framework of financial management and incentive compensation. The adoption of EVA system by more and more companies throughout the world clearly depicts that it provides an integrated decision-making framework that can reform energies and redirect resources to create sustainable value for companies, customers, employees, shareholders and firm management. Ochsner (1995)2 says companies that use shareholder value growth alone as a measurement for executive performance pay, leave less-skilled management dependent on luck. Economic Value Added measures [6], with some modification and in varying form, can serve as leading indicators of company performance. Thus, investors will use them to give managements a compass to steer by. A company that adopts EVA is likely to need a substantial education program for managers. It also may elect to state EVA in terms of operating profit and use of capital. This put EVA in the role of a target-setting mechanism, which assures that EVA figures will be available to the board of directors and, if necessary, major shareholders for tracking and comparison purposes. Cramer and Pushner (1996)3 empirically test the strength of the relationship between EVA and Market Value Added. The results do not fully support the arguments of EVA proponents that it is the best internal measure of corporate success in adding value to shareholder investments. On the contrary, the market seems more focused on "profit" than EVA. Benerjee (2000)4 says corporations in the U.S. have started disclosing EVA information from the beginning of 90s as a measure of corporate performance. It is believed that market value of a firm (hence shareholder wealth) would increase with the increase in EVA.

Various studies done in the U.S. also confirm this belief. He attempts to find the relevance of Stewart's claim that market value of the firm is largely driven by its EVA generating capacity in the Indian context. Based on a sample of 200 firms over a period of five years, his study shows that market value of a firm can be well predicted by estimated future EVA steams. His study has also found that market value of most of the firms in the sample is explained more by current operational value than future growth value of firms. Pal Singh and Garg (2004)5 have compared some selected financial variables like ROCE, EPS, ARNW, MVA and NPV with EVA. They observed in almost all cases, the positive relationship has been established between the variables under reference. The different correlation matrix tables have approved that EVA is also giving the results in the same direction for the rational underlying.

During the multiple regression analysis in their study, it became apparent that EVA was the single largest and most consistent variable, which has a decisive role in predicting the MVA. Their study concludes that the relationship between EVA and MVA is statistically significant. Ismail (2006)6 examined the superiority of EVA as a financial metric compared with other financial measures. The paper used a sample of 2252 firm year observations from the UK market and applied panel data regressions to test the relative information content of EVA and other accounting measures and the incremental information content of EVA and other accounting measures and the incremental information content of EVA components in explaining stock returns.

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It has been found that NOPAT and Net Income outperform EVA and RI in explaining stock returns. It was also found that accruals and operating cash flow have significant incremental information content, while accounting adjustments of EVA proponents have significantly less contribution in explaining stock return. Nikhil Chandra Shil (2009)7 an earnest effort has been made to explain theoretical foundation of EVA and the reasons for the corporate houses planning to move from traditional to value based performance measures. He concluded that value based management has made a strong entry in the assortment of management tools in the form of EVA. It has successfully taken an important place in corporate world. T. Satyanarayana Chary, N. Saibaba (2015)8 reviewed Economic Value Added (EVA) is a firm's true economic profit after deducting the full opportunity cost of all invested capital, equity and debt.

It is regarded as a comprehensive measure of performance and is an indication of value creation and calculated by deducting the cost of capital from NOPAT (Net Operating Profit after Tax). Thus, EVA is considered as the true measure of corporate surplus or effectiveness, which should be shared by the shareholders, management and employees. It turns balance sheet assets into a charge to profit, just like cost of goods sold. EVA increase the wealth of the share holders when managers streamline operations, control the costs and invest capital in growth oriented projects whose cost of capital is affordable to earnings, EA is also measured after eliminating accounting distortions that could change the true value. Hence, it improves performance through all possible ways and wealth is created.

NEED FOR THE STUDY:

In today's competitive world, value and wealth creation for shareholders are among the most important goals of businesses. The financial performance of any sectors or any industry is very essential and significant for the better future of Indian economy. Hence, there is a need to study the financial performance of the Services sector in a fervent manner; particularly the IT sector should give utmost importance to their financial performance analysis as they contribute a lot in exports of the country. Therefore, the present study is a modest attempt to evaluate the financial performance of selected IT companies using Value Addition Metrics and also the study examines the relationship of EVA with SVA and MVA [7].

OBJECTIVES OF THE STUDY:

1. To assess and analyze the Economic Value Addition (EVA) of select IT companies.
2. To assess and analyze the Market Value Addition (MVA) and Shareholders Value Addition (SVA) of select IT companies.
3. To study the impact of EVA on MVA and SVA of select IT Companies.

HYPOTHESES:

- Ho1: The impact of EVA is not significant on SVA of select IT Companies.
- Ho2: The impact of EVA is not significant on MVA of select IT Companies.

SOURCES OF THE DATA:

As the study largely depends on secondary data, the required data was collected from Stock Exchange Official Directories to find out the market return and Beta values to compute the cost of equity by CAPM method [8], daily closing values of industry and concerned IT companies. Besides, the data was collected from journals, books, theses works and dissertations for the purpose of literature review and references. Similarly, the data was also collected from websites and Annuals Reports of the select companies for the financial years of 2007-2008 to 2016-2017 to compute the Value Addition Metrics such as EVA, SVA and MVA.

DATA ANALYSIS

REGRESSION VALUES OF AVERAGE EVA TO AVERAGE SVA AND AVERAGE MVA OF SELECT IT COMPANIES

Particulars	Multiple R	R Square	Adjusted R Square	Standard Error	t-Stat	P-value
Avg EVA to Avg SVA	0.51	0.26	0.01	11551.63	1.02	0.38
Avg EVA to Avg MVA	-0.13	0.01	-0.309	13303.03	-0.23	0.82

Source: SPSS calculations

1. There is a medium positive correlation between Average EVA to Average SVA. As SVA moves by one, EVA moves by 0.51 in the same direction. 0.26 % change in EVA is due to change in SVA. The t-statistics of this is found at 1.02. The p-value in this case is 0.38, which is higher than 5%. Therefore, Null hypothesis is accepted.

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2. There is a negative correlation between Average EVA to Average MVA. As MVA moves by one, EVA moves by –0.13 in the opposite direction. 0.01 per cent change in EVA is due to change in MVA. The t-statistics of this is found at -0.23. The p-value in this case is 0.82, which is higher than 5%. Therefore, Null hypothesis is accepted.

Conclusion:

As per the calculations, there is no significant relationship between EVA and SVA. And also there is no significant relationship between EVA and SVA. Hence, it is concluded that Shareholder Value and Market Value Added does not shows impact on Economic Value Added.

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