



THE PROCESS OF CREATING ECONOMIC VALUE ADDED: CAUSES, FACTORS AND IMPLICATIONS

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Abstract *The economic value added is formed under the influence of two major factors: the difference between the economic profitability and the weighted average cost of capital, called the rate of economic value generation and the value of the economic asset exploited by the company. To stimulate the process of creation of economic value added, the company must act in the sense of increasing the rate of economic value generation and development of the volume of the economic asset.*

Key words:

Economic rate of return, weighted average cost of capitals, economic asset, elasticity, intensive and extensive factors of development

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1. Introduction

The economic value added represents the expression of gross cash flow generated by the enterprise after the remuneration of the mobilized capitals. The remuneration rate of the capitals is the weighted average cost of capitals, i.e. the minimum return that the investments made by the company must generate to simultaneously satisfy the shareholders' return requirements (by the cost of share capitals) and the profitability requirements of the creditors (by the indebtedness cost). Thus, the weighted average cost of capitals (wacc) represents the minimum remuneration required by all financial funds providers. The value created above the level of wacc is an economic value added that remains entirely to the company to finance different needs (Ehbar, A., 2000: pp. 18-19).

2. The process of creating economic value added (EVA)

The economic value added measures the overall efficiency of the company's economic asset (EA), respectively the capacity of the total investments in business to produce wealth. Since the main source of value is the firm's exploitation (basic) activity, the benchmark for the process of generation of economic value is represented by the economic rate of return (E_r) measured by the result of exploitation considered according to the tax on income ($ER(1-t)$):

$$E_r = \frac{ER(1-t)}{EA} \quad (1)$$

The economic value added results from comparing the E_r size with wacc level. The company generates economic value added every time E_r is higher compared to wacc. In all other cases, the company does not create, but consumes economic value. The economic value added is formed under the influence of two major factors (Dumitrașcu, V., 2013: pp. 65-71): 1) the difference between the economic profitability and the weighted average cost of capital, called *the rate of economic value generation* (R_{GEVA}) and 2) the value of the economic asset exploited by the company. *To stimulate the process of creation of economic value added, the company must act in the sense of increasing the rate of economic value generation and development of the volume of the economic asset.* In this situation, EVA is:

$$EVA = (E_r - wacc) \times EA = R_{GEVA} \times EA \quad (2)$$

The first factor – the rate of economic value generation – is of qualitative nature and characterizes the intensity and effectiveness of the exploitation of the economic heritage of the company. This rate depends, in its turn, on the particular factors that appear in shaping the economic profitability and the weighted average cost of the capital. The elements of configuration of the economic profitability and the factors influencing the weighted average cost of capitals will be analyzed in a subsequent section. Obviously, the greater the difference between profitability and average cost of capital, the more important the economic value

generated by the company and vice versa. Of course, in certain circumstances, the business development may involve the simultaneous increase at the level of profitability and the level of the cost of mobilized capitals. It is important that, in relative terms (percentage), the increase of economic profitability be higher than that of the capitals' cost, in order to ensure the consolidation of the qualitative basis of the process of creation of economic value added (Dumitrașcu, V., 2014: pp. 72-74).

The second factor – the economic asset – is of quantitative nature and characterized the global volume of economic resources of business. Economic asset is calculating in two forms:

- 1) Economic asset = Own capitals + Financial debts (Long term debts)
- 2) Economic asset = Long term assets + Short term financial needs

The economic asset influences the economic value added in two distinct and seemingly divergent ways: directly and positively by its absolute dimension, as a multiplier of the economic value; indirectly and negative, by the fact that economic profitability is calculated on its value, so that a greater economic asset has the meaning of lower profitability and, consequently, a smaller economic value added. In other words, the increase of the economic asset on the one hand stimulates the process of generation of economic value added and its final size and, on the other hand, penalizes them. In this way, the impact of the economic asset on the economic value added is ambiguous.

3. The elasticity of the result of the exploitation compared to the changes in volume of the economic asset

The question is under what conditions however, the positive effects exerted by the increase of the economic asset exceed as scale and intensity the negative effects? The answer lies in the nature of the relationship between the result of exploitation and the economic asset, namely the type of sensitivity developed by the result of exploitation depending on the variations of the economic asset. We may discuss, therefore, about *the elasticity of the result of the exploitation compared to the changes in volume of the economic asset*, which indicates the percentage of the exploitation's result level varies, when the dimension of the economic asset varies by one percentage:

$$E_{ER/EA} = \frac{\Delta ER}{ER} : \frac{\Delta EA}{EA} = \frac{\Delta ER}{\Delta EA} \times \frac{EA}{ER} \quad (3)$$

This elasticity coefficient may take both positive and negative values. Negative values have the meaning of the developments in the same direction of the exploitation's result and the economic asset, while negative values indicate opposite evolutions of the two variables.

The following conclusions settles into shape: for all the less than 1 values of the coefficient $E_{ER/EA}$ the evolutions of the economic value added and the economic asset have opposite directions – in *caeteris paribus* conditions, increases of the economic asset determines decreases of the economic value generated by the firm and, contrarily, decreases of the economic asset produce increases of the economic value added, when $E_{ER/EA}$ is equal to 1, the variations of the economic asset, whatever their sense, do not cause changes of the economic value added; for the values $E_{ER/EA}$ bigger than 1, the increase of the economic asset generates the increase of the economic value added and the decrease of the economic asset generates the decrease of the economic value added.

