International Journal of Economics, Commerce and Management
United Kingdom Vol. III, Issue 2, Feb 2015
http://ijecm.co.uk/ ISSN 2348 0386

IMPLICATIONS AND APPLICATION OF ECONOMIC VALUE ADDED IN BANKING SECTOR IN ALBANIA

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Abstract

This paper aims to create a framework about the way how can be Economic Value Added estimated in Albanian Banking System context. The purpose is analyzing the EVA philosophy with the restrictions met during its implementation. In this way identifying the problems that traditional measures have with the intention of presenting the opportunities that EVA has against them. So main questions that drive this study consist on: Which are the traditional measures based on accounting data and the economic measures for bank performance evaluation? What is Economic Value Added and the implications of using EVA in developing countries, especially in Albanian banking sector? At the end of the evaluation process it is presented that to have a better understanding of the financial strength of the banks we can not rely only on financial ratios. For most of the banks even when they reported profits, their economic value added was negative. This may lead to another point of view of bank financial performance evaluation in two directions from shareholders as it is usually used but also in bank supervision context. So the theories adopted in this paper and EVA calculations can serve in a future research in evaluating the efficiency of commercial banks.

Keywords: Financial Performance, Financial Ratios, Economic Value Added, Weighted Average Cost of Capital, Albanian Banking System

INTRODUCTION

The role of managers in any kind of company is wealth creation and maximization through the adequate allocation of resources. To fulfill this function, managers use different indicators, known as traditional measures like financial ratios. Then these ratios are used in different perspectives, from shareholder's point of view, from other parties interested in evaluation of the financial position of the company etc. In case of banks, according to different studies neither any of the financial ratios can serve as the best estimator for their financial strength. According to Lee (1996), the challenge for empiric modern finance is the identification of a new, more advantageous measure than the financial ratios.

The value of a bank, represent the sound and the financial position in long run. So the value and value based management represent a very important process which is based on economic value, used widely from academics and practitioners.

For bank financial evaluation purposes, we must consider two aspects: first, must be considered the methods used for financial evaluation, and second, their adaption according to the features of the banking system to be evaluated. The most important dimensions of financial evaluation with respect to banks, are profitability and risk. So these dimensions, must be reflected in the evaluation measure to be used.

Stern and Stewart, represented for the first time in 1990, a new measure, registered then as a trademark, and called Economic Value Added. An effort at that time was the Fortune which considered EVA as "the financial idea of these days"(1993). While Drucker (1998) in Harvard Business Review, stated that the increased popularity of this measure, reflects the demands of information era for a total productivity factor. Since then, this measure is used in two aspects: for shareholder value creation and for bonuses policy.

Implications of Economic Value Added

EVA concept, develops further the concept of residual income which is a standard measure of the efficiency of earnings while EVA measures the financial health of the bank in respect of shareholders perspective. It expresses the net operating profit after taxes adjusted with a charge for capital and debt. This description refers to the general statement of EVA, since relating to financial services companies especially banks, there must be some specific elements to be discussed. Since estimating EVA we use the net operating profit from income statement and capital from the balance sheet reflecting the cost of that capital it must be a better measure of the change of the overall return to shareholders than traditional measures based only on accounting data such as ROE.

So in general we can state that EVA must direct better managers through value based decision making, ensuring in this way a more stable environment inside the company.

As we know, a company increases it shareholder`s value if required return is higher than the cost of equity used to achieve that return. So in this context, EVA represents the difference between the required return minus the cost of capital.

The basic form, suggested from Stern & Stewart, for estimating EVA is the equation above:

EVA= NOPAT– CAP * WACC (1)

Where,

NOPAT-net operating profit after taxes

CAP-capital invested

WACC-weighted average cost of capital

If we want to adapt this measure in respect of banks, we have to consider some different aspects:

First, from the basic model proposed for non-financial service companies, NOPAT have to be adjusted to reflect the economic profit of the period. There are identified almost 160 different adjustments that arise from accounting principles applied according to Stern & Stewart, but companies adopt the most 10 important (Drury, 2006).

These adjustments are important in order to achieve a better correlation between EVA and the stock price (Young, 1999).

Accounting profit is not a measure of value creation and as a result they cannot be used for performance evaluation and even more in compensation plans for managers.

