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## **EVA and HR Decisions: A Need for Linking HR Decisions**

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### **Abstract:**

*EVA is an innovative tool in contemporary environment to motivate human resources in an organization to increase productivity. EVA as an effective instrument may ensure better capacity utilization resulting in enhanced productivity. EVA may be used for financial incentive compensation that directly or indirectly links each and every employee to create additional shareholder value and managers work as owners. Proper motivation of human resource is a complex task. A number of incentive strategies are launched to motivate workforce to ensure better capacity utilization and productivity. EVA works as an effective tool for rendering compensation to all employees in an organization. Conventional incentive schemes or bonus systems largely depend on profitability and such benefits are highly sensitive and responsive to profitability fluctuations. Even Bonus may be Zero which may give a negative message. On the other hand EVA may be continuously rising, hence compensation- incentives may also increase accordingly. Thus, EVA is an emerging tool in India which may be used for compensation-incentives to reward all employees at all level of an organizational hierarchy. The paper formulates an EVA-HR Incentive model for better productivity and performance.*

### **1. Introduction**

EVA is an innovative tool in contemporary environment to motivate human resources in an organization to increase productivity. EVA as an effective instrument may ensure better capacity utilization resulting in enhanced productivity. EVA may be used for financial incentive compensation that directly or indirectly links each and every employee to create additional shareholder value and managers work as owners.

It is a fact that J.J. Irani, Ex-Managing Director of Tata Iron and Steel Company (TISCO) (Retired in August 2001) brought about a sea change in the management of this oldest steel plant and the outcome was multiplied labour productivity. On his retirement he felt that his accomplishments did not include a higher shareholder value. He said, "The shareholder value for Tata Steel should have been higher than what it is today."<sup>1</sup> His successor B. Muthuraman took over the challenge of increasing shareholder value and he decided to implement the concept of EVA in TISCO. He linked EVA with performance of 43000 employees in TISCO. Bimalendra Jha of TISCO commented on this decision that, "There's a finance manager in every individual. We tried to tap into him."<sup>2</sup> Thus, EVA could be positive when employees performed as Finance managers or owners to create better shareholder value with a high value based management.

### **2. Hr Decisions for Motivation**

Proper motivation of human resource is a complex task. A number of incentive strategies are launched to motivate workforce to ensure better capacity utilization and productivity. Incentive Strategies have to be foolproof in the sense that for higher productivity higher incentives are provided and vice versa. EVA works as an effective tool for rendering compensation to all employees in an organization. Increase in EVA results in an automatic escalation of incentive compensation where trade union intervention is discouraged. Generally profit-sharing, incentive schemes and enhancement in productivity are domain of trade unions and every then & now negotiations take place, however, EVA avoids such conventional workers, weapon. Many organizations have introduced EVA linked Bonus plans to make compensation management successful. Whereas Bonus is mandatory and generally fixed, EVA linked compensation –incentives for employees are hassle free with no upper limit. An automatic escalation in compensation may be arrived at with a positive EVA. Such organizations may offer better incentives liberally if employees enhance EVA.

Obviously, conventional incentive schemes or bonus systems largely depend on profitability and such benefits are highly sensitive and responsive to profitability fluctuations. Even Bonus may be Zero which may give a negative message. On the other hand, EVA may be continuously rising, hence compensation- incentives may also increase accordingly.

Thus, EVA is an emerging tool in India which may be used for compensation-incentives to reward all employees at all level of an organizational hierarchy.

<sup>1</sup> Financial Express, August 03, 2001

<sup>2</sup> "Busting the business cycle," Business world, June 2003

### 3. Objective

The objective of the paper is to:

- a. Highlight the Changing pattern of HR management in India
- b. Conceptual framework of EVA and
- c. To formulate an EVA-HR Incentive model for better productivity and performance.

