

Performance Evaluation of the Value Basis of Enterprise

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Keywords: Performance Evaluation, Economic Value, Accounting Value, Market Value Added, Economic Value Added.

Abstract. Economic value refers to the concept of value in economics. The concepts of value in economics, such as income, cost and profit are different from those of accounting.

Introduction

Great attention of the stakeholders concerned is attracted by the performance of an enterprise. However, until now no method of measuring the performance is widely recognized. The difficulty of measuring the performance lies in two aspects. Firstly, various methods of measuring reflect certain aspect of the performance of an enterprise, which are effective but one-sided. Secondly, measurement of performance is limited by the reasonable cost. Easy method of measurement shares poor authenticity of the response of the performance; the method reflecting better authenticity requires more costs.

Economic Value and Accounting Value

Financial Earnings and Accounting Income

Financial earnings refers to the maximum cost of certain period under the premise of being wealthy both at beginning of period and at ending of period. Here, the income is calculated according to property law. If there is no cost, then income at current period refers to the part that market value at end of period minus the capitals at beginning of period.

Income at current period = capitals at ending of period - capitals at beginning of period

For example, the capital at the beginning of the year is 50,000 RMB Yuan, and at the end of year the capitals increases in value to 70,000 RMB Yuan and the wage income of this year is 40,000 RMB Yuan. The economists believe that the total income is 60,000 RMB Yuan, which includes capital accretion of 20,000 RMB Yuan.

Accounting income is different from financial earnings. The accountants believe that the total income of the year is 40,000 RMB Yuan. The capital accretion of 20,000 RMB Yuan cannot be counted in the income in that it has not been realized by marketing, which is lack of objective proof of recording as income. Except the capitals that are transacted frequently, the value of change during periods of most of them is hard to be measured.

The accountants have a problem that if the capital that has already appreciated is sold, then 70,000 RMB Yuan is obtained. Then the 70,000 RMB Yuan is used to buy the capital back. It is admitted by the accountants that the value-added income of the capital of 20,000 RMB Yuan is realized. The income of the year will be 60,000 RMB Yuan. The income can be changed by this virtual transaction, which is contradicted with the economic theory and is difficult to be understood and accepted by the non-professionals. Accounting profit is manipulated by many enterprises using this defect of accounting.

Economic Cost and Accounting Cost

Economic cost not only includes the cost that is actually paid on accounting, but also the opportuni cost. For example, the capital of shareholders also belongs to the cost, which is one part of the current costs. It should be deducted when calculating profits in that the capital invested by the shareholders is an indispensable condition of production and management and the capital is by no

means without cost. The justification of the shareholders requiring return is no less than that the creditors require learning and the staffs require wage.

The obligation that is supposed to be paid by the shareholders are not confirmed by the accountants and the capital cost of the stock equity is not listed as the deduction of the profit statement in that no proof shows that how much money should be paid to the shareholders and the accountants are unwilling to estimate without proof.

Economic Profit and Accounting Profit

Cost of equity is not deducted from accounting profit, which gives people a false impression that the money can be distributed to everyone if there is accounting profit. Then the managers will require bonus, government comes to collect taxes and the staffs require a higher pay when the shareholders have not got the deserved reward. According to the simplest explanation, the biggest difference between economic profit and accounting profit is that all the capital cost is deducted, but only the interest of debt is deducted in accounting profit.

Economic profit is a theoretical concept, which has two methods of measuring in practice, namely, market value added and economic value added.

Market Value Added

The Concept of Market Value Added

Market value is the value that is formed due to the relation between supply and demand. If the enterprise is considered as a commodity which is able to produce cash, then its value is determined by the relation between supply and demand. But the object of transaction is not ordinary commodity, but the property of the enterprise. In an effective and ordered financial market, the price of the property of the enterprise can accurately reflect the value of the enterprise. The increase of the value of the enterprise is also the increase of the wealth of the owners of the property. Therefore, the change of the value of the enterprise can be used to measure its performance.

From the perspective of the creation of wealth, the market value of the enterprise itself cannot explain everything. The market value of the enterprise does not show how much capital is not invested to obtain the market value and the creation of wealth is determined by the market value of the enterprise but by the margin of the capital invested into the enterprise by the market value and investors. If one dollar of capital invested by the enterprise produces the market value less than one dollar, then the enterprise is destroying the wealth of the shareholders. At the end of 1996, the market value of Dell was \$ 8.7 billion, and the market value of digital equipment corporation was \$ 8.1 billion. The two were almost the same. However, the capital of Dell was \$ 418 million, which created wealth worth of \$ 8.282 billion; the capital of the digital corporation was \$ 12 billion, which destroyed the value of shareholder worth of \$ 3.9 billion. Therefore, the digital corporation was acquired by Compaq.

The method used to evaluate the performance of enterprise is not market value, but market value added, which is the margin of the total market value and total capital.

