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Full Length Research Paper

A study of the relationship between the share and criterion of companies' performance using profit and cash flows: Some Iranian evidence

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The aim of the current study is to present a relationship between share yield and criterion of companies' performance using profit and cash flows and items of listed companies on Tehran Stock Exchange during 2004 to 2009. Results show that, there is no meaningful relationship between independent variables such as gross profit, operational profit, profit before tax, net profit and operational cash flow, while cash flow does not exist for free items in the independent variable known as share yield.

Key words: Profit, operational cash flow, free cash flow, share yield, performance criterion, capital market.

INTRODUCTION

Among various topics related to companies, performance evaluation of managers and control of manager behavior have a special role. Performance evaluation of companies is most important due to investors' credit, government and managers, and is based on the internal and external decision of the organization. Selection of the best way among various ways of performance evaluation should be applied carefully. Performance evaluation shows that the level of success of an organization is achieved by goals. Rights and rewards of managers should be relevant with their performance, in that companies' performance exist in relation with goals. From traditional views, if the manager of companies could maximize profit or value, they may reach to company's goal, and in this way, have favorable performance (Salehi, 2008). In new views, the company's goal is not determined, but the goal of transactions parties should be used to maximize self profit, sales price, profit price, earning per share (EPS), return on assets and return on equity measurement, in that traditional companies' performance gained accounting information.

Traditionally, the methods of measurement of corporate performance are numerous. The common bases used are: net profit margin (NPM), operating profit margin (OPM), return on investment (ROI), return on net worth (RONW), etc. Profit after tax (PAT) is an indicator of the profit available to the shareholder and "profit before interest after tax" (PBIAT) is an indicator of the surplus generated profits using total funds. ROI is still recognized as the most popular yardstick of profitability measurement. Traditionally, 'profit after tax' is shown in the 'profit and loss account' to indicate the profit available to the shareholders, both in preference and in equity (Salehi, 2009). Ability to maintain dividend is not a test of profit adequacy, but the ability to generate "economic value added" is the only test of profit adequacy. Any surplus generated profit from operating activities over and above the cost of capital is termed as Economic Value Added (EVA). In recent years, criteria based on value and among 'economic value added' had importance in the analysis of companies' performance. EVA is one of the performance criteria that presented the actual stock

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holder assets. EVA means the ability of the commercial unit to earn much yield based on risk, and it explained the difference of investment with assets due to money (Salehi and Biglar, 2009; Salehi and Rostami, 2009).

This study reviews the relation of EVA with the operational level and the company and compared it with other variables, but the main problem is that does a meaningful relation exist between EVA and the operational level? In this research, variables such as growth of sales and profit are examined. Also, EVA is examined as an independent variable, while operational level, growth of sales and profit, which are criteria of value measurement, are examined as independent variables.

Research objectives

An accepted financial axiom is that the role of managers is to maximize the wealth of shareholders by the efficient allocation of resources. In order to operationalise this objective, shareholder wealth is traditionally proxied by either standard accounting magnitudes (such as profits, earnings and cash flows from operations) or financial statement ratios (including earnings per share and the returns on assets, investment and equity). This financial statement information is then used by managers, shareholders and other interested parties to assess current firm performance, and is also used by these same stakeholders to predict future performance. Further, under the semi-strong form of the efficient market hypothesis, the publicly available information contained in these variables is readily interpreted by the market, and thereby incorporated into future stock prices. Unfortunately, the empirical literature to date suggests that there is no single accounting based measure upon which one can rely to explain changes in shareholder wealth (Chen and Dodd, 1997; Rogerson, 1997). This is despite the fact that such a measure would prove invaluable to the various parties interested in aspects of firm performance.

So, the main objective of the current study is to examine the meaningful relation that exists among EVA and the operational level, and EVA and the level of sales and companies' profit. EVA is a criterion of management performance in performance economic indexes, and its results can be reviewed for managers, administrators and experts in the evaluation of strategic design and improvement. As such, its effect on managers, stockholders and creditors, exists in the study.