### 4. Changing Scenario of Human Resource Management in India

Human Resource Management in India was popularly known as personnel Management. A Personnel Manager in India had to fight for his own existence and this was a long journey. Since Independence, industrialization took place at a rapid rate, however, it was a seller's market, hence profitability was high and therefore, no one was concerned about HR. Quality control, better productivity and international business through India were not found in Indian dictionaries. With Economic Planning and greater restrictions, goods were in short supply, that resulted in black marketing and huge profits. The situation was favourable for financial Managers, Production Executives and Marketing-HR functions didn't emerge as a force to reckon with.

Under Factories Act, it was mandatory to appoint a welfare officer and therefore, he used to discharge all functions of labour or personnel Management. These were routine functions and welfare officer performed them, however, he was not given the status of Personnel manager/officer.

Labour Acts and their implementation was the sole objective for a welfare officer which mainly promoted paper formalities but fear of prosecution discretionary powers of labour inspectors, Factories & boiler inspectors, PF/ ESI Inspectors led to an indirect threat to working of factories that developed under hand practices.

During these years' trade unions had strong emergence and national level organizations like INTUC, AITUC and HMS granted affiliations to unions at local and regional levels. Growth of unions, strikes, Gheraos, tool down, work to rule, go slow tactics compelled employers/Management /Industrialists to assign the task of managing workforce to Personnel Management as a separate independent Department and entrusted the task beginning with recruitment/selections. At a much later stage, Personnel /HR Departments were created and HR Managers got a right place in organizational hierarchy at par with other functional areas of management. The forex crisis in India inspired all concerned to earn foreign exchange, build up forex reserves, export goods and expand capital markets overseas with new financial instruments. Export goods needed quality orientation, productivity management and production at global standards. These developments called for greater role to HR Managers to impart training to workforce and arrange EDPs for managerial cadres.

Liberalization/globalization process got initiation in 1990 simultaneously in India, erstwhile USSR, China and many other emerging economies. Opening up of economies removed trade barriers and paved way for migration on manpower from one continent to the other. Trade in services, WTO regulations expanded the existing horizons and manpower planning, HR Development, Control, Motivation, global packages, fringe benefits, social security attracted attention of HR Departments.

During last 15 years' massive exodus of trained manpower/management executives, engineers took place and India exported services but at the same time services were imported from many countries because of entry of multi-national corporations in the country. HR departments equipped itself with the changing scenario.

The HR department now, has to be a Department with global approach and attitude. Methods of recruitment, selection, compensation, incentives, fringe benefits, social security and welfare measures have all changed drastically at global level and therefore, impact in the domestic economy is inevitable. Another important trend with HR Departments is use of internet and communication through it which has reduced working and made recruitment process easier. Even record keeping and compensation payments are easier now with use of computers.

HR Development, regular training programmes, EDPs, updating of knowledge, exposure to new production techniques, innovations & inventions have increased responsibility of HR Department to draw a comprehensive programmes for all Department executives and employees for ensuring greater efficiency.

#### 4.1. Survival of the Fittest

Globalization process is now heading towards global capitalism and dependence on market economy. The outcome is competition and survival of fittest. This amounts to continuously lowering down of costs which largely depends on HR efficiency. HR of all departments together have to strive hard with a team work to achieve the goal of greater efficiency. Technological advancement calls for timely training programmes to be arranged by HR Departments. This trend has resulted in high importance of HR Department.

### 5. Conceptual Framework of Eva

EVA is considered as the best tool for measurement of performance; financial as well as of Human Resources. It was rightly said that "At one level, they are accurate measures of the wealth created by a company. At another, they are tools that can be used to enhance the quality of governance and management within an organization"<sup>3</sup>. Thus, EVA may be used for measuring management efficiency and quality of governance. EVA is the contribution of US consultants namely Messers Stern Stewart and co. EVA refers to Net operating profit after taxes minus the cost of capital. Hence

1.  $EVA = NOPAT - \text{Capital cost}$
2. EVA is a residual cash flow after tax having deduction of cost of capital.

