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DEFERRED TAX AND ITS IMPACT ON THE MEASUREMENT OF ECONOMIC VALUE ADDED (EVA)

IMPOSTO DIFERIDO E SEU IMPACTO NA MENSURAÇÃO DO VALOR ECONÔMICO AGREGADO (EVA)

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Abstract
Many companies use the concept of Economic Value Added (EVA) as an indicator to evaluate the value generated for their shareholders, implying the need to adjust this metric. This adjustment seeks to convert the book value to economic value, avoiding distortions in the information provided. In the field of Ecuadorian small businesses, this study aims to determine if the deferral of deferred taxes impacts the EVA. The use of quantitative approaches is highlighted, and secondary data was used covering various commercial activities in Ecuador between 2016 and 2019. Adjusted and unadjusted Economic Value Added are compared to analyze the pre- and post-effects of the deferred tax on the relevant variables. The results indicate that the deferred tax can underestimate or overestimate the value of the EVA during the analyzed period. The regression analysis using SPSS reveals the joint relevance of all the predictors of the deferred tax, evidencing its significant impact on the value of the EVA. Consequently, the study suggests that companies make deferred tax adjustments in the calculation of Economic Value Added.

Resumo
Muitas empresas utilizam o conceito de Valor Econômico Adicionado (EVA) como indicador para avaliar o valor gerado para seus acionistas, o que implica a necessidade de ajustar essa métrica. Esse ajuste busca converter o valor contábil em valor econômico, evitando distorções nas informações fornecidas. No âmbito das pequenas empresas equatorianas, este estudo visa determinar se o diferimento de impostos diferidos impacta o EVA. Destaca-se a utilização de abordagens quantitativas, e foram utilizados dados secundários que abrangem diversas atividades comerciais no Equador entre 2016 e 2019. O Valor Econômico Adicionado ajustado e não ajustado é comparado para analisar os efeitos pré e pós do imposto diferido sobre as variáveis relevantes. Os resultados indicam que o imposto diferido pode subestimar ou superestimar o valor do EVA durante o período analisado. A análise de regressão utilizando o SPSS revela a relevância conjunta de todos os preditores do imposto diferido, evidenciando seu impacto significativo sobre o valor do EVA. Consequentemente, o estudo sugere que as empresas façam ajustes de imposto

Keywords: Economic Value Added (EVA). Deferred Tax. Small Businesses. Financial Performance. Ecuador.

Palavras-chave: *Valor Econômico Adicionado (EVA). Imposto Diferido. Pequenas Empresas. Desempenho Financeiro. Equador.*

1 INTRODUCTION

In recent years, there has been growing interest in the concept of value creation, with numerous companies globally focusing on making decisions that generate value for both the company and its shareholders.

Shareholders are recognized as one of the most crucial stakeholders of a company, as their investment in shares constitutes the main source of capital. In this sense, the need for managers to put the interests of shareholders first when making decisions is highlighted, with the purpose of creating value for them (Collier, 2012).

To achieve this, managers must prioritize the interests of shareholders by making decisions beneficial to them, with the ultimate goal of management being to increase investor wealth by aligning management's interests with those of shareholders (Lovata and Costigan, 2002) and (Sharma and Kumar, 2010).

Measuring value is crucial to increasing shareholder value, and many companies use Economic Value Added (EVA) as a tool to assess shareholder value.

In the late 1980s, Bennett Stewart and Joel Stern introduced EVA as a value-based accounting measure (Stewart, 1991). This indicator measures the value created by a company and, therefore, the value generated for shareholders. The EVA score indicates whether a company is generating or destroying value (Latha, 2009).

Ray (2001) points out that corporate conglomerates worldwide have successfully adopted EVA to evaluate their businesses. The EVA formula developed by Stern Stewart and Company is EVA = NOPAT – (TCE * WACC%), with NOPAT being net operating profit after taxes, TCE being Total Capital Employed, WACC% being weighted average cost of capital and COC being Cost of Capital. In terms of the EVA formula, NOPAT represents the return on capital employed, TCE represents the total amount of capital invested in the company (including equity and debt), and COC refers to the cost of invested capital.

The objective is for the company to generate a profit (NOPAT) above its cost of invested capital (COC). A positive EVA (NOPAT > COC) indicates value creation, while a negative EVA (NOPAT < COC) indicates value destruction (Young, 1997).

Calculating EVA involves extracting accounting information from the company's financial statements, but annual reports, prepared in accordance with accounting principles, reflect book values.