LITERATURE REVIEW

Value added does not have a new meaning, but for the first time in the 18th century in America, it accounts for the national earning that was used. Moreover, its design in economic texts lasted for about 200 years, until 1920. Easton et al. (1992) observed that EVA is an increasingly popular corporate performance measure; one that is often used by companies not only for evaluating performance, but also as a basis for determining incentive pay. Like other performance measures, EVA attempts to cope with the basic tension that exists between the need to come up with a performance measure that is highly co-related with shareholders wealth, and at the same time, somewhat less subject to the random fluctuations in stock prices. This is a difficult tension to resolve and it explains the relatively low correlation of all accounting based performance measures with stock returns at least on a year to year basis.

Stewart and Bennett (1994) observed that "EVA is a powerful new management tool that has gained growing international acceptance as the standard of corporate governance. It serves as the centerpiece of a completely integrated frame-work of financial management and incentive compensation". In essence, EVA is a way used to both legitimize and institutionalize the running of a business in accordance with basic microeconomics and corporate finance principles. The experience of a long list of adopting companies throughout the world strongly supports the notion that an EVA system, by providing such an integrated decision making framework, can refocus energies and redirect resources to create sustainable value for companies' customers, employees, shareholders, and for the management.

Young (1997) observed that several measurements were used previously to gauge our financial outlook from earnings per share to discounted cash flow and return on average assets. Bonuses of all managers were determined solely by whether variety achieves its EVA targets. At our company, every decision and action result from the analysis that uses EVA principles. Mallik and Rakshit (2005) showed that, in order to have an understanding of how the traditional performance measures are comparable to EVA, the data of three financial years between 1996 and 1999 were chosen from 28 companies. Only 6 out of the 28 companies have positive EVA, while the others have negative EVA. The EVA as a percentage of 'capital employed' (EVA/CE) has been found to indicate the true return on capital employed. Comparing EVA with other traditional performance measures, the study indicates that all the companies depict a rosy picture in terms of EPS, RONA and ROCE for all three years. The study shows that the traditional measures do not reflect the real value of shareholders, and EVA has to be measured to have an idea about the shareholders value.

Ray (2001) observed that the missing link between EVA and improved financials is actually productivity. As such, EVA can be a powerful tool; when properly applied, it allows a firm to ascertain where it is creating values and

where it is not. More specifically, it allows a firm to identify where the return on its capital is outstripping the cost of that capital. For those areas of the firm, where the former is indeed greater than the latter, EVA analysis then allows the firm to concentrate on the firm's productivity in order to maximize the value created from the firm. Finally, as investors buy more shares in the firm in order to have more claims on its increased value, they automatically bid up and eventually maximize the share price of the firms. Furthermore, as it is known by any good capitalist, maximizing share price is the name of the game in a free market economy. Thereafter, marginal increases in value added can be attained by either decreasing the firms cost of capital or by increasing its productivity.

EVA: The concept and definition

EVA is a value based financial performance measure, which is an investment decision tool and a performance measure reflecting the absolute amount of the shareholder value created. It is computed as the product of the "excess return" made on an investment or investments and the capital invested in that investment or investments. EVA is the net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise or project. It is an estimate of true economic profit, or the amount by which earnings exceed or fall short of the required minimum rate of return that investors could get by investing in other securities of comparable risk (Stewart, 1990). EVA is not new, and so, residual income, which is an accounting performance measure, is defined to be operating profit with a capital charge subtracted.

Thus, EVA is a variant of residual income, with adjustments to how one calculates income and capital. Stern Stewart and Co, a consulting firm based in New York, introduced the concept of EVA as a measurement tool in 1989, and trademarked it. The EVA concept is often called "economic profit" (EP) to avoid problems caused by the trade marking. EVA is so popular and well known that all residual income concepts are often called EVA, even though they do not include the main elements defined by Stern Stewart and Co (Pinto, 2001).

