Economic Profit as Indicator of Food Retailing Enterprises' Performance

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 Abstract:

Saturation of developed markets opens opportunities for food retailers to enter emerging markets. Due to this, there is active expansion of the largest network retailers of international level in emerging markets. Like in many emerging markets, modern formats of trade have been developed in Russia, such as supermarkets and hypermarkets.

The major purpose of this article is to substantiate the practical value of the EVA concept in assessing the performance of food retailing enterprises. Quantitative methods of analysis of industry sectors and enterprises are applied to identify the trends in development of the Russian FMCG (Fast-moving consumer goods) retail market.

Scientific value of the work lies in the development of the method for assessing the economic EVA profit, which was applied in practical assessment of performance of food retailing enterprises. The results obtained during the study revealed that only three of the five companies under study use the owners' invested funds efficiently. The other two large FMCG retailers use investment capital inefficiently, which has led to a drop in the market value of the enterprises.

Practice of international companies that apply such an indicator as EVA to assess their performance indicates the expediency of its calculation in the assessment of the investment of network retailers in expanding the commodity-producing infrastructure in emerging markets.

Keywords: Economic profit, economic value added, EVA concept, food retailing, FMCG market.

JEL Classification: L10, L19.

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1. Introduction

The Russian economy has been recessing since early 2015, and it was still under intense pressure in 2016 due to many local and international problems, including economic sanctions, low oil prices, and a drop in GDP. Consumer demand is shrinking, Russians are moving to a more restrained consumer model. In real terms, consumer spending in Russia decreased by 17% over the last two years, while household income decreased by 11% over three years. The growing influence of the price factor on the choice of goods can be observed: demand for more affordable products has increased, striving to stretch the already tight household budgets as much as possible.

Due to the increasing negative trends in the Russian economy, reducing investment and shrinking consumer demand over the past three years, the Russian retail market demonstrates a slowdown in growth. While food inflation fell to 5%, growth in retail food sales slowed down to zero by late 2016 (Dudin *et al.,* 2014; 2017; Lyasnikov *et al.,* 2017).

The Fast-moving consumer goods (FMCG) retail market is traditionally more resistant to such negative influences because food products are treated as essential goods, but the protracted negative trend and the changes in the model of consumer behavior of Russians caused by it all led to a slowdown in the performance of the FMCG market players in general (Research agency M.A. Research, 2016). It must be noted that retail chains have been and remain the driver of retail trade development, and their revenue is growing faster than the retail trade turnover in general. This trend is typical for most segments of food retail. Despite the negative trends, retail FMCG chains retain their positions, generating about 30% of the retail trade turnover in the Russian Federation. According to the study by M.A. Research, the share of FMCG chains in the retail trade turnover in the Russian Federation amounted to 25.8% in 2015 and to 28% in 2016 (Sfera, 2017).

The Russian retail food market is fragmented, especially in the international context. However, when providing good opportunities for growth, it remains attractive to federal players. The growth rate of the FMCG retail chain turnover slowed down but remained high (+21% in 2016, roughly estimated, against 32% in 2015). At the same time, the negative impact of macroeconomic factors affects business performance of food retailing enterprises. An increasing number of food retailing enterprises opt for the concept of maximizing returns on invested capital in developed markets. This implies introduction of modern approaches to management, and, accordingly, new performance criteria that take creation of value added into consideration. When only traditional indicators are used to describe a company, such as revenue or accounting profit, it does not give insight into the actual business results and often leads to improper business decisions (Reshetov, 2008; Rupeika-Apoga and Solovjova, 2017).

Results of various studies confirm that for successful operation in the retail FMCG market, companies should not confine themselves to analyzing only their internal documentation and achieve prevalence of actual revenues over expenditures. On the contrary, it must take the market situation into account, which generates lost profits in the form of alternative costs of using the capital invested in it (Sitnik, 2008).