Adjustments made to NOPAT bring it close to cash flows unaffected from accounting principles, from classifying assets as tangibles and untangibles, from accounting treatment of goodwill, from the off-balance sheet debt, etc (Young 1999).

The number of adjustments made reach 15 ones but recently their number is less relating to their insignificant effect on the result (Young, 1999).

The accounting adjustments must be grouped in two categories: capital adjustments and profit adjustments. In these two categories, mostly we refer to adjustments made for result recognition, research and development, deferred taxes, amortization, depreciation, provisions, structural changes and macroeconomic conditions (Rennie, 1997).

Fiordelisi and Moulynex (2009), represented the most common adjustments made to NOPAT and to CAP, some of them are presented below:

NOPAT= profit before taxes (1-tax)

+ expenses for research and development
+ expenses for personal training
+ expenses for rent
+ provisions for loan loss
+ (provisions for taxes- cash tax paid)
+ other net provisions for other risks inherent

CAPITAL = Accounting value of shareholders capital

+ capitalized expenses for research and development
+ capitalized expenses for personnel training
- amortization expenses for research and development
- amortization expenses for personnel training
+ present value of future rent
- rent amortisation
+ net reserves for loans
+ deferred credit taxes
- defers debit taxes

These adjustments reflect the real value of economic profit and the capital used and as a consequence, their usage result in an adjusted EVA, while if they are not considered the result is the basic EVA.

What offers EVA more than traditional measures?

First of all, when we have to consider the features of banking activities when we want to use EVA. While a bank requires capital to fulfill the objectives for growth, in the same time to fulfill the regulatory requirements, it should respond to market requirements on base which reflects the risk for ensuring the financial capital for shareholders, and human capital from the final stakeholders.

The growth strategies and the target fields should reflect all possible risks. Strategies like “good profitability/low risk” have a high probability to default in short run. Target objectives for growth should include not only volume targets but they should be build in a way where there are reflected all the dimensions of potential risks.

EVA can serve as a very important tool in evaluating the financial performance from banker's perspective and for improving it. Since EVA considers the shareholders interest, its use can lead to different decision making from managers comparing the case when the traditional measures are used.

The banking activities differ essentially with the activities of other enterprises. We can mention the debt first of all. For other forms of enterprises debt serve as a financial source and interest expense is not included in the NOPAT so this figure does not reflect the risk when it is used in return estimations according to capital, assets or invested capital.

The term "debt" does not mean the same thing for banks, as it is the "raw material" which is intermediated in assets with high return. In analogy, the interest expenses are not just expenses but they are considered the same as "the cost of products sold".

The capital of a bank include the shareholders equity plus the reserves excluded from capital like the reserves for loan losses which in economic terms function like capital. For capital calculation purposes also the long term debt is included.

The traditional measures of financial performance like ROE, ROA are based on accounting data. The most important limitation concerns the accounting profit they use. For asset measures are used historic accounting data, while the measures of income statement are expressed with their present value. That's the reason why accounting return rates does not reflect the real rate of return from an investment. Its tendency is to overvalue the rate for the first ten years and then undervalue it. One of the reasons refer to the linear amortization method used from fixed assets (Malkelainen 1998).

So the accounting measures of performance are doubtful, as they are based on the asset structure which refers to the actualization of asset values. If there is a continuous flow of assets there must be no problem but in bank context assets are too old or too new. In these terms is difficult to determine the real performance of banks.

Traditional measures mentioned at the beginning of this section does not consider the cost of equity capital. They consider only the interest paid for debt, reflected in the operating profit.

On the other hand, traditional measures can lead managers to invest in activities that increase the actual return, leaving out those that have higher return compared to the cost of capital. Selecting investments with return higher than the actual return does not mean that the shareholders wealth can be increased. So do traditional accounting measures like ROA, ROE etc. Using for a long period of time only these measures it is possible that managers select for investing in activities like those mentioned above that decrease the rate of return below the rate required from shareholders.

Economic value added supporters, mainly for the reasons mentioned above, state that the traditional measures cannot be used as wealth creation concept.

Value creation and profitability ore two objectives quite different since, short run performance (profitability) can be improved without considering the long run stability of the bank. Decisions taken for increase profits purposes can be short run in nature, while value creation is focused in long run well being of banks.