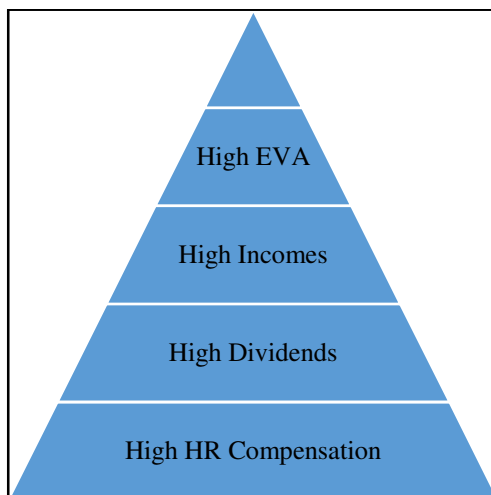
<sup>3</sup> Business Today, New Delhi, March 2001, P.57

3. EVA helps to evaluate the real profitability of a business unit.
4. EVA is a surplus over cost of capital.
5. EVA depicts impact on shareholder's wealth.
6. EVA is an estimate of true economic profit.

Obviously "EVA, or economic value added, is the proprietary tool they have developed to end inefficient use of capital. The crux of EVA is to effectively put a cost to equity capital and make it a pre-tax charge while calculating returns. In effect, a company is said to be EVA-positive as long as its net operating profit after tax (NOPAT) is higher than the cost of the capital."<sup>4</sup>

It will be clear that-

- Zero EVA means that shareholders have earned a return which compensates risk.
- Negative EVA represent decline in shareholder's value/wealth or returns are less than cost of capital employed.



*Table 1: Positive EVA means returns are more than cost of capital employed*

It will be clear from the Pyramid that:

- Increased EVA leads to
- Increased Incomes
- Higher Dividend Payments
- Higher HR Compensation

"It is cropping up fast all over as a means to improve upon the EEPP (efficiency, effectiveness, productivity, profitability) for both the commercial and not for profit entities."<sup>5</sup>

If operating profits increase, it does not mean that efficiency, effectiveness, productivity and overall profitability have increased. The reason is that profits do not account for cost of capital. Obviously EVA is being applied for measurement of financial performance. EVA, therefore, is a residual income after deducting the cost of capital contributed by lenders and shareholders by earning operating profits over the cost of capital employed in a business unit. If without employing additional capital operating profits increase (After deducting cost of capital) than such residual amount shall reflect greater efficiency, effectiveness and improved productivity.

<sup>4</sup> R. Jagannathan, theme/EVA, Indian Management, The Journal of the All India Management Association, New Delhi, Vol. 4, July 2002, p.31

<sup>5</sup> Dr. Lalit Gupta etc., EVA Research, Indian Journal of Accounting Vol. xxxii Dec.2001, P.37

## EVA Trends : 1996-2005 (Unaudited)

(Rs. crores)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>Cost of Capital Employed (COCE)</b>										
1. Average Debt	156	160	165	162	93	50	45	881	1588	360
2. Average Equity	815	1127	1487	1908	2296	2766	3351	2899	2116	2200
3. Average Capital Employed : (1) + (2)	971	1287	1652	2070	2389	2816	3396	3780	3704	2560
4. Cost of Debt, post-tax %	7.88	8.82	9.10	8.61	8.46	7.72	6.45	4.88	5.19	3.38
5. Cost of Equity %	19.70	19.70	19.70	19.70	19.70	16.70	14.40	12.95	14.77	15.50
6. Weighted Average Cost of Capital % (WACC)	17.80	18.34	18.64	18.83	19.27	16.54	14.30	11.07	10.66	13.80
7. COCE : (3) x (6)	173	236	308	390	460	466	486	418	395	353
<b>Economic Value Added (EVA)</b>										
8. Profit after tax, before exceptional items	413	580	837	1070	1310	1541	1716	1804	1199	1355
9. Add : Interest, after taxes	32	21	19	14	8	5	6	43	82	12
10. Net Operating Profits After Taxes (NOPAT)	445	601	856	1084	1318	1546	1722	1847	1281	1367
11. COCE, as per (7) above	(173)	(236)	(308)	(390)	(460)	(466)	(486)	(418)	(395)	(353)
12. EVA : (10) - (11)	272	365	548	694	858	1080	1236	1429	887	1014

