

THE ROLE OF ECONOMIC VALUE ADDED IN STRATEGIC FINANCIAL MANAGEMENT

Yusupov Ulugbek Yo'ldoshboy o'g'li

Lecturer at ISFT Institute, Uzbekistan

Abstract: *This thesis examines the role of Economic Value Added (EVA) in strategic financial management and its importance in improving corporate financial performance and long-term business sustainability. Economic Value Added is a financial performance measurement tool that evaluates a company's ability to generate economic profit after accounting for the cost of invested capital. The study explores how EVA supports strategic financial planning, investment decision-making, efficient capital allocation, and shareholder value creation. Particular attention is given to the advantages of EVA over traditional financial indicators, such as Return on Investment (ROI), Return on Equity (ROE), and net profit.*

Key words: *Economic Value Added (EVA), strategic financial management, financial performance, shareholder value, capital allocation, cost of capital.*

In the modern business environment, strategic financial management plays an essential role in ensuring the long-term growth, competitiveness, and financial stability of organizations. Companies are increasingly required to make effective financial decisions that not only generate profits but also create sustainable economic value. Traditional financial indicators, such as net profit, Return on Assets (ROA), and Return on Equity (ROE), provide important information about business performance. However, these indicators do not always fully reflect the cost of capital employed in business operations. Consequently, Economic Value Added (EVA) has emerged as an important financial management tool that helps organizations evaluate their actual economic performance.

Economic Value Added represents the economic profit generated by a company after deducting the cost of all capital invested in its operations. The concept became widely recognized through the work of Stern Stewart & Co., particularly as a framework for measuring corporate value creation. According to Stewart (1991), EVA provides a practical approach to determining whether a company generates returns exceeding the cost of capital invested by shareholders and creditors [1]. The growing importance of EVA is closely associated with the development of value-based management, which focuses on maximizing long-term shareholder value rather than achieving short-term accounting profits. Strategic financial management involves capital budgeting, investment planning, financial risk assessment, and resource allocation. EVA contributes to these activities by providing a financial indicator that connects operational performance with the cost of invested capital.

For example, a manufacturing company may report an annual operating profit after tax of \$500,000. However, if the company has invested \$4 million in capital and its weighted average cost of capital is 10%, the annual capital charge equals \$400,000. Therefore, the company's

EVA is only \$100,000. This example demonstrates that accounting profitability alone does not necessarily indicate the actual economic value created by an organization.

Economic Value Added is considered one of the important instruments of strategic financial management because it measures the financial performance of a company by considering both operating profitability and the cost of invested capital. Unlike traditional accounting measures, EVA focuses on whether a business generates sufficient returns to compensate investors for the financial resources they provide. This approach encourages managers to evaluate business activities from the perspective of long-term economic value creation.

The fundamental formula for calculating Economic Value Added is:

$$\text{EVA} = \text{NOPAT} - (\text{WACC} \times \text{Invested Capital})$$

Where NOPAT represents Net Operating Profit After Taxes, WACC refers to the Weighted Average Cost of Capital, and Invested Capital represents the financial resources invested in the company's operating activities.

For example, consider a company with a net operating profit after taxes of \$800,000, invested capital of \$5,000,000, and a weighted average cost of capital of 12%. The annual cost of capital is calculated as \$600,000. Consequently, the Economic Value Added equals \$200,000. This positive EVA indicates that the company has generated economic profit beyond the required return on its invested capital. Conversely, a negative EVA would indicate that operating profits are insufficient to cover the capital charge.

One of the most significant contributions of EVA to strategic financial management is its application in investment decision-making. Companies regularly face decisions concerning business expansion, technological modernization, infrastructure development, and new product introduction. These investments require substantial financial resources and involve different levels of risk. EVA can help managers determine whether proposed investments are expected to generate economic value after accounting for their capital costs. Young and O'Byrne (2001) emphasize the importance of integrating value-based performance measures into corporate financial management and managerial decision-making [2]. Their approach demonstrates how value-based management can connect financial performance evaluation with strategic planning and organizational objectives.

For instance, suppose a company is considering two investment projects. Project A requires an investment of \$1 million and is expected to generate an annual NOPAT of \$150,000. Project B requires an investment of \$1.5 million and is expected to generate an annual NOPAT of \$210,000. Assuming that both projects have a weighted average cost of capital of 10%, Project A generates an annual EVA of \$50,000, while Project B generates an annual EVA of \$60,000. Although Project B requires more investment, it creates a higher absolute annual economic value under these assumptions. Nevertheless, managers should also consider project duration, future cash flows, investment risks, and the net present value of each alternative before making a final decision.

Another important aspect of EVA is its relationship with capital allocation efficiency. Strategic financial management requires companies to distribute limited financial resources

among different departments, business units, and investment opportunities. Inefficient capital allocation can reduce profitability and weaken long-term competitiveness. EVA provides a useful framework for identifying activities that create economic value and those that consume capital without generating adequate returns.