Due to significant changes in the external business environment, more powerful and complex financial and non-financial indicators are needed to assess the performance of the organization. Economic profit is one of the indicators of the company economic value. It must be noted that, unlike accounting profit that reflects the efficiency of the current business model of the company, economic profit shows how efficiently the enterprise uses available assets (Nedaa *et al.,* 2012).

Economic profit reflects an integrated approach to assessing the enterprise performance, and thus serves as valuable information for an investor when they plan their further actions and make decisions about investing funds (Reshetov, 2012). One of the central problems of practical application of this indicator in assessing the performance of food retailing enterprises is the insufficiently developed methodological basis for calculating economic profit. The purpose of this article is to substantiate the expediency of assessing the performance of food retailing enterprises based on the EVA indicator of economic profit. The following tasks have been solved in this work to achieve this purpose:

1) Give theoretical justification for economic profit and provide the methodology for calculating EVA as the key indicator of the company's financial performance;
2) Describe the market of the chain FMCG retail and assess the economic performance of the largest food retail chains in Russia;
3) Calculate the indicator of EVA and build a rating of the companies under study using the EVA criterion.

2. Methodology

The best-known method of estimating economic profit is the Economic Value-Added indicator (EVA™), developed by the consulting company Stern & Stuart (Stern *et al.,* 2001). The economic essence of EVA is that the enterprise should not only ensure break-even operation, including the return on investment, but also generate value added (the school of classics calls it the additional cost) (Thilakerathne, 2015).

EVA indicator is an indicator of the company's true financial performance, as well as the strategy to create corporate and joint-stock capital (Sofrankova *et al.,* 2017; Anikina *et al.,* 2016; Cipovová and Dlaskova, 2016). EVA is an indicator of economic profit that exceeds investors' expectations and serves to directly compare companies with the same risk profile. The EVA® calculation method was adopted by such companies as Coca Cola, DuPont, Eli Lilly, Polaroid, Pharmacia (formerly

Monsanto), Whirlpool, etc. Methods of reading financial statements (retrospective, in-depth, trend and comparative analyzes), as well as the method of financial ratios are used to calculate the EVA indicator.

EVA® can be defined as the net operating profit after tax (NOPAT) less the cost of capital. Calculation of economic profit indicators is based on information on the company performance, which is contained in the company's financial statements. EVA calculation stages are the followings:

1. Calculation of net operating profit after tax (NOPAT). Net operating profit after tax (NOPAT) represents the company's potential monetary income if its capitalization was unclaimed – i.e. if it had no debt. It is calculated using the following formula:
NOPAT = operating income x (1 – tax rate).
2. Calculation of the company's invested capital (IC). The invested capital (IC) is the total amount of liabilities, net of interest obligations, which is defined using the following formula:
IC= Dtl + Ei + LD + SD,
where
Dtl is deferred tax liabilities;
E is equity;
LD is long-term debt;
SD is short-term debt.
3. Determination of the weighted average cost of capital (WACC):
    To calculate the WACC, the cost of each capital component must be multiplied by its proportional weight and the results must be summarized.
    The calculation method can be expressed in the following formula (Duff & Phelps, 2016):

$$WACC = \frac{E}{V} * Re + \frac{D}{V} * Rd * (1 - Tc),$$

where:
Re is equity value;

$\frac{E}{V}$ is share of joint-stock capital in financing sources;

Rd is debt value;

$\frac{D}{V}$ is share of debt capital in financing sources;

Tc is profit tax rate.

The CAPM model is used to calculate the equity value (Re), expressed by the following formula (Damodaran, 2015):
Re = Rf + β(Rm — Rf),

Where: Rf is a risk-free rate of return. The risk-free rate is understood as the average monthly yield of the 3-5-year government bonds index (RUGBITR5Y).