Advantages of EVA

EVA is frequently regarded as a single, simple measure that provides a real picture of shareholder wealth creation. In addition to motivating managers to create shareholder value and serve as a basis for the calculation of management compensation, there are further practical advantages that value based measurement systems can offer. An EVA system helps managers to (Roztoci and Needy, 1998):

1. Make better investment decisions;
2. Identify improvement opportunities; and
3. Consider long-term and short-term benefits for the company.

EVA is an effective measure of the quality of managerial decisions and a reliable indicator of a company's value growth in the future. Constant positive EVA values over time will increase company values, while negative EVA values might decrease company values. EVA is different in operational net profit after tax, and so it is different in the traditional device used for accounting measurement, such as profit before interest and tax, and profit before interest and amortization, because it is the price of the investment supply. In other words, EVA is the index for performance measurement, and it had multiplied among yield price (r) and capital price (c) in investment:

$$EVA = (r - c) \times \text{investment}$$

$$EVA = (r \_ c) \text{ capital}$$

$$r = \frac{NOPAT}{Capital}$$

For account capital yield rate, the operational and financial supply has similar results with other supplies that were used, while the financial approach that is based on capital yield rate is accounted for as:

i. Remainder in the year's equivalent capital + beneficiary debt + salary of stock holder = Capital
ii. Beneficiary debt = gained financial facility + long-term debt + loan interest.
iii. Equivalent capital = the remaining cost not paid + supply of advantage remains + decreased supply remains + tax supply remains.
iv. Alternative changes in equivalent capital + net profit before tax deficit = NOPAT

For accounting capital rate, the following formula is used for average capital:

$$WACC = (Wd \times Kd) + (Wp \times Kp) + (We \times Ke) + (Ws \times Ks)$$

Ws, We, Wp and Wd percent of debt assistance, superior share, normal stock holder salary and new normal share, are shown respectively.

Likewise, Ks, Ke, Kp and Kd percent debt rate, superior share, normal share owner and new normal share are shown respectively.

Companies with free share expression (Wp × Kp) do not work with this formula, while companies that are accepted in the stock exchange have normal share without price, and so they account for normal share rate (Ke) and a new normal share rate (Ks).

WACC = (Wd × Kd) + (We × Ke)

$$Wd = \frac{beneficiary\ debt}{source\ sum}$$

$$We = \frac{salary\ of\ stock\ holder\ and\ stored\ profit}{source\ sum}$$

After accounting for EVA every year in the growth level, it had gained the following relation:

$$\Delta\ EVA = \frac{ENA\ n - EVA\ n-1}{EVA\ n-1}$$

METHODS OF EVA

Methods used to increase EVA

Operational performances, such as: increase in workforce beneficiary, decrease in personal price, supply of a cheaper material (with its quality kept) and the selection process of the production, caused increase in the product and other ways of orientating decision, based on increase in yield rate or net profit after tax without new investment.

Investment in projects that had an almost similar yield rate with capital price rate

This method accepted that EVA is only a performance measurement criterion that is related to law of budget and a decrease of EVA gain of capital project, respectively. So other opportunities are created positively by EVA. One commercial unit (EVAs) factor, which is the concept of MVA, was used to add the 100 million rials (Iranian currency) and 500 million rials capital, to give a market value added as 600 million rials (Stewart, 1994). Fundamentally, the release of the non economic activity, the sales of low yield assets and assets in profit activity or the return to ownership investors, had anticipated a yield in the investment. As such, this yield resource created much yield in the investment and concurred to the decrease of MVA. Another way by which EVA can be increased is to increase the capital asset that is possible by financial policies.

Average decrease is not a simple work, because in a competitive capital market, making a good law price is hard. So the strategy could be used to replace debt instead of share in structure. Debts are cheaper in two ways: Lenders accept low risk, and then expect low yield. The important factor is the decreased tax, including the pay rate that is accounted for, based on the law of commercial tax and rate of loan in tax, when debt is replaced by the stockholder and the price rate is related to debt and part of the price. The present value of tax increases EVA. However, increase in EVA means to make value for the company, but use of MVA is to know if the performance of a company is made or not?