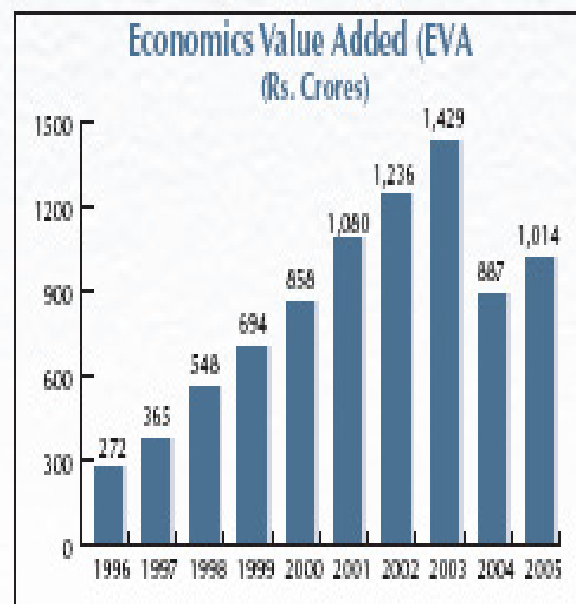


Table 2

Source: Annual Reports of HLL (Hindustan Lever Limited)

A Study of EVA calculated in case of Hindustan lever Limited reveals that an increase in EVA shows better financial performance and vice versa. Accordingly, decisions for Bonus, HR compensation and Incentives may be taken for long run motivation to employees/workers to increase productivity and to shareholders to invest more.

EVA trends in HLL present a rosy picture. EVA increased in HLL since 1996 continuously. In 1997 it increased to Rs. 365 crores as compared to 272 crores in the previous year. In 1998 it increased to Rs. 548 crores, in 1999 to Rs 694 crores, in 2000 to 858 crores, in

2001 to 1080 crores, in 2002 to 1236 crores and in 2003 to Rs 1429 crores. In these years EVA increased drastically. In the year 2004 there was a decline in EVA to Rs 887 crores, however HLL again picked up in 2005 and EVA increased to Rs 1014 crores.

In fact, HLL has used the concept of EVA for decision making and also for performance evaluation. HLL believes that share holder value creation (SVC) is directly connected to EVA. It is clear that increase in EVA of HLL since 1996 has registered a fast growth and accordingly the company has paid rich dividends. The price of its shares in stock market has been high beyond expectation. HLL's annual report, 2002 reveals that "HLL's philosophy is to add value to shareholders. It considers that the concept of EVA is more relevant in creating shareholder value rather than the conventional measures such as earnings capitalization, market capitalization and present value of estimated future cash flows."

The HLL has stated its corporate philosophy in following words which speaks volumes about their efforts to increase EVA: -

- Our long-term success requires a total commitment to exceptional standards of performance and productivity, to working together effectively and to a willingness to embrace new ideas and learn continuously.
- We believe that to succeed requires the highest standards of corporate behaviour towards our employees, consumers and societies and world in which we live.
- This is our road to sustainable, profitable growth for our business and long-term value creation for our shareholders and employees.
- Our approach to Corporate Social Responsibility (CSR) is rooted in the belief that "to succeed requires the highest standards of corporate behaviour towards our employees, consumers and the societies and world in which we live."
- Our CSR philosophy is embedded in our commitment to all stakeholders – our consumers, our employees, the environment and the society that we operate in. It is this commitment we believe that will deliver sustainable profitable growth.

The objectives are mainly based on HR performance.

#### **6. Evolving Eva-Hr Incentive Model**

Incentives play an important role in a capitalist economy to boost productivity. In fact, financial incentives are gaining currency and EVA linkage provides a better method of rewarding all employees. Traditional bonus and other incentive plans of compensation are of no avail in modern times. Such methods do not tempt employees/workers for better performance.

When EVA refers to amount as a residual of NOPAT minus capital charge, such amount is available for shareholder, it means that the residual is shareholder value which should be more than the targeted EVA and this residual is to be linked as an incentive.