β is a ratio that determines the change in the price of the company's stock compared to the change in the stock prices for all companies in this market segment. The source of information about the β ratio value is the financial analytics service Conom (https://www.conomy.ru/retail-rk-vert) and the brokerage information sites Finanz.ru, Investing (Ru.tradingview.com) and others.

(Rm — Rf) is premium for market risk.

Rm is average market rates of return on the stock market.

The information base for calculating the value of debt capital is the accounting statements of companies, where the amount and average interest rate on loans and borrowings are reflected.

4. Calculation of the company's EVA

The formula to calculate EVA® is as follows:

EVA = NOPAT – IC*WACC,

where EVA is economic value added;

NOPAT is net operating profit after tax;

IC is invested capital;

WACC is weighted average cost of capital.

The accounting and financial reporting data of the five largest FMCG networks in Russia were used in this study: X5 Retail Group, Magnit, Dixy, Lenta, O'Key.

3. Results

3.1 State of the Retail FMCG Market and Indicators of Development of the Largest Food Retail Chains in Russia

The Russian economy has been in recession since early 2015 until now and remains under strong pressure. The retail market largely depends on the consumer purchasing power (Klein and Schmitz, 2017). After the macroeconomic events of 2014, the sharp weakening of the ruble and introduction of the food embargo, the situation in the industry significantly deteriorated. Retail trade turnover shrinks both in food and non-food segments.

According to Rosstat, retail trade turnover in 2016 amounted to 28,317.3 bln rub. and decreased by 4.6% in commodity weights by 2015 (there was a decrease of 10% in 2015). The share of food products in the structure of retail trade turnover did not change in 2016 relative to 2015. Turnover of retail trade in food products in 2016 decreased by 5%, and, in monetary terms, food products RT increased by 2.4% relative to 2015. Changes in retail turnover of food products in Russia are shown in Figure 1.

Figure 1. *Changes in retail trade turnover of food products in Russia in 2012-2016*
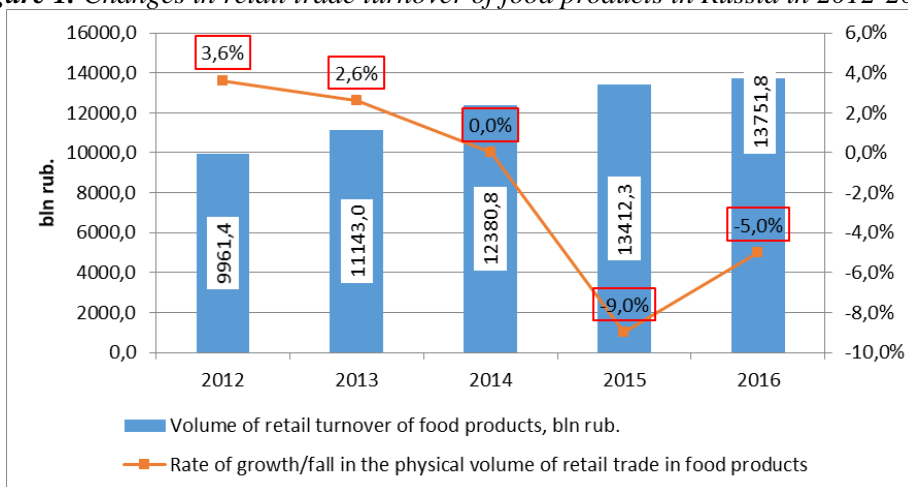
At the 2016 year-end, retail chains generated 33.1% of the total volume of retail trade turnover in food on average for the Russian Federation, including beverages and tobacco products (30.7% in 2015, 27.9% in 2014) (Russian Federal State Statistics Service, 2016).

Revenue of the largest networks grew primarily through the development of stores in the "discounter" and "neighborhood shop" formats. Operators of hypermarkets and supermarkets in 2016 grew far more slowly than the top 10 players in general (Butov, 2016). At the 2016 year-end, the average revenue growth rate of the 5 largest food retailers in Russia in 2016 was 19.1%. X5 Retail Group and Lenta demonstrated the highest revenue growth among retail chains in Russia over 3 years. Revenue indicators of the 5 largest FMCG retailers in Russia in 2014-2016 are presented in Table 1.