Burksaitiene (2009) argues that accounting values are distorted due to the application of generally accepted accounting principles (GAAP). To calculate EVA, the book value must be adjusted to reflect the economic value. For example, annual profits are transformed into net operating profit after tax (NOPAT), and capital is converted into an economic value known as total capital employed (TCE). This process of converting book value to economic value is called adjustment (Burksaitiene, 2009).

It is essential that the economic value is reflected in the EVA indicator, thus justifying its name of Economic Value Added. Stewart (1991) suggests that EVA should also be adjusted to take into account other accounting transactions during the year, such as research and development, operating leases, depreciation, and deferred taxes.

These adjustments are necessary since accounting transactions affect NOPAT and TCE values. Although Sharma and Kumar (2010) argue that companies may find it difficult to understand and apply these adjustments, Young (1997) highlights that some companies choose to keep the number of adjustments at 10 or less to avoid complexities in the EVA system.

Ultimately, it is crucial that managers make decisions that benefit shareholders, thereby creating value (Collier, 2012). This approach is consistent with management's primary objective of increasing shareholder wealth by aligning their interests with those of management (Lovata and Costigan, 2002), a principle supported by Sharma and Kumar (2010).

1.1 Conceptual framework

According to Stewart (2013), Economic Value Added (EVA) can undergo various accounting adjustments, these being the elimination of specific accounting transactions. Transactions such as operating leases, research and development, deferred income taxes,

among others, are excluded due to their distorting effect on EVA. To avoid such distortions, adjustments are made to these items.

The application of an accounting adjustment for the EVA implies the correction of the Net Operating Profit after Taxes (NOPAT) and the Total Capital Employed (TCE). Accounting transactions are removed from the unadjusted NOPAT to obtain the adjusted NOPAT, and similarly, they are removed from the unadjusted TCE to obtain the adjusted TCE.

Applying these adjustments ensures obtaining accurate values for NOPAT and TCE (adjusted NOPAT and adjusted TCE), resulting in an accurate calculation of the EVA (Larrabee & Voss, 2012).

2 BIBLIOGRAPHIC REVIEW

2.1 Non-adjusted and adjusted NOPAT

Various studies have explored the impact of accounting adjustments on the NOPAT, examining variables such as write-downs, restructuring expenses, research and development, impairment losses, mergers and acquisitions, gains and losses on asset disposals, and stock-based compensation costs. . These studies have concluded that accounting transactions tend to distort the NOPAT, resulting in an undervaluation of this indicator.

Marques (2010) presented mixed results, showing that NOPAT was undervalued in 52% of companies and overvalued in 48%.

2.2 Unadjusted and adjusted TCE

Studies examining the impact of operating leases and research and development on TCE revealed consistent results, indicating that unadjusted TCE was lower than adjusted TCE. These findings suggest that such accounting transactions tend to understate TCE.

2.3 Unadjusted NOPAT, adjusted NOPAT and deferred taxes

Some studies point to a growing trend of companies using deferred tax expenses to manage NOPAT. Results indicated that a decrease in deferred tax expenses translated into higher unadjusted NOPAT and lower adjusted NOPAT, suggesting an overstatement of NOPAT. On the other hand, an increase in deferred tax expense resulted in a lower unadjusted NOPAT and a higher adjusted NOPAT, indicating an understatement of NOPAT.

2.4 Unadjusted TCE, adjusted TCE and deferred tax assets/liabilities

Previous studies on the relationship between deferred tax assets and TCE in the banking sector suggested that banks use deferred tax assets to maintain an adequate level of TCE, thereby overstating TCE. Additionally, the reporting of a deferred tax liability resulted in a lower unadjusted TCE and a higher adjusted TCE, indicating a possible understatement of the TCE.

2.5 Empirical evidence on accounting adjustments and EVA

Few studies have addressed the relationship between accounting adjustments and EVA. Anderson, Bey, and Weaver (2005) investigated the impact of various accounting adjustments on EVA, concluding that adjustments such as R&D and LIFO generate significant changes in the value of EVA. However, a lack of homogeneity was observed in the selection of settings, which affected comparability and statistical significance.

To avoid these difficulties, this study focuses on a single adjustment, the deferred tax, which is commonly presented in all companies, exploring its impact on EVA in the Ecuadorian context, an area that has not yet been investigated.