In other words, if different division of a company or all employees at all levels of management contribute more than the targeted EVA then such residual amount of EVA shall be paid to all employees on the basis of HR incentive model. Hence all employees shall dedicate themselves for a manifold increase in EVA. In this case entire human resource of an organization will be a combined entity. May be that individually some of executives or employees have exceptionally good performance, but a division / or section of that organization has poor performance, then incentive payment shall be based on combined performance only.

Joel stern, managing partner of Stern Stewart Co. says EVA – linked incentive schemes can help motivate employees to grow shareholder value year after year. Once EVA is more than the target the surplus may be used as an incentive.

Proposed EVA – HR incentives model will concentrate on a correlation between EVA and cash bonus. In other words, increase in EVA as compared to targeted amount shall automatically escalate the bonus of all employees and this amount shall be treated as a payment to owners themselves where employees are treated as owners.

Proposed EVA – HR incentives model will concentrate on a bonus – bank also which has a long term perspective plan as compare to traditional short term bonus plans. After giving EVA share to employees, residual excess amount of EVA increase is transferred to Bonus- Bank for future sustainable payments. This is popularly known as 'Bonus at Risk.'

While talking to BT'S Dilip Maitra, Joel Stern said, "The real magic in EVA comes from changing behaviour through out an organization and that depends crucially on using it as the basis for incentive compensation. Most important, EVA initiates an internal system of corporate governance that motivates all managers and employees to work cooperatively and enthusiastically to achieve the very best performance possible. At heart, EVA is not about finance or economics, it is about people, EVA is a means to unlock the potential for achievement that exists through out every organization. It is a management system that makes employees accountable for performance and properly rewards mean for success.....If you link incentives with higher operating margins you will get no sales; Pay for market shares, and you will get market shares, but your profits may go out of the window. Thus if you pay people for generating more EVA you will get it and with it, your higher share price and greater shareholder wealth. You also will get a more successful organization that provides greater non monetary satisfaction as well."

Stewart (III) and Bennett, G. (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".

Rice, V.A (1996) observed that "with EVA, I saw a way to meet our business objectives and create a new corporate corporate culture. It permeates every level from boardroom to the shop floor. Bonuses of all managers are determined solely by whether variety achieves its EVA targets".

### 6.1. Salient Features of the Model

- ❖ Determine a Target EVA
- ❖ If Actual EVA is more than the target, the surplus of such EVA may be shared by all employees
- ❖ Surplus of EVA Target may be divided into two parts, namely 75% for distribution and 25% to be transferred to 'Bonus Bank'.
- ❖ 75% of surplus of target EVA be shared by all employees on the basis of a fixed % of basic salary/ wages
- ❖ 25% of surplus of target EVA is transferred to bonus bank for long term use and to maintain a uniform level of EVA distribution in coming years.
- ❖ Develop a method for rewarding divisions of company having better performance and discouraging poor performance of particular Division.

### 7. Conclusion

Simple profit calculations are always vague and ambiguous. The concept of EVA is foolproof in view of the fact that it accounts for cost of capital also makes it an economic Profit. Increase in EVA beyond a targeted value is to be shared by Human Resource of an organization by way of an incentive plan based on proposed model. It motivates all employees to work as shareholders of such organization. In fact, 'EVA pays for itself or in other words employees themselves generate more EVA to pay themselves plus they leave surplus for a Bonus Bank. When EVA increases beyond a target, share prices of such an organization increase automatically, hence wealth stands created.

### 8. References

- i. Financial Express, August 03, 2001
- ii. "Busting the business cycle," Business world, June 2003
- iii. Business Today, New Delhi, March 2001, P.57
- iv. R. Jagannathan, theme/EVA, Indian Management, The Journal of the All India Management Association, New Delhi, Vol. 4, July 2002, p.31
- v. Dr. Lalit Gupta etc., EVA Research, Indian Journal of Accounting Vol. xxxii Dec.2001, P.37