Against all the restrictions mentioned above, EVA stays above them. The net operating profit can be adjusted; the capital considered can be selected according to specific features of different industries; it includes the cost of capital, measuring in this way the net economic balance.

In general it is impossible to implement EVA in its full model since it is difficult to calculate the cost of capital in all economies. Market returns can not be used as representatives of the rate of return required from shareholders, as market tent to under evaluate the results or over evaluate them.

Even if is used the CAPM, there are some other restrictions such as determining the risk free rate or the market premium. This difficulty arises even more in countries that do not have capital markets or they are not liquid. Empiric studies have shown that the interest rates and volatility in capital markets are higher in developing countries than in developed countries. As a result, application of EVA can be more appropriate in developed countries because of these restrictions.

Application of EVA in banking sector in Albania

Albanian financial system consists on banks, non-bank financial institutions, insurance companies, pension and investment funds. About 89% (Bank of Albania, 2014) of the financial system is represented from banks, 16 banks, and the rest from other financial operators. It is apparent the importance of the banking sector considering that it is the main financing source for economic operators. Recently there are realized some studies in respect of banking sector for profitability measurement, competiveness, efficiency, etc. Albania since is a developing country meets some restrictions mentioned when implementing the EVA concept.

First, the capital market known as TSE (since it was opened in 2002), has never functioned so it was recently closed in December 2014. So even all the banks that operate in Albania are listed, there were no activity that allows to evaluate the market prices for their shares, or the measures based on them.

In order to measure the economic value added I am focused in only five of 16 banks which the headquarters are listed on their original capital market places. This selection is based

on the argument that the banks should have the same primary activity, the headquarters are listed all in their respective countries of origin.

The banks selected for this analysis are: Raiffesen Bank, Alpha Bank AE, Intesa San Paolo, Societe General, Credit Agricol. For each of the banks the analysis was focused on a period of eight years, with the intention of evaluating the trend and realizing a comparison between them. So let's begin with the calculations of the components of economic value added:

-***Net operating profit after taxes*** (NOPAT)

According to Valez-Pareja (2000), the equation for EVA was adapted in the form below:

$EVA_{t-1,it} = NOPAT_{ti} – CAP_{t-1,i} * WACC_{t-1,it} = NOPAT\ i_t – CAPi_{,t-1} * WACC_{t-1,it}$(2)

This implies that the economic value added for the bank i, it is used the NOPAT of year t, with the Capital of the year t-1. The authors of this adjustment argument that the NOPAT of the current year is realized using the beginning balance of capital of this year.

For NOPAT accounting adjustment, were used the data from the annual reports of each of banks. It was impossible to find the information needed to adjust NOPAT is recommended from Fioderlisi and Moulynex (2009), in the same time for all the banks for all the periods. So in order to have the same data for the same period I considered the free adjustment NOPAT. These data are presented in the table below:

Table 1- Net operating profit after taxes for shareholders (in 000 ALL)

Bankat	2006**	2007**	2008	2009	2010	2011	2012	2013*
RBAL	*3,593,209*	*4,442,784*	*5,035,204*	4,680,568	5,344,032	7,069,320	5,202,653	4,422,403
ABAL	902,342	*1,198,464*	*1,291,292*	894,170	*(187,501)*	*(944,283)*	*(637,981)*	136,057
CAAL	118,528.55	*(12,089)*	*110,952*	*(218,713)*	127,012	*(824,991)*	*(693,670)*	*(338,796)*
SGAL	*61,265*	*26,838*	51,065	*(557,235)*	*(55,722)*	214,007	475,242	457,412
ISPAL	947,014.60	*1,035,576*	*1,876,908*	1,974,995	1,698,090	1,838,869	2,356,013	1,092,352

Source: Annual Reports of Banks

*(*- data publicated in websites from CEO, unaudited)*

***- data publicated from Albanian Association of Banks)*

As may be seen above RBAL, is the most stable bank if we refer to the absolute values of profit while the worst is CAAL. So for this last one we don't expect to have a positive economic value added since it reflects a loss in 2007, 2009, and from 2011-2013.