Market value added = total market value - total capital

Total market value includes the value of the creditor's rights and the equity value. Total capital is the capital invested by the providers of the capital. The accumulative market value added can be calculated by using the current total market value minus the current capital invested. The market value added of certain year can be calculated by using the accumulative market value added at the end of year minus the market value added at the end of last year. Estimation of the value of the creditor's rights of an enterprise is easy, which is normally the current value of the future cash flow. The equity value of the public company can be estimated by the price of each share and the total number of shares; estimation the equity value of the unlisted company is not that easy which can

only be estimated according to the share price of the public company of the same kind or with other indirect methods.

Due to the fact that the total capital is reported according to the historical cost, which is not able to reflect the current value of the total capital, therefore, a series of adjustments are necessary. Accounting standards almost tend to underestimate the total value of the capital of a company. From the perspective of economics, the expenditures in cash which contribute to future profits are considered as investment, but the many items are recognized as expense by accountants. When the accountants face with several options, they almost always choose the most conservative method of profit statement and balance sheet. The conservative tendency of the accountants is natural. Historically, the main users of accounting statement are the creditors. However, the concerns of the creditors are different from those of the managers. What the creditor concern is whether the property is enough to pay off the loss of property when the company bankrupts. Therefore, the accounting statement is used to describe the financial conditions of the company according to making arrangement for the bankruptcy of the company.

Advantages of the Market Value Added

Theoretically, market value added is an accurate way of evaluating the wealth created by the company which is better than other ways. It is the margin between the inflow of cash and the outflow of the cash that is calculated by this way. Market value added is the accumulative amount of the wealth of the shareholders increased or decreased in an enterprise, which is the best way to evaluate the performance of an enterprise.

The risk of the enterprise can be reflected by the market value added. Not only is the judgment of the risk by the investors included by the market value of the enterprise, but also the evaluation on the performance of the enterprise. Therefore, market value added can not only directly compare the enterprises in different industries, but also compare the performance of the enterprises from different countries. Market value added itself is the ultimate goal of the competition of creating wealth.

Limitations of the Market Value Added

It is controversial that whether the A stock market is able to really evaluate the value of the enterprise. Though the theory of effective market has a long history, and is proved by many empirical studies, it has almost the same number of disproof. Because of asymmetric information, incorrect expectations are often made by the investors which results in the deviation of the share prices from the enterprise value.

In short term, the change of the overall level of the B stock market can drown the behavior of the managers. Stock prices are not only influenced by the performance, but also by the overall level of the stock market.

Only when a company goes public can it have a relatively fair market price so that it can calculate its market value added. The estimation of the market value of a company that does not go public is not reliable. Most of the companies do not go public which do not own proper data of estimating the market value and the application of market value added is limited.

Economic Value Added

The Definition of Economic Value Added

Economic value added can be defined as the residual income after all the cost is deducted from the revenue of the enterprise. It is equivalent to the amount after the debt and equity cost is deducted from the after-taxed operating profit. Economic value added can be calculated in two ways:

Definition 1

Economic value=after-taxed operating profit-all capital cost Definition 2

Economic value = initial invested capital × (rate of return of the initial invested capital - weighted average cost of capital)

The conclusions of the two methods are the same. Economic value added is the income or the residual income created by the capital in certain period. If economic value added is positive, the value is created by the enterprise; if economic value added is negative, then the due value is destroyed; if economic value added is zero, a general expectation is obtained by the enterprise which exactly compensates the capital cost.

Advantages of Economic Value Added

Economic value added is directly connected with the wealth created by the shareholders. The higher the economic value added is pursued means that the higher share price is pursued. For the shareholders, the more the economic value added, the better it is. In this respect, it is the only correct measuring index of performance, which is able to measure the improvement of the performance.

Economic value added is not only an index of performance evaluation, but also a framework of comprehensive financial management and incentive payment system. The attraction of economic value added lies in that the capital budget, performance evaluation and incentive payment are combined, managed by economic value added whose goal of operating is economic value added. Basis of decision on capital budget is the economic value added discounted at a proper rate of discount. The index of measuring the effectiveness of operation is economic value added. Bonus is determined by economic value added according to the proper target of unit. Management is made easy, simple, uniform and harmonious in this way. It is also an internal control system managing the company, which really unifies the interests of the managers and shareholders.

Limitations of Economic Value Added

Different enterprises have different capital cost, therefore the defect of the economic value added is that it is lack of the capability of comparing the companies with different scales.

Conclusion

Evaluation of the value of the enterprise refers to a comprehensive evaluation on the fair market value of the integral capital taking the enterprise as an organic integrity according to its overall profitability in full consideration of the various factors influencing the profitability of the enterprise. The organic integration of the performance evaluation and value management and the introduction of the managing tools such as the method of comprehensive performance evaluation, balanced score card and economic value added is not only a change of the system of management and evaluation, but also a method to change the administrative concept and the behavior of the enterprise, involving every layer of the management of the enterprise and the adjustment of the interests. Great importance should be attached by the leadership of the enterprise. And strong support should be provided for the evaluation system with the core as value management so that a real shift of the focus and mode of business management can be achieved.

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