Table 1. *Revenue of the 5 largest FMCG retailers in Russia in 2014-2016*

Name				Growth rates, %	
	2014	2015	2016	2016/2014	2016/2015
X5 Retail Group	634	809	1034	163.1%	127.8%
Magnit	764	951	1074	140.6%	113.0%
Dixy	229	272	311	135.8%	114.3%
Lenta	194	253	306	157.7%	120.9%
O'Key	**152**	163	175	115.1%	107.4%
Total	2,287	2,791	3,325	145.4%	119.1%

There are two clearly pronounced leaders in the market: Magnit and X5 Retail Group, whose shares at the year-end 2016 amounted to 7.8% and 7.5%, respectively. Both leaders have increased their share over the past year.

Although Magnit formally retained its leadership in 2016, net of its Drogerie stores proceeds (-64.5 bln rub.) and wholesale (-5.6 bln rub.), its revenue amounted to 1,004 bln rubles. The first signs of Magnit's impressive growth rate slowdown were noticed back in 2015: at the time, despite the powerful expansion, revenue growth fell to the lowest level in a decade – 24.3%. The trend continued in 2016, and the year in many ways was the worst in the company's records. Sales growth was 13% (it was 30-40% in 2007-2014). Despite the slowdown in revenue, Magnit remains the absolute market leader in terms of gross and net profit, EBITDA and profitability (Table 2).

Table 2. *Key financial indicators of 5 FMCG retailers of Russia in 2016*

Indicator	X5 Retail Group	Magnit	Dixy	Lenta	O'Key
Gross profit, bln. rub.	250	295.8	83.2	67.8	40.2
Net profit, bln. rub.	22.3	54.5	-2.8	11.2	-0.14
EBITDA, bln. rub.	79.5	107.8	9.6	31.8	9.3
EBITDA margin, %	7.4%	10%	3.1%	10.4%	5.3%

X5 Retail closed 2016 with a record revenue growth rate (+27.8%). A large-scale expansion of the main X5 chain made a large contribution to the record growth rate: 2,167 Pyatyorochka stores were opened over the year (against 1,537 a year earlier), and the increase in the sales area was about 1 mln sq.m.

The third largest food retailer had problems with maintaining the revenue growth rates back in early 2016. As a result, the annual growth in total revenue of the Dixy Group of Companies dropped to 14.3%. The key reasons for the Dixy drop in 2016 included a weak expansion (the network grew by 5% over the year): Dixy Group of Companies opened 141 and closed 47 stores over the 12 months of 2016, which resulted in 94 new openings. Another reason for the decline is worsening of competition in the "neighborhood" format, which is the main format for the company.

St. Petersburg's Lenta had a noticeable change for the better among the other major players: its market share increased from 1.9% in 2015 to 2.2% in 2016. At the year-end 2016, Lenta sales rose by 20.9% to 306 bln rubles. In terms of sales volume growth Lenta ranks second after X5. In terms of profitability Lenta also remains one of the strongest players on the market. Without taking the powerful expansion into account (36 hypermarkets were opened in Q4 alone – more than over the whole 2015), sales grew not so fast – LFL + 3, 9% against 7, 5% for X5. Key indicators of the O'Key network were lower than those of the key competitors, but unlike Dixy and Magnit, the retailer did not lose growth rates compared to 2015. O'Key total revenue increased by 7.4%. EBITDA decreased by 7.9% to 9.3 bln rubles. It must be noted that three of the five companies under study worsened net profit figures. Dixy net loss amounted to 2.8 bln rubles in 2016 against profit of 589 mln rubles received a year earlier. O'Key chain net loss amounted to 138 mln rubles.