-Capital

Another important component is capital. In case of financial companies, such as banks the capital includes shareholders equity, all kinds of reserves and the capitalized financial result. So

I referred again to accounting data since additional information is not publicly available for adjustment purposes. If we refer to non-financial companies for the term capital there are other components to consider, but in case of banks we exclude deposits since they represent a productive input and not a financial source (Fiordelisi, Moulynex,2009).

Furthermore the cost of interest bearing liabilities are included as an expense in the income statement, that's the reason why they should be included again in the cost of capital.

Table 2-The capital (in 000 ALL)

Banka	1.1.2006	1.1.2007	1.1.2008	1.1.2009	1.1.2010	1.1.2011	1.1.2012	1.1.2013
RBAL	4,348,233	10,492,763	14,896,746	19,724,519	24,449,415	27,584,687	29,394,430	30,668,493
ABAL	2,832,544	4,268,654	5,583,264	6,988,421	7,882,591	7,695,000	9,545,607	5,032,737
CAAL	1,288,512	1,643,107	2,149,720	3,840,125	4,074,951	4,201,964	4,075,975	4,840,766
SGAL	1,086,318	1,547,986	3,135,878	3,381,102	4,340,314	5,176,042	6,095,049	7,265,291
ISPAL	3,965,481	4,532,654	5,378,944	9,028,194	10,990,958	12,712,506	14,559,079	16,907,160

Source: Annual Reports 2008-2013, Albanian Association of Banks 2005-2007

-Weighted Cost of Capital (WACC)

The third important component refers to cost of capital. Since we do not include deposits and other liabilities in the capital so do we when refer to the cost of capital. So the basic form of calculating the WACC is adapted for banks in the way that WACC is equivalent to the Re.

According to financial theory there are different approaches to evaluate Re. Some of them use the expected dividend and the market price of shares. In our case banks are branch of foreign banks, so Bank of Albania prohibited them to deliver dividends based on the argument for not transferring the capital abroad. Also the market price of the shares is omitted since there was at that time an illiquid capital market. So this approach is not applicable. Another way is using the cash flow actualization, but the restrictions mentioned above are the same in this case.

Another approach is CAPM proposed by Traynor (1961), Sharpe (1964) and Litner (1965). Its form is presented below:

$R_e = Rf + \beta (Rm – Rf)$ (3)

where,

Rf = risk free rate,

Rm = market return,

β = beta coefficient

Even why this approach has some limitations, it offers in our case the best approximation of the required rate of return for shareholders. First, this approach requires to choose the risk free rate between the rates of treasury bills or those of government bonds. As there is no real risk free rate in some studies the treasury bills interest rate is used and in some others the long run government bonds interest rate. The last one usually is more stable in the long run (Damodaran, 1998). As the treasury bills are more liquid than treasury bonds, they are evaluated frequently during the year so in this manner reflecting better the concept of risk free rate. Actually, in this study is used the treasury bill interest rate. So I used the treasury bill interest rate from 2006-2013 with maturity of twelve months as a simple average among all auctions realized for this maturity in each of these years. From the table below it is evident that the rates at the of the respective years do not differ from the average except in 2013 where they decreased in 3.84%. Since EVA requires the cost to be evaluated when the NOPAT is finally estimated I used the end year interest rate.

Table 3- Treasury bills interest rate with a maturity of 12 months

Vitet	2006	2007	2008	2009	2010	2011	2012	2013
Mesatare vjetore	7.37%	8.13%	8.49%	8.95%	7.95%	6.90%	6.80%	5.20%
Norma me 31.12	7.47%	8.26%	8.56%	9.16%	7.09%	6.95%	6.37%	3.66%

Source: Bank of Albania, adopted time series

Second, the formula (3), requires to determine the beta coefficient and the market premium. Since there was an illiquid capital market, there were no market prices for shares of the banks. I choose these banks as representatives of the banking system in Albania, since they are all branches of commercial banks with foreign capital. Each of the parent banks, are listed in a common market in Europe, so I used the Euro Stoxx 50® Index, which is a leader in Eurozone and covers 50 companies from twelve countries of Europe, respectively: Austria, Belgium, Netherland, France, Finland, Germany, Greece, Ireland, Italy, Luxemburg, Portugal and Spain.

For beta estimation purposes I referred to day to day closed prices for shares of each of the banks, calculating the daily return. This action was done also for the index.