Relationship between EVA and MVA

MVA is different between market value and capital in any company. In contrast yield rate, it shows one period's profit. As such, it shows that a company is successful and predicts an opportunity of making profit in the future.

$$MVA = \frac{EVA\ 1}{(1+c)1} + \frac{EVA\ 2}{(1+c)2} + \ldots\ldots\ldots \frac{EVA\ n}{(1+c)n}$$

$$MVA = \sum_{i=1}^{n} \left(\frac{EVAn}{(1+c)n} \right)$$

The primary goal of the private unit is to maximize MVA. EVA had created MVA because the present value of EVA is in the future. Based on the evaluation and worthwhile of the company, EVA is used as an internal criterion for performance evaluation. If EVA has a positive share, it will be sold in market, but if it has a negative company share that is low as its value, it will not be sold. However, MVA shows the evaluation of an investor and the effectiveness of its performance in one year. As such, EVA and MVA are the internal and external criteria in performance.

Relationship between EVA and NPV

EVA has a close relationship with NPV. In fact, EVA is simply improved by NPV law. NPV in each project is equal to the present value added in a life time:

$$NPV = \sum_{n=1}^{n} \left(\frac{EVA\ t}{1+Kc} \right) t$$

This relationship corresponds to EVA. However, explanation of other values of the company is as follows:

Firm value = capital investment in place + NPV asset in place + $\sum_{t=1}^{t=\infty} NPV$

Firm value = capital investment in place $\sum_{t=1}^{t=\infty} \frac{EVA\ t, assets\ in\ place}{(1+Kc)t} + \sum_{t=1}^{t=\infty} \frac{EVA\ t, future\ projects}{(1+Kc)t}$

1. Investment used in present assets.
2. Present value of EVA, including present asset.
3. Present value of EVA, including future asset.
4. Standardization of EVA.

One failure exist, despite the many advantages of EVA as the best criterion, in that it could not be used to compare the commercial unit in different size means, and as such, the investment is assumed to be equal to 100:

2 year

$$ENA = \frac{capital}{capital} \times 100 \times (r - c)$$

One year

The main stimulus in the verification of REVA, including the economic value and change of EVA in account assets, occurs in the company asset based on the rate in the market. So, for understanding the value of the stockholder, the following proposition should be based on the market value and stock holder value that had gained a verification of Stewart EVA:

REVA = NOPAT – WACCX × MV

Operational leverage

Identification of an operational stable cost in predicting sales and designs, such as amortization and long term assets, stable cost, marketing and assurance are reviewed in the operational level. If the private unit increases the sales, the profit of the private unit is increased, because in determining the level, stable cost is not covered. However, increase in sales does not change the cost and the activity is not dependent. Accordingly, the profit of the private unit that increased changes to 1% in sale, and so, the operational profit in the private unit increased.

$$DoL = \frac{\frac{\Delta EBIT}{EBIT}}{\frac{\Delta Q}{Q}} = \frac{Q(P-V)}{Q(P-V)-F} = \frac{\%\Delta EBIT}{\%\Delta S}$$

Q = level of sale.
P = price of net sale on one unit.
V = variable cost in one unit.
F = total stable costs.

Operational leverage in product and sales should be below the negative point, that is, if the company is faced with risk, it is necessary to have many sales and destroy operational losses. Negative point of the operational leverage is the lowest point, while degree of operational leverage in the activity level is finite. However, percent of changes in sales is zero and it cause the leverage to move to proficiency. In order to account for profit before interest and tax (EBIT), first, profit before tax is extracted and added to interest; then, sales price in financial statement percent is accounted:

$$\%\Delta \text{ EBIT} = \frac{EBIT\,n - EBIT\,n-1}{EBIT\,n-1} \times 100$$

$$\%\Delta S = \frac{S\,n - S\,n-1}{S\,n-1} \times 100$$

Growth of profit

Profit, as a variable, is important such that performance evaluation index relation with EVA account for the level of growth, and then net profit in the financial statement is extracted as:

$$\Delta \text{ Net profit} = \frac{\text{net profit } n - \text{net profit } n-1}{\text{net profit } n-1}$$

Sales growth

Sales, similar to profit as a variable and index, had an effective relationship with EVA. For account sales growth, the extract net sale in the company's financial statement is used in the following relation:

$$\Delta S = \frac{S\,n - S\,n-1}{S\,n-1}$$

Research methodology

Due to the review of administration, explanatory – correlation is as an applied research, which covers the listed companies on Tehran Stock Exchange during 2004 to 2009.