3 RESEARCH METHODOLOGY

3.1 Design of the investigation

3.1.1 Quantitative research study

The research adopted a quantitative approach by calculating unadjusted and adjusted EVA from companies' financial statements. This approach involved numerical data collection and analysis, thus focusing on quantitative analysis. Deferred tax expenses and deferred tax assets/liabilities, as well as unadjusted and adjusted EVA, were collected for each year from 2016 to 2019, making the research longitudinal.

3.1.2 Kind of investigation

The fundamental purpose of the investigation was to determine if the adjustment for deferred taxes generated a significant change in the EVA measure. This objective guided the choice of a causal study to establish relationships between variables. Therefore, statistical analysis was employed to produce correlational statistics that measured the impact of the independent variable on the dependent variable.

3.1.3 Research strategy

An experimental design was chosen to examine the causal relationships between variables and to evaluate whether a change in an independent variable affected the dependent variable. This was achieved through pre- and post-measurements of the dependent variable. The pre-measurement constituted the EVA without adjustment for deferred taxes, while the post-measurement represented the EVA with the application of the deferred tax adjustment. The experimental design included a control variable (unadjusted VAS) and an experimental variable (adjusted VAS).

3.2 Population

The population consisted of small companies incorporated in Ecuadorian territory, registered with deferred taxes according to the resolution issued by the Superintendence of Companies.

3.3 Sampling

A purposive sampling method was implemented to select the financial statements that included the deferred tax.

3.4 Information collection

The financial statements were downloaded from the database provided by the Superintendency of Companies, including the statement of financial position and the income statement. The calculation of the weighted average cost of capital was carried out using data from the financial statements and the market.

3.5 Analysis of data

Data were stored in Excel, where unadjusted EVA, deferred tax adjustment, and adjusted EVA were calculated. The income statements were used to calculate the unadjusted NOPAT and to locate the values of deferred tax expenses necessary to calculate the adjusted NOPAT. The statement of financial position was used to calculate unadjusted TCE and to locate the values of deferred tax liabilities essential to calculating adjusted TCE.

To make the deferred tax adjustments according to Stern Stewart specifications, the following formulas were applied:

- Increases in deferred tax expenses: Added to unadjusted NOPAT.
- Decreases in deferred tax expenses: Subtracted from unadjusted NOPAT.
- Deferred tax liability: added to unadjusted TCE.
- Deferred tax asset: subtracted from unadjusted TCE.

The EVA formulas according to Stern Stewart were:

- Unadjusted EVA = Unadjusted NOPAT - (unadjusted WACC TCE × %)
- Adjusted EVA = Adjusted NOPAT - (Adjusted WACC TCE × %)

Unadjusted EVA represented non-deferred tax EVA, including deferred tax values. It was necessary to eliminate the deferred tax components (deferred tax expense and deferred tax liabilities) from the EVA components (NOPAT and TCE).

3.6 Research hypotheses

The proposed hypotheses were formulated to examine the relationship between the variables. The regression analysis provided indicators of the statistical significance of these relationships, allowing the alternative hypothesis to be accepted or rejected.

- H0 = The adjustment for deferred taxes does not have a significant impact on the EVA measure.
- H1 = The adjustment for deferred taxes has a significant impact on the EVA measure.

3.7 Validity

All disruptive variables, including accounting and non-accounting adjustments, were controlled to ensure that the unadjusted EVA and adjusted EVA models measured as expected, considering all variables that could affect the EVA.

4 EMPIRICAL RESULTS

4.1 Descriptive statistics

Figure 1

Deferred Tax Liability

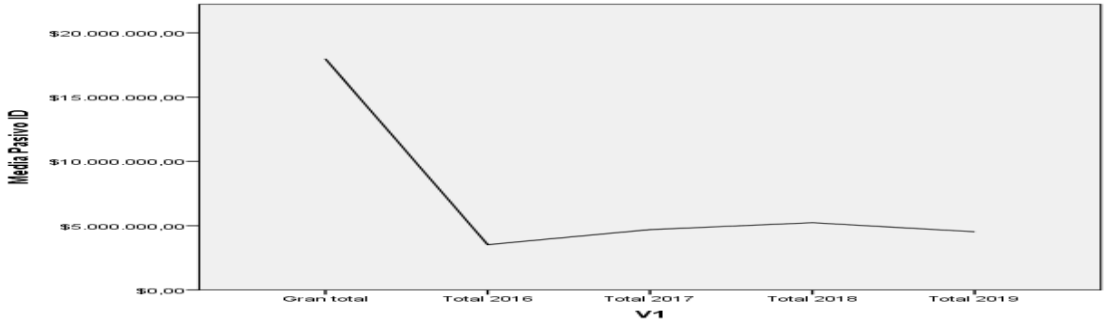


Figure 1 shows the evolution of the deferred tax liability variable throughout each of the years under study. It is highlighted that, in all the years analyzed, the various companies reflect this component in their financial statements. An upward trend has been observed since 2016, with a slight decrease in 2019. In summary, it is inferred that companies, in perspective, must pay taxes to the corresponding entity.