3.2 Indicators of Economic Profit of the Food Retailing Enterprises

In accordance with to the presented method, the first stage of the research into the economic profit of food retailing enterprises includes calculation of the NOPAT indicator, the results of which are presented in Table 3.

Table 3. *Calculation of the NOPAT indicator for the 5 largest food retail chains in Russia*

Indicator	X5 Retail Group (2016)	Magnit (2016)	Dixy (2016)	Lenta (2016)	O'Key (2016)
Operating profit, bln rub	45.63	81.96	0.837	23.695	3.394
Profit tax, bln rub.	6.36	1.455	0	3.35	0.054
Pre-tax profit, bln rub.	28.65	31.24	-3.08	14.553	0.271
Effective profit tax rate, %	22%	5%	0.00	23%	20%
NOPAT	*35.50*	*78.14*	*0.84*	*18.24*	*2.72*

According to data in Table 3, despite the net loss of Dixy and O'Key retail chains, the operating profit after tax is positive. This means that the losses are caused by the relatively high financial cost of borrowing. The result of the second stage of the study is calculation of the invested capital of each of the companies under study. Table 4 provides data on the invested capital of the five largest food retail chains in Russia.

Table 4. *Calculation of indicators of the invested capital of the 5 largest food retail chains in Russia*

Indicator	X5 Retail Group	Magnit	*Dixy*	Lenta	O'Key
Equity	127.04	196.08	*29.03*	47.13	22.66
Deferred tax liabilities	6.5	15.6	*1.63*	7.36	0.62
Long-term debt	110.87	77.5	*28.84*	66.96	31.67
Short-term debt	45.17	50.11	*2.97*	35.25	4.47
Invested capital, total, bln rub.	289.58	339.29	*62.47*	156.7	59.42

Magnit and X5 Retail Group are leaders in terms of investment capital. The bulk of investment is allocated to the development of the producing infrastructure. For example, Magnit opened 1,970 stores in 2016 and increased its sales area to 5.07 mln sq.m. X5 Retail Group opened 2,167 stores, more than 95% of which fell on the Pyatyorochka network.

The third stage of the study results in the calculation of the average weighted capital rate of each of the food retail chains under study. To do so, the equity value of the companies under study was determined and presented in Table 5.

Table 5. *Calculation of the equity of 5 largest food retail chains in Russia*

Indicator	X5 Retail Group	Magnit	Dixy	Lenta	O'Key
Risk-free rate	8.08%	8.08%	8.08%	8.08%	8.08%
Beta	0.86	0.95	0.46	0.46	0.42
Market return Rm	10.47%	10.47%	10.47%	10.47%	10.47%
Equity value Re, %	10.14%	10.35%	9.18%	9.18%	9.08%

The efficiency of the investment policy of the companies under study is indicated by the WACC, the calculation of which is provided in Table 6.

Table 6. *Calculation of WACC of the 5 largest grocery retail chains in Russia*

Indicator	X5 Retail Group	Magnit	Dixy	Lenta	O'Key
Amount of debt, rub.	346.445	258.84	69.63	179.04	70.43
Amount of equity, rub.	127.04	196.08	29.03	47.13	22.66
Equity value, %	6.4%	6.2%	7.2%	7.2%	7.3%
Debt value, %.	11.3%	10.1%	12.4%	9.8%	9.6%
WACC	8.1%	8.2%	11.7%	7.5%	7.6%

The last stage of the study results in the calculation of the EVA for the companies (Table 7).