Research hypotheses

With regards to the review of the previous studies, as well as the objectives of the study, the following hypotheses were postulated in the current study.

H_1: there is a meaningful relationship between EVA and the operational leverage.
H_2: there is a meaningful relationship between EVA and sales growth.
H_3: there is a meaningful relationship between EVA and profit growth.
H_4: the relationship between EVA growths and operational level is more than the relationship between EVA and profit growth.
H_5: the relationship between EVA and operational leverage is almost the same with the relationship between EVA and profit growth.

TESTING OF HYPOTHESES AND RESULTS

In order to test the hypotheses, various suitable tests were employed, that is, Jarque – Bera test, t-test and F test.

H_0: there is no meaningful relationship between EVA and operational leverage.
H_1: there is a meaningful relationship between EVA and operational leverage.

With regard to t-test, student and P-value regarding the first hypothesis, Table 2 shows that the coefficient is related to the growth variable of EVA and the level in confidence is 95%. As a result, P-value is equal to 0.0353 and smaller than 0.05, while P-value regression is equal to 0.000158 and smaller than 0.05. Consequently, when the hypothesis without regression failed, the regression of the equation is reached:

EVA = -0.18 to 0.005 (point of operational leverage).

In result, H_1 accepted the means that there is a meaningful relationship between EVA and operational leverage.

Regarding the results of Tables 1 and 2, which show the results of T-test, student and P-value, the coefficient that is related to the variable of EVA and sales growth in the level of confidence is not meaningful; as such, P-value

Table 1. The descriptive statistical results.

Variable	DOL	EVA	PROFIT	SALE
Mean	3.472222	0.416757	0.406389	0.234324
Median	0.640000	0.250000	0.305000	0.220000
Maximum	82.27000	5.880000	1.930000	0.480000
Minimum	-5.160000	-5.180000	0.070000	0.000000
Std. Dev.	13.82321	1.826603	0.341234	0.098926
Skewness	5.363725	-0.081187	2.871184	0.089432
Kurtosis	31.04545	7.098113	12.68535	3.043424
Jarque-Bera	1352.438	25.93222	190.1711	0.052229
Probability	0.000000	0.000002	0.000000	0.974224
Sum	125.0000	15.42000	14.63000	8.670000
Sum Sq. Dev.	6687.840	120.1132	4.075431	0.352308
Observations	36	37	36	37

H_2: there is a meaningful relationship between EVA and sales growth; H_0: there is no meaningful relationship between EVA and sales growth; H_1: there is a meaningful relationship between EVA and sales growth.

is equal to 0.7893 and larger than 0.05. However, null hypothesis without meaningful relationship between the two variables is accepted and the other is rejected.

H_3: there is a meaningful relationship between EVA and profit growth.
H_0: there is no meaningful relationship between EVA and profit.
H_1: there is a meaningful relationship between EVA and profit.

With regards to t-test, student and P-value show that the coefficient related to EVA variable and profit in the confidence level is 95%, while P-value is equal to 0.0138 and smaller than 0.05 and P-value regression is equal to 0.000158 and smaller than 0.05. Therefore, the research hypothesis is accepted, and the null hypothesis is rejected alternatively.

EVA = -0.18 + 2.29 (profit growth).

H_4: The relationship between EVA growth and operational level is almost the same with that of EVA and sales profit.

According to the aforementioned tables, which show the results of the fourth hypothesis, the research hypothesis is rejected and the null hypothesis is accepted.

