

## **CREATING VALUE OR JUST PROFITS ?**

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Some business managers would find it difficult to name a more comprehensive performance measurement than profitability. We learned at an early age to focus on profits because the only proof of a well-run company is a healthy bottom line. Unfortunately, this isn't enough. Manufactures must also increase shareholder value.

Some manufactures work on the basic concept that profit is comprised of two distinct layers. The primary profit layer must cover the costs of material, labor and overhead. The second profit layer provides for all other long-term income and capital needs, including compensation of shareholders for use of the money. This category is confusing to most manufacturers and many CPAs because it is difficult to understand and compute.

Unfortunately, most mid-sized manufacturers do not adequately understand and can't accurately compute their primary profit layer. For all of the advancements in manufactures aren't closer to computing product profitability that they were 30 years ago. Knowing product profitability (cost) is the basic "atom" on which a well-run, profitable company is built.

There is a big difference between the creation of profits and the creation of shareholder value. Making sure both profit layers are satisfied and shareholders realize an above

average return is the focus of Economic Value Added (EVA). EVA's core concepts are fairly straightforward and have been around for more than 50 years.

1. Any business activity must not only provide a profit or break even, it must also earn enough to justify the cost of capital used in business pursuits.
2. Management must assure profits compensate shareholders for the use of their capital.
- 3.

Would earnings expectations be the same for different sized companies or for companies with a widely capital base? Most people would say the level of earnings is dependent upon the capital base used to generate it.

Consider the information in Table 1 and determine which company is most attractive.

**Table 1**

	<b>Company A</b>	<b>Company B</b>
Profit	1,000,000	1,000,000
Number of employees	55	250
Plant and equipment	2,000,000	52,000,000

Company A has done a better job because they've generated the same level of profit with less, which is the fundamental concept behind EVA. It's not just the earnings level, investors and shareholders must examine what it took to generate profits. Company B took significantly more resources to generate the \$1 million profit.

EVA takes an independent look at value creation. It makes no difference if you're involved in running the plant, a sole owner, or an outside shareholder. The business either creates value or it destroys value. Operating management must continuously

review its operations to determine if specific actions and projects are increasing or decreasing the company's value.

### **Are You Creating Shareholder Wealth?**

It's fairly simple to measure your EVA position. Although there are more than 150 adjustments that can be made to a profit number, the largest adjustments to EVA are accounted for with a few minor changes. The first step is adding another line to your P&L to capture implicit costs of plant and equipment, inventories, receivables and payables.

These items are simply aggregated and multiplied by a cost of capital. This "capital charge" is then reflected as another P&L expense item that lowers overall economic profitability. Once these additional items are subtracted, and the EVA profit number remains positive, the company is creating long-term economic profit. If the EVA profit figure is negative, shareholder value is being destroyed. The balance sheet, like the P&L, should also reflect a few changes. An EVA "restated" set of financial documents might look like this:

Sales	\$800
Cost of goods	<u>\$500</u>
Gross profit	\$300
SG&A	<u>\$100</u>
Operating profit	\$200
Taxes @40%	\$80
Net operating profit after tax	\$120
<b>Balance Sheet Adjustments</b>	(000)
(Increase) decrease in cash	20

Increase (decrease) in accounts rec.	100
Increase (decrease) in inventory	300
(Increase (decrease) in accounts pay (200))	
Equals net working capital change	<u>270</u>
Fixed assets employed	530
Total capital employed	800

This company required 800 of total capital to generate 120 in profit. To calculate the additional cost of capital charge, assume a 12 percent cost of capital.

Total capital	800
Cost of capital	12%
Capital employed charge	96

The resulting change in profitability would be:

Net operating profit after taxes	120
Capital employed charge	<u>96</u>
Economic Value Added	24

In this example, the company was creating shareholder. But as the cost of capital increases, economic profit falls and can swing a positive EVA company to the negative side. Even with the same earnings and capital base, examine the way EVA fluctuates in Table 2. Obviously, EVA is very dependent upon the cost of capital and the amount of capital employed.

### **Put EVA to Work**

EVA and its concepts are being used increasingly by financial institutions, individual investors, and the United States government. But an EVA's true beauty is its internal use in the planning and evaluation of business segments.

EVA should be used by all levels of your organization. Before opening another plant site or expanding an existing facility, calculate and understand the costs in economic terms. EVA can and should be used as a common yardstick to evaluate alternative investment decisions.

At the plant level, EVA measure if specific actions are creating volume or value.

Assume a plant manager wants another piece of equipment and he said all the "right" things (lower cost, higher productivity, etc.). In many cases, owners must decide if the project makes sense and evaluate its strategic value to the company. CEOs and business owners use EVA to exploit business expansion opportunities. The more progressive business owners push operational management to understand capital is not free.

An operational managers understand that there is no source of free capital, several things happen. First, they look at their existing plant floor and ask if all the machinery and equipment in place is actually needed. This makes operational managers either "deal with or deal away" unproductive assets. Second, new acquisitions of plant and equipment are held to a higher value creation standard.

An individual yearly measure of EVA is interesting; however, EVA is best viewed over multiple years. Most companies can withstand one of two years of negative EVA; but eventually shareholder value must be "rebuilt".

Shareholders want to make sure the capital base generates the greatest amount of profits. It's over this point that shareholders and manufactures often conflict. Most manufactures believe profitability is critical, but not everything. An EVA can provide a unique and interesting view of your operations, but it can't measure the long hours it took to get the business off the ground, or the pride you feel when a product beats the competitors. But if attention isn't paid to the fundamental EVA issue, every business will fail.

**Table 2**

<b><u>Case</u></b>	<b><u>1</u></b>	<b><u>2</u></b>	<b><u>3</u></b>	<b><u>4</u></b>
Total Capital employed	800	800	800	800
Cost of capital	9%	12%	15%	18%
Capital employed charge	72	96	120	144
Net operating profit after taxes	120	120	120	120
Net operating profit after taxes	72	96	120	144
Economic value added	48	24	0	-24

This table show the true picture about the measurment of performance of four companies having equal net oprating profits. But first no. company is creating higher EVA with lower cost of capital. Which shows this company is adding maximum value to its shareholder's. It is a positive sign of growth of business. While third no. company have no EVA value & Fourth No. company is showing a negetive value of EVA, which means last company is destroying it's value.

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