Figure 2

Deferred tax assets

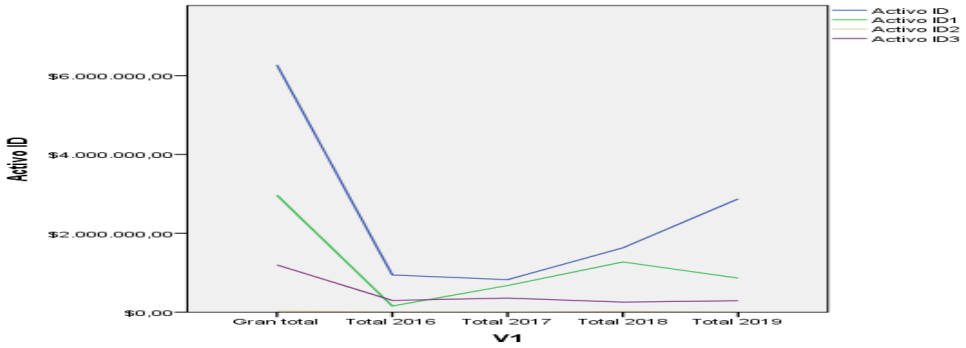
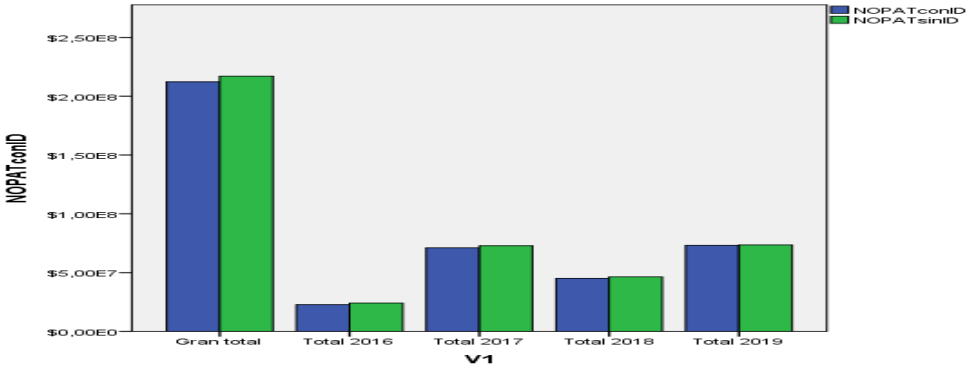


Figure 2 shows the evolution of the deferred tax asset variable during each of the years examined. It is noted that in all years the different companies reflect these aspects in their financial statements. The general trends for these aspects are upward, indicating

that a tax credit is anticipated in their favor in the future. This covers both temporary differences and tax losses subject to amortization in future years, as well as tax credits.

Figure 3

Adjusted and unadjusted NOPAT



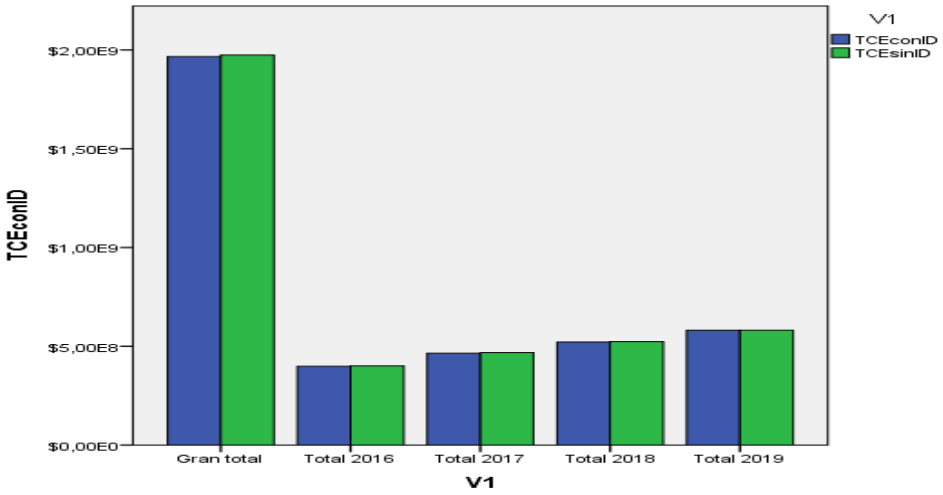
The increase in deferred tax expenses, which represent outstanding taxes, created a disparity between the NOPAT, that is, the unadjusted NOPAT was found to be less than the adjusted NOPAT. As a consequence, the value of NOPAT was underestimated throughout all the years examined.