H_5: The relationship between EVA and operational leverage is almost the same with that of EVA and profit growth.
H_5: The relationship between EVA and operational leverage is not the same with that of EVA and profit growth.

With regard to the results of hypotheses 1 to 3 and the regression equation related to them, the variable coefficient in the regression is 0.005 and the coefficient is 2.29. The concept is stable and the other factor without operational level is increased by 1%. Consequently, EVA is decreased to 0.005, and then it is increased to 2.29. Thus, the variable of growth plays an important role in the operational level related to profit.

R^2 analysis

With regard to R^2 equation of regression, 47% of the dependent variable is determined by the explanatory variable and the number is equal to the cross – section's data, while the low R^2 is not based on the model. Results of the test with regard to the hypothesis in the following table had been analyzed.

CONCLUSION AND SUGGESTIONS

In the first hypothesis, the relationship between EVA and operational leverage in evaluation of the performance of the listed companies in Tehran Stock Exchange had been examined. The results showed that a meaningful relationship exist between EVA and operational leverage in an inverse way. The results show that the point of operational leverage is increased, and the company's risk is increased as well. Also, it shows that the decreased demand in market and share exposes the increase of asset for stockholders to risk. The results of the second hypothesis showed that there is no meaningful relationship between EVA and sales in evaluation of the company in stock exchange. As such, EVA reached its results without a relationship, based on decision making.

Table 2. Results of the hypotheses.

Dependent variable: EVA				
Method: Least squares				
Sample (adjusted): 1 37				
Included observations: 35 after adjustments				
Weighting series: 1/PRO				
Heteroskedasticity-consistent standard errors and covariance				
Variable	Coefficient	Std. error	t-Statistic	Prob.
DOL	-0.005008	0.002275	-2.201758	0.0353
PROFIT	2.297124	0.880174	2.609852	0.0138
SALE	-0.213208	0.790872	-0.269586	0.7893
C	-0.181259	0.299364	-0.605479	0.5493
Weighted statistics				
R^2	0.472945	Mean dependent variable		0.350849
Adjusted R^2	0.421940	S.D. dependent variable		0.675942
S.E. of regression	0.576288	Akaike info criterion		1.842791
Sum squared	10.29533	Schwarz criterion		2.020545
Log likelihood	-28.24884	Hannan-Quinn criter		1.904152
F-statistic	9.272469	Durbin-Watson stat		1.943992
Prob. (F-statistic)	0.000158			
Un-weighted statistics				
R^2	-0.217414	Mean dependent variable		0.624286
Adjusted R^2	-0.335228	S.D. dependent variable		1.576519
S.E. of regression	1.821701	Sum squared		102.8764
Durbin-Watson test	2.540496			

In the third hypothesis, the relationship of EVA with growth in the listed companies' performance on Tehran Stock Exchange is examined. The results show that a meaningful relationship exists between the two criteria. As the company's profit increases, the EVA and stockholder asset could increase as well. These results show that among the three criteria point of operational level, the correlation profit criterion with EVA is explained.

Suggestions for research administration

The following suggestions could be useful and should be applied in the results test for further studies:

1. Recommendation for economic performance is based on EVA and an awareness of the operational leverage of the commercial unit.
2. Economic performance evaluation is based on EVA, whereas sales growth is less important and recommended for decision finding.
3. Economic performance evaluation based on EVA, pays attention to net profit.
4. Economic performance measurement based on EVA, pays attention to profit of operational leverage.

Suggestions for future researches

With regard to the present research, in full level, the suggested topic of the research review in various industries has a possible kind of industry effect on the results. In addition, the research done in various Industries suggested that the review was done for a long time.

1. Review of a relationship between operational level and profit growth of EVA.
2. Review of EVA criterion as a reward to managers and the effect it has on manager performance.
3. Comparison research of EVA with the kind of possession (public and non-public).
4. Effect of EVA applied with other variables, such as

ABC in companies' value.

In evaluation of the companies, economic performance as well as financial index, is examined by non financial index such as beneficiary index and innovation.

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