According to Damodaran (2012), the relationship between investment returns, the cost of capital, and value creation is fundamental to corporate financial decision-making [3]. Businesses create value when the returns on their investments exceed the required return associated with the risks of those investments.

For example, a company operating in the textile industry may have three production divisions. The first division generates an EVA of \$120,000, the second generates \$75,000, and the third reports a negative EVA of \$30,000. These results suggest that the first two divisions create economic value, while the third does not currently earn enough to cover its capital charge. Management may investigate the third division's operating costs, production efficiency, market conditions, and investment requirements before deciding whether to restructure or improve its operations.

Economic Value Added also plays an important role in evaluating managerial performance and developing corporate incentive systems. Traditional performance evaluation methods often emphasize sales growth, accounting profits, or market share. However, these indicators may encourage managers to pursue expansion strategies that increase reported profits without creating sufficient economic returns. EVA-based evaluation can encourage managers to consider the cost of capital when making operational and investment decisions. For example, a department manager may increase annual operating profit from \$300,000 to \$350,000 by investing an additional \$1 million in equipment. If the company's cost of capital is 10%, the additional investment creates a capital charge of \$100,000, while the additional operating profit is only \$50,000. As a result, the decision reduces EVA by \$50,000 despite increasing accounting profit. This example illustrates how EVA can reveal the difference between profit growth and economic value creation.

Research by Biddle, Bowen, and Wallace (1997) examined the relationship between EVA, earnings, and stock returns. Their findings indicate that EVA does not necessarily provide greater explanatory power for stock returns than traditional earnings measures [4]. This evidence suggests that EVA should be viewed as a complementary financial management instrument rather than a complete replacement for conventional financial indicators.

In addition, EVA can contribute to strategic financial planning by helping organizations establish long-term financial objectives. Companies can use EVA targets to evaluate investment strategies, improve operational efficiency, and monitor the effectiveness of capital utilization. When EVA is incorporated into financial planning, managers can focus on generating sustainable economic returns instead of concentrating exclusively on short-term accounting results.

For example, an industrial enterprise planning a five-year modernization strategy may establish annual EVA improvement targets. During the first year, the company may invest in

energy-efficient equipment, resulting in increased invested capital and a temporary reduction in EVA. In subsequent years, lower operating costs, higher production efficiency, and improved product quality may increase NOPAT and generate positive EVA. Therefore, EVA analysis should consider the timing of investments and the long-term financial consequences of strategic decisions.

The application of EVA is particularly relevant to developing economies, where businesses often face challenges related to financing costs, investment efficiency, and corporate governance. In Uzbekistan, enterprises operating in manufacturing, construction, transportation, and service industries can potentially benefit from introducing EVA-based financial evaluation systems. Such systems may support more disciplined capital investment decisions and encourage greater transparency in corporate financial management.

For instance, a hypothetical Uzbek manufacturing enterprise may report annual NOPAT of UZS 12 billion, invested capital of UZS 80 billion, and a weighted average cost of capital of 13%. The annual capital charge would equal UZS 10.4 billion, resulting in a positive EVA of UZS 1.6 billion. This calculation would indicate that the enterprise generates economic profit after covering its estimated cost of capital. If operating costs increased or capital became more expensive, management would need to review its financial strategy to preserve positive economic value creation.

Despite its advantages, EVA has certain limitations. The calculation of the weighted average cost of capital may be complicated, especially in markets where reliable financial information is limited. Moreover, differences in accounting practices and the need for adjustments to financial statements may influence the accuracy and comparability of EVA calculations. Another limitation is that EVA measures economic profit for a particular period and may not fully capture the long-term benefits of research, innovation, employee development, and other strategic investments.

Fernández (2002) discusses several approaches to company valuation and the importance of carefully distinguishing accounting performance from economic value creation [5]. This perspective highlights the need to combine EVA with other financial analysis techniques when evaluating corporate performance and strategic investment opportunities.

Overall, Economic Value Added provides a useful connection between financial performance measurement and strategic management. By incorporating the cost of capital into performance evaluation, EVA encourages businesses to improve investment efficiency, optimize resource allocation, and focus on sustainable economic value creation. Its effective implementation requires reliable financial information, appropriate capital cost estimates, and a clear understanding of the organization's long-term strategic objectives.

REFERENCES

1. Stewart, G. B. (1991). *The Quest for Value: A Guide for Senior Managers*. HarperBusiness, New York.

2. Young, S. D., & O'Byrne, S. F. (2001). *EVA and Value-Based Management: A Practical Guide to Implementation*. McGraw-Hill, New York.
3. Damodaran, A. (2012). *Investment Valuation: Tools and Techniques for Determining the Value of Any Asset*. 3rd Edition. John Wiley & Sons.
4. Biddle, G. C., Bowen, R. M., & Wallace, J. S. (1997). Does EVA Beat Earnings? Evidence on Associations with Stock Returns and Firm Values. *Journal of Accounting and Economics*, 24(3), 301–336.
5. Fernández, P. (2002). *Valuation Methods and Shareholder Value Creation*. Academic Press.