The results obtained in this research are contrasted with the results of previous studies in the literature. Phillips, Pincus, and Rego (2002) explored the usefulness of deferred tax expenses to identify NOPAT manipulation. The results of their research suggested that an increase in deferred taxes resulted in an underestimation of the value of NOPAT. These results agree with the empirical findings of the present research.

In a study conducted by Noor et al. (2005), the reason behind the growing gap between unadjusted NOPAT and adjusted NOPAT was investigated. The investigation revealed that this growing gap was due to the management of NOPAT through the use of deferred tax expenses. Furthermore, results from previous studies indicated that reductions in deferred tax expenses resulted in an overstatement of NOPAT. Therefore, the findings in the literature by Noor et al. coincide with the empirical evidence presented in this study.

Figure 3

Adjusted and unadjusted TCE



To adjust the deferred tax to the TCE, the deferred tax liabilities are eliminated from the unadjusted item of the TCE, which leads to the adjusted TCE.

The TCE analysis revealed that the unadjusted TCE is lower than the adjusted TCE. This conclusion confirms that the adjustment made resulted in an underestimation of the TCE.

A study conducted by Gee and Mano (2006) noted that managers were using deferred tax assets to manipulate the value of TCE. Their findings indicated that companies were excessively recording deferred tax assets to inflate TCE. They also highlighted that, by declaring deferred tax liabilities, an underestimation of the TCE was generated. Consequently, these results are consistent with the empirical results presented in this study.

In summary, by examining the descriptive statistics, the relationships between deferred taxes and EVA were evaluated. This involved analyzing how EVA components, such as NOPAT and TCE, are related to deferred tax components, including deferred tax expense and deferred tax liabilities. Descriptive results indicated that deferred tax expenses distort NOPAT and that deferred tax liabilities distort TCE. Therefore, in summary, it was concluded that deferred taxes have a distorting effect on EVA.

4.2 Inferential statistics

The inferential results constitute regression statistics, the ANOVA test for overall significance and the individual significance coefficient test for both the unadjusted VAS and the adjusted VAS.

Table 1

Multiple regression model of the unadjusted VAS

Model Summary

model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	1,000a	1,000	1,000	$0.00000

to. Predictors: (Constant), TCEconID, NOPATconID

Referring to Table 1, the unadjusted VAS regression model yielded a perfect positive correlation. of +1. This implies that the independent variables accurately predict the value of the unadjusted VAS.

Table 2

ANOVA test for overall significance

ANOVAa

model	Sum of Squares	df	Mean Square	F	Next.
1 regression	1106616012510611,000	2	553308006255305,500	.	0.000b
Residual	,000	2	,000		
Total	1106616012510611,000	4			

to. Dependent Variable: EVAconID
b. Predictors: (Constant), TCEconID, NOPATconID

Referring to Table 2, the ANOVA (f tests) assessed the overall importance of the independent variable over the dependent variable. The results revealed that all independent variables (unadjusted) had overall importance (p value < 0.05) in predicting the value of the unadjusted EVA variable.

Table 3

ANOVA test of individual significance

Coefficientsa

	Unstandardized Coefficients		Standardized Coefficients	t	Next.
model	b	Std. Error	Beta		

1	(Constant)	4.003E-8	,000		-1,179.	0.243
	NOPATwithID	1,000	,000	4,458	7927466.069	0.000
	TCEwithID	-,113	,000	-4,501	0.608	0.048

to. Dependent Variable: EVAconID

Table 3 shows the test of significance coefficients of individual variables. The results revealed that the unadjusted NOPAT value and the unadjusted TCE value were the most significant variables in predicting the unadjusted VAS value. The reason for the lack of importance.