Since beta reflects the risk inherent in a share comparing to the market, in this case the index, I build a relation between them, considering as an independent variable (x) the daily return of the index and as a dependent variable (y) the daily return of the respective shares, as below:

$R_{sj} = a_j + b_j R_i$ (4)

Where,

R_{i-} is the daily return of the index,

R_{sj}- is the daily return of shares of bank j

b_j- is the beta coefficient of shares of bank j

a_j- intercept

In this way I estimated the regressive beta which has some limitations, so according to finance theory to bring that more close to reality, it must be adjusted with the standard procedure of Bloomberg. This is necessary due to the limitations of this study, for the index choice, for the period and the time interval of return calculations.

The standard procedure may be expressed as below:

Adjusted Beta = β_j (0.67) + β_M (0.33)= β_j (0.67) + 0.33, where $\beta_M = 1$ (5)

So in this context, the regressive betas and the adjusted betas result as below:

Table 4- Historic beta coefficient evaluation for bank shares in Albania

BANKAT	2006	2007	2008	2009	2010	2011	2012	2013
Raiffeisen Bank	-0.34	-0.11	1.03	1.44	1.44	1.34	1.46	0.85
Alpha Bank	0.78	0.77	0.8	0.7	0.78	0.71	0.41	-0.01
Intesa San Paolo	0.08	0.09	1.07	1.58	1.60	1.85	2.04	1.25
Credit Agricole	1.58	1.66	1.62	1.67	1.72	1.96	1.98	1.26
Societe Generale Bank	0.06	0.28	0.98	1.71	1.80	2.11	2.01	1.50
Beta mesatare vjetore	0.43	0.54	1.10	1.42	1.47	1.60	1.58	0.97
Beta e rregulluar	0.62	0.69	1.07	1.28	1.32	1.40	1.39	0.98

Source: Own calculations

So I estimated the betas for each bank in a respective year and then calculated their average, which was adjusted giving the final row betas. The adjusted beta of a year will be used in CAPM to evaluate the cost of equity capital in that year.

This objective can not be fulfilled without the market premium. Since we do not have a market return, let's consider which are the arguments, relating to it in non capital market countries.

Erb, Harvey and Viskanta (1996) supportsthe idea that the market premium can be estimated if we refer to the ability of a country to default in repaying the debt. These evaluations are realized from rating agencies. The authors referred to Euromoney, which used a rating

grade from 0-100, where the low score stand for non ability to repay the obligations and vice versa. The authors referred to a linear relationship between this ability or non ability as an independent variable to the required return from an investment in a certain country. Their study was based on 88 developed countries, and extended in other developing countries especially in those countries which do not have or have illiquid capital markets, where was included Albania. The market premium was expresses in a semiannual basis in US dollars since Euromoney offered their rating twice a year.

Damodaran (1998) proposed another way to estimate the market premium, especially the premium for risk in capital market for a certain country. He estimates the market premium of a mature and stable market adding than a risk premium for the country risk.

For the stable and mature market premium he considered the S&P 500 Index, and for country risk he used the ratings offered by Moody's for the country's currency. This is the way Damodaran evaluated the market premium in capital markets.

In our case, I followed another way to choose which market premium to consider. Some of the banks that operate in Albania have their parent bank in Greece so any shareholder wherever he may be, must require the minimal market premium of the worst country of origin of the banks. In this case the worst market premium will be the market premium of Greece.

That's the reason why I referred to a study of Fernandez, Aguirreamalloa dhe Corres (2010, 2011, 2012, 2013) which intention was identifying the market premiums used from academics, researchers and practitioners and from rating agencies for 82 countries in the world. In this study is included the market premium for Greece from 2009-2013. For 2006 I used a study of Damodaran for a Greek company while for 2008-2009 I used the average for the Eurozone. Even that the last figures do not refer to the same source, the differences are not identified. Now it is possible to evaluate the required return from shareholders point of view using the data and calculations above.

