# CHAPTER 1: INTRODUCTION

## 1.1 Background

In recent years, Economic Value Added (EVA) has gained significant attention as an alternative to traditional accounting measures for use in corporate performance, company valuation as well as incentive compensation. Much of this publicity stems from a September 20, 1993 article in the Fortune magazine (Tully 1993). Tully (1993) writes that managers and investors, rewarded by knockout results, are peering into the heart of what makes businesses valuable by using EVA. EVA is touted as being today's hottest financial idea and getting hotter, and EVA is praised for its strong link to stock prices (Tully 1993). Indeed, managers and investors, who adopt the precepts of EVA, have benefited handsomely from the rise in the value of their companies and investments respectively (Tully 1993).

Some of the large corporations that owe much of their success to the application of EVA include Coca-Cola, AT&T, Quaker Oats, Briggs & Stratton, Chrysler, Compaq Computer, GE and CSX. William H. Kurtz, AT&T's financial executive, testifies that EVA played a significant role in the company's decision to acquire McCaw Cellular for US$12.6bn (Tully 1993). William Smithburg, Quaker Oats' chief executive officer, adds that EVA makes managers act like shareholders and it is the true corporate faith for the 1990s (Tully 1993). Eugene Vesell, managing director of Oppenheimer Capital, explains that their decision to invest in a company is influenced by whether the company is motivated by EVA instead of earnings per share (EPS) and return on equity (ROE) measures (Tully 1994).

In reality, the EVA concept is not new. The need to earn more than the cost of capital is actually one of the oldest ideas in business (Hamilton 1777, Marshall 1890). EVA is a variant of the residual income (RI) concept, the latter which has been around for a while but in many different forms (Edey (1957), Edwards and Bell (1961), Kay (1976), Peasnell (1982), and Feltham and Ohlson (1995)).

Marshall (1890) defines RI as total net gains less the interest on invested capital at the current rate. In short, RI is the after-tax operating profit minus a charge for invested capital.

It was not until the late 1980s that Joel Stern and Bennett Stewart begin popularising the EVA idea. They register EVA as a trademark of Stern Stewart & Company, a consulting firm that is based in New York City. In his book *The Quest for Value*, Stewart (1991) describes EVA as the only measure that tie-in directly to intrinsic market value and the fuel that fires up a premium in the stock market value. Stewart (1991) advocates that EPS should be abandoned, and net income (NI), NI growth and EPS are misleading measures of corporate performance. Ehrbar (1998) lends support by stressing that when EVA becomes the focus for all decisions, it establishes clear and accountable links between strategic thinking, capital investments, operating decisions and shareholder value.

Such is the great enthusiasm of the consulting community in promoting this new financial idea that consultants begin to package and market quite similar performance measures but in different terms and forms to avoid problems with trade marking. KPMG Peat Marwick uses the term economic value management (EVM), the Boston Consulting Group's HOLT Value Associates labels it cash flow return on investment (CFROI) while Marakon Associates calls it discounted economic profits (DEP).

### 1.2 Scope of the Study

This study attempts to examine the impact of EVA and traditional accounting measures like EPS on stock prices and stock returns. The latter two is measured using Market Value Added (MVA) and changes in MVA as proxies. This study also intends to increase the awareness and knowledge of shareholder value issues in Malaysian companies. A period of five years is taken into consideration, spanning from 1992 to 1996. The study will focus on the 100 largest companies listed on the Kuala Lumpur Stock Exchange (KLSE) according to their market capitalization as at December 31, 1996. Banks, finance, stock broking and insurance institutions that are featured in the top 100 list are excluded from this study. They are replaced by other subsequent large market capitalized companies so that the sample size remains at 100. The market capitalization ranking list is obtained from the Investors Digest, a monthly publication of the KLSE.

### 1.3 Significance of the Study

This study is motivated by the numerous claims cited earlier and the increasing number of success stories by companies adopting EVA. Indeed, interest in EVA remains hot, be it among consultants, business press, companies, academics, investment analysts and policy makers.

Essentially, proponents of EVA have made two major assertions, that is (1) EVA better explain stock returns and company values than the traditional accounting measures like EPS and ROE, and (2) they better motivate managers to create shareholder wealth. If these assertions are true, then managers should use EVA as a tool for capital budgeting decisions while investment analysts and investors should use EVA to measure corporate performance and value companies.

The value creation concept also has major implications for companies in Malaysia. The financial crisis in 1997 and 1998 should serve as an important lesson for Malaysian corporates. Indeed, one of the biggest mistakes made by Malaysian companies is that they often destroy value by investing in a significant number of projects and businesses with returns below their cost of capital. This is partly due to the top management's preoccupation with growing in size rather than in value.

The challenging and dynamic market environment coupled with increasing exposure to institutional investors will also play an important role. As competition for capital intensifies globally, the market will drive the emphasis on shareholder value. Companies in Malaysia will have no choice but to place increasing importance on maximizing shareholder value.

Furthermore, academic research on EVA, especially on Malaysian companies, remains sparse. Studies conducted overseas especially on U.S. companies, for instance, on the impact of EVA on MVA have produced mixed results. This study hopes to contribute to the small but growing body of research on EVA.

### 1.4 Organization of the Study

The remainder of this study is organized as follows. Section 2 describes the EVA framework. Section 3 presents a review of past studies on EVA. Section 4 discusses the research methodology while Section 5 provides and reports the empirical results. Finally, Section 6 concludes the study.