Table 7. *Calculation of EVA for the 5 largest food retail chains in Russia*

Indicator	X5 Retail Group	Magnit	Dixy	Lenta	O'Key
NOPAT, bln rub.	35.50	78.14	0.92	18.24	2.72
IC, bln rub.	289.58	339.29	62.47	156.7	59.42
WACC, %	8.1%	8.2%	11.7%	7.5%	7.6%
Economic profit, bln rub.	11.91	50.44	-6.38	6.54	-1.79
Net profit, bln rub.	22.3	54.5	-2.8	11.2	-0.14

As can be seen from Table 7, the real value of the companies under study for owners is much lower than the net profit earned according to accounting statements. The obtained results reveal that the invested funds of the owners are used efficiently enough in three out of the five companies. EVA indicator has negative value for Dixy and O'Key, which indicates an incorrect investment policy, which led to a drop in the market value of enterprises. Management of the companies under study needs to develop levers to control EVA in order to improve the efficiency of the use of invested capital.

4. Discussion

It must be noted that despite the successful application of the EVA indicator in foreign practice when assessing the efficiency of enterprises, the value-focused management has not become popular among Russian companies. For example, according to the conducted study, the cost approach in management is applied by no more than 25% companies, while 60% of the companies use only certain elements of the value approach. At the same time, the experience of applying the EVA concept

shows that this indicator most accurately reflects the efficiency of the enterprise from the standpoint of the owners, for whom the positive result consists in making profits that exceed profitability of alternative investments. The apparent advantages of this indicator include:

- Relatively easy calculation;
- Can be used as a tool to increase the company's productivity;
- Can be used for the development of the system of remuneration and compensation for the top management.

However, none of the solutions is ideal for everyone, and EVA is no exception. When deciding on the introduction and use of EVA in Russian companies, the shortcomings of this indicator in the comparative assessment of companies should also be noted.

First, the indicator is highly exposed to accounting errors and analyst adjustments. Stern Stewart & Co. accounts for more than 160 adjustments in the accounting records of its client companies that implement and use EVA. However, such many adjustments are not required in practice: as a rule, their number does not exceed 15. Stern Stewart & Co. notes that adjustment of accounting values will be characteristic for each company and may be subjective. Since EVA is based on accounting data, management can relatively easily change accounting methods to increase EVA. Experts bring attention to the fact that analysts should be especially cautious about the EVA indicators published by the companies, unless a full explanation for each of the EVA components (profit, capital and cost of capital) and reconciliation of profit and capital with accounting data are provided. This is because adjustments to accounting data are highly subjective but can have a significant impact on EVA (Sirbu, 2012). Secondly, the EVA indicator does not take the difference in the size of companies or branches into consideration. Back in 1999, Peter Brewer ?reference? and his co-authors mention the problem of "difference in size" in the article "Economic Value Added (EVA): Its Use and Limitations." Brewer notes that two companies can be compared to find out that one of them has higher EVA but lower return on investment. Thirdly, EVA will be influenced by macrofactors that are beyond the control of the company's management. It does not take into consideration the impact of inflation, investment profile or currency impact on the capital book value and accounting profit. These aspects, along with many others, limit the usefulness of EVA as a tool for making decisions about the quality or competence of management (Cromwell, 2000).

In conclusion, it must be said that the indicator of economic profit has practical value both in analyzing the performance of the entire company and its individual structural divisions, and in evaluating investments in expanding the producing infrastructure of food retail companies. It does not necessarily measure the value added for shareholders.

5. Conclusion

The indicator of economic profit is viewed as a promising tool to assess the companies' performance in terms of the investment capital use. The results obtained allow to make the following conclusions:

- The method presented in this work is quite easy in calculations but is of practical value because it allows to obtain solid results for making investment and managerial decisions in the interests of the company owners.
- In the context of the rapid development of the retail FMCG market, companies need a financial tool that would allow for objective and realistic assessment of the efficiency of investment capital. The EVA indicator can become such an instrument.
- Application of the presented method in practical assessment of the performance of the five largest food retailers in Russia led to the conclusion that their real value for owners is much lower than the net profit earned according to the accounting statements.
- Calculation of the EVA indicator and its application in analytical operations will allow to make rational and competent managerial decisions to increase the market value in the interests of the company owners.

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