Comparing the findings of this research with those of the literature, it is observed that Lynn, Seethamraju and Seetharaman (2008) demonstrated that the unadjusted NOPAT value was statistically significant, which is in accordance with these current findings.

Table 4

Multiple regression model of the adjusted VAS

Model Summary

model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	1,000a	1,000	1,000	$0.00000

to. Predictors: (Constant), TCEsinID, NOPATsinID

Referring to Table 4, the model returned a perfect positive correlation value of +1. This implies that the independent variable predicts 100% of the dependent variable.

Table 5

ANOVA test for overall significance

ANOVAa

model		Sum of Squares	df	Mean Square	F	Next.
1	regression	1078419919444107,500	2	539209959722053,750	.	0.000b
	Residual	,000	2	,000		
	Total	1078419919444107,500	4			

to. Dependent Variable: EVAsinID
b. Predictors: (Constant), TCEsinID, NOPATsinID

Referring to Table 5, the ANOVA (f test) showed that all independent variables had overall significance of the dependent variable. The findings revealed that all independent variables had overall significance (p value < 0.05) on the adjusted VAS value.

Table 6

ANOVA test of individual significance

Coefficientsa

model	Unstandardized Coefficients		Standardized Coefficients	t	Next.
	b	Std. Error	Beta		
1					
(Constant)	1,342E-8	,000		.	0.093
NOPATsinID	1,000	,000	4,608	.	0.000
GID Impact on NOPAT	1,000	,000	.078	716624.832	0.000
PID Impact on TCE	–2.384E-08	,000	,000	-0.076	0.940
TCEsinID	-,113	,000	-4,571	.	0.609

to. Dependent Variable: EVAsinID

The results presented in Table 6 indicate that the deferred taxes that affect the unadjusted value of the NOPAT show a significant impact (p value < 0.05) on the value of the adjusted EVA. However, the deferred taxes that affect the TCE (Total Capital Employed) and the unadjusted TCE are not individually significant (p value > 0.05) to predict the value of the dependent variable.

Importantly, previous research by Noor et al. (2007) found that deferred taxes affecting NOPAT were statistically significant, consistent with the results of this study.

In contrast, a study conducted by Gallemore (2012) concluded that the taxes that impacted the TCE were statistically significant. However, this finding differs from the results of this study, possibly because Gallemore reported deferred tax assets, while deferred tax liabilities were recorded in this study.

In this study, four independent variables were evaluated, of which two were found to be statistically significant, while the remaining two were not individually significant. However, in general terms, it has been shown that there is statistical significance between the study variables.

The discrepancies in the empirical results may be attributed to the nature of the previous studies, which focused exclusively on specific components of the VAS, while this study investigated the entire VAS model.

In summary, the current empirical results are partially consistent with the findings of previous literature, suggesting a more complete understanding of the relationship between deferred taxes and EVA.

5 CONCLUSIONS

This study focused on examining the impact of the deferred tax adjustment on the EVA (Economic Value Added) of small businesses in Ecuador. The conclusions are summarized in two key findings, supported by both descriptive statistics and regression analysis. First, it was observed that an increase in deferred tax expenses understates NOPAT (Net Operating Profit after Taxes), while a decrease in these expenses overstates NOPAT. Secondly, it was evident that the deferred tax liability underestimates the TCE (Total Capital Employed).

Regression analysis revealed overall statistical significance of all predictors related to deferred taxes in relation to EVA. This finding led to the rejection of the null hypothesis, supporting the idea that deferred taxes have a substantial impact on EVA, affecting its value in a distorted manner.

Consequently, the implementation of the deferred tax adjustment was proposed as a measure to counteract these distorting effects. The importance of considering cash flow aspects was emphasized, as EVA reflects actual cash flows, as opposed to deferred taxes. This consideration provides additional justification for the application of such an adjustment.

The overall conclusion of the study suggests that the implementation of the deferred tax adjustment would improve the accuracy of the EVA, benefiting both management and shareholders. Improved precision would allow shareholders to more accurately know the wealth generated by their stock investment, while managers could make more informed decisions, positively impacting shareholder wealth.

Therefore, it is strongly recommended that companies consider implementing the deferred tax adjustment. This study represents a significant milestone in providing empirical evidence measuring the impact of deferred taxes on EVA. The results presented constitute historical data that may be valuable to future researchers and practitioners who wish to examine the relationship between deferred taxes and EVA.

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Authors' Contribution

Both authors contributed equally to the development of this article.

Data availability

All datasets relevant to this study's findings are fully available within the article.

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