Table 5- The shareholders required rate of return according to CAPM

	2006	2007	2008	2009	2010	2011	2012	2013
Rf	7.47%	8.26%	8.56%	9.14%	7.09%	6.95%	6.37%	3.66%
Adjusted Beta	0.62	0.69	1.07	1.28	1.32	1.40	1.39	0.98
Market Premium	5.96%	5%	5.10%	5.70%	5.70%	7.40%	9.60%	7.31%
R e	11.17%	11.71%	14.02%	16.44%	14.61%	17.31%	19.71%	10.82%

Source: Own calculations

It is evident from the results above that the required rate of return reached the highest value in 2012 while in 2013 it was the lowest during the period chosen. Referring to 2013 this may be that the market and the entire financial system seems to be more stable in shareholders eyes. The lowest interest rate is a result of the lowest treasury bills interest rate, due to the decisions taken from Bank of Albania to decrease the basic interest rate.

After calculating the last component of EVA equation, now it is possible to measure the value added of the chosen banks.

Table 6- Economic value added for five Albanian banks

Bankat	2006	2007	2008	2009	2010	2011	2012	2013
RB-AL	3,107,511.37	3,214,081	2,931,783	1,437,857.1	1,771,972	2,294,411	-590,989	1,104,072
AB-AL	585,946.84	698,604.60	502,935.10	-254,726.4	-1,339,148	-2,276,288	-2,519,420	-408,485
CA-AL	25,398.24	-204,497.00	-192,588.00	-850,029.6	-468,338	-1,552,351	-1,497,045	-862,567
SG-AL	-60,076.72	-154,431.00	-391,721.00	-1,113,088	-689,842	-681,966	-726,092	-328,692
ISP-AL	504,070.37	504,802.20	1,117,401	490,759.91	92,311.04	-361,666	-513,581	-737,003

Source: Own calculations

What is expected and what not in these results? Banks such as CA-AL or AB-AL or SG-AL which reported loss is some years are expected to not have added value. In fact AB-AL has reported losses in 2010-2012, but its EVA it is worsen in 2011 and reached its peak in 2012. Also it has a negative EVA in 2013 even if it has reported gains. For CA-AL it is not surprising that the bank consumed the value, because of its continuous losses.

It is of interest to emphasize the value added for SG-AL as it reported losses only in 2009-2010 but during the period of study it has not added value neither of the years. On the other hand we have RB-AL and ISP-AL that has never reported losses but the first experienced some negative EVA in 2012 while the second for the three last years.

CONCLUSION

Financial ratios for measuring the financial strength of bank performance are not enough considering the wide range of products and services banks offer. So financial ratios such as ROE, ROA etc. used in different contexts are based on accounting data. They are followed with lots of limitations especially when there are still in developing progress the accounting standards applied to a certain country. At the beginning of `90 the Stern and Stewart Consulting Group, proposed a new metric called Economic Value Added.

In this paper I tried to apply this metric in five banks in Albania. There are certain difficulties met to evaluate EVA in Albania first, since it is impossible to adjust NOPAT and CAPITAL in the way that literature propose.

Second, for evaluating the WACC, in absence of capital market, I referred to five banks which parent banks are listed in EuroStoxx 50 for estimating EVA. For market risk premium I chose the worst case that of Greece. So finally, I estimated EVA for the banks and the results were different from those calculated if the financial ratios would be used.

For a future research, the EVA evaluation results can be used for a detailed efficiency evaluation of the banks.

RECOMMENDATIONS

Considering the results from the EVA evaluation, there is not any observed difference between the banks. It was expected that from CAAL and ABAL to have a negative EVA since they operated at loss. While the results of ISPAL and RBAL are quite surprising. They both declared profits for the entire period in analysis, but their cost of capital was higher compared to the return on equity, so the banks destroyed value in some years. So in this way we can conclude with some recommendations:

- it is very important to use risk adjusted metrics such as Economic Value Added to evaluate the performance of banks in respect to value added.
- the required return from shareholders point of view is highly effected from the treasury bills interest rate so this must be reflected in the interest of financial products.
- the financial performance evaluation must not be relied only in financial ratios since they are based only on accounting data and do not reflect the risk.
- RBAL and ISPAL represent the largest banks so the managers and supervisory authorities must concern about their negative EVA in order to prevent any undesirable event.

LIMITATIONS OF THE STUDY

This paper is an attempt to evaluate the Economic Value Added for Albanian commercial banks. This evaluation was restricted to five of sixteen banks that operate in Albania. So for further research this evaluation must be applied to all the banks and the results may be used as a variable to productivity evaluation of commercial banks.

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