It is noted that for $0 < E_{ER/EA} < 1$ even if the result of the exploitation increases when the economic asset increases, the economic value added has, however, a negative evolution. We call this phenomenon *the illusion of profitability*. What explains this paradoxical phenomenon? The values of the elasticity coefficient from the mentioned range have the following meaning: the increase by one percentage of the economic asset is translated through an increase smaller than one percentage of the exploitation's result. Developing the reasoning, in these circumstances, the denominator of the profitability economic rate (economic asset) increases faster than the numerator of this rate (exploitation's result). Therefore, the value of the profitability economic rate will tend to decrease. However, this means also the decrease of the level of the generation rate of economic value ($R_e - wacc$). The closer the coefficient $E_{ER/EA}$ to the value 0 the more drastic the reduction the level of the rate R_e , diminishing the positive effects of the increase of the absolute value of the economic asset on the economic added value added.

Likewise, we have also seen that for negative values of $E_{ER/EA}$ the increase of the volume of the economic asset causes decreases of the economic value. We call this phenomenon *sterile accumulation of patrimony*. Both reported phenomena – the illusion of profitability and sterile accumulation – result from the same causes: erosion of the intensive, qualitative factors of stimulation of the economic efficiency. These factors are mainly related to the degree of business sophistication and innovation incorporation in the processes of creating economic value. In other words, these factors summarize the knowledge invested in the

economic processes. Their function is to counteract the decreasing evolution of the performance of production factors embedded in the economic asset. The decreasing performances appear when, despite the increase of the absolute volume of the economic asset, the efficient exploitation of its constituent elements is not improved. Therefore, more economic asset does not always mean better performance. Without accessing the intensive development factors, the business will go towards the mainly extensive development area, characterized by a lower relative economic efficiency, even though the absolute quantity of the mobilized economic resources is increasing. At a certain point – when the elasticity coefficient $E_{RE/AE}$ takes negative values – continuing the process of patrimonial accumulation, i.e. the expansion of the economic asset's volume – will no longer result in positive evolutions of the created economic value, but, on the contrary, will determine its reduction.

4. Conclusions

Periods of extensive development by quantitative accumulation must therefore alternate with periods of predominantly intensive development, during which qualitative adjustments of the patrimonial and exploitation structures must be made, in order to improve the organization and functioning of the business processes, so that the generation of economic value to be stimulated. However, this approach requires changing the business model (the generic way to purchase incomes and realization of expenses), which implies, fundamentally, the development and enrichment of the key competencies held by the company and, consequently, major adaptations of the type of competitive advantages that will be the base of the business' success. The logic of the approach is shown in Fig. 5.

Key competencies represent the ability, the capacity or the skill of the company to perform certain functions, activities or operations, essential to the process of economic value creation, in terms of efficiency significantly better than those of the competitors.

The main functional areas where key competencies may be located and developed are:

- *Sales*, the company has the capacity to sell and communicate more effectively with the market than the main competitors.
- *Execution/manufacturing*, the company knows how to organize, develop and monitor, in terms of superior efficiency, the operational flows, ensuring, in this way their flexibility, functioning, economy and quality.
- *Innovation of products, technologies and systems*, the company holds obvious skills regarding the invention, development and diffusion of new elements

able to improve, incrementally or disruptively, the offer, the activities and financial performances.

The new key competencies are reflected in a different manner of organizing and functioning of the company. However, this leads inevitably to the reconfiguration of the basic economic and financial flows, namely the adoption of a new business model. Any business model explains how the company obtains its main revenues, implicitly from where the main collections come and which the most important categories of expenditures are, i.e. to which areas the payments made by the company are directed. In other words, from where the company's money come and to where they go. These essential aspects depend decisively on the architecture of the internal operational flows and the consistency of the company's relations with the economic environment. Basically, the business model specifies two essential aspects: 1) to which customer segments will be directed the company's offer (couples "product – market") and 2) what phases of the process of value creation will be performed within the company (internalized operations) and what business elements will be bought from the market (outsourced operations). Therefore the business model reflects the "production mechanism" or the principled scheme of the process of creation of economic value added (Lequeux, J. L. and Saadun, M., 2008: p. 120).

Competitive advantages represent those aspects of the offer and of the way of functioning of the firm that make it more attractive, from the customers' perspective, compared to its main competitors (Turdean, M. S. and Vana, D. T., 2012: pp. 2686-2692) Direct effects of key competences and efficiency in organizing the business model, the competitive advantages have the function of positive differentiation of the company on the market. Thus, the competitive advantages ensure better sales and, in this way, a level of economic profitability above the average level observed in the field of business in which the company operates. Likewise, an important function of the competitive advantages is, among others, ensuring an average cost of the capitals attracted below the market average. A real competitive advantage may result from a financial structure of the firm that minimizes the financing cost compared to the one the competitors must bear. Thus, the competitive advantages are reflected ultimately in levels of economic profitability and weighted average costs of the capitals that allow the release of a consistent flow of economic value added.

The operationalization of the presented approach requires an integrative, systemic perspective on the business which transcends substantially the strictly financial optical. The objective of maximizing the economic value added represents, therefore, the target of the overall managerial effort and not just an

exclusive concern of the financial management. Unquestionably, maximizing the economic value added determines the increase of the business global value and this, as shown, represents a specific objective of the management of the company's financial function.

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