CHAPTER 10: EVA AND ITS CRITICS

10.1 The Opposition's View to the Usage of EVA

There are implications of EVA on management motivations, complexity and education.

(a) EVA motivates managers to rethink their usage of capital in the pursuit of profits. Efficient usage of capital translates into higher EVA values and greater wealth contributions to shareholders and participants in the EVA incentive plan. However, focusing primarily on EVA, make managers greedy and heightens the tendency to focus more on short term gains. For example, managers may have a greater tendency to reduce appropriate spending in areas such as research and development for short-term gains. Therefore, an effective EVA incentive plan should penalize managers that make decisions resulting in long-term losses.

(b) Another cautioning consideration for implementing EVA is its mere complexity. Since EVA's take-off in the early 1990s, many consulting firms have aimed at getting their own piece of action. A trend toward companies creating their own unique system using the most desirable characteristics of several packages already on the market has kept consultants on their toes. While their packages tend to vary slightly, the adoption of one of these systems tends to involve hiring a team of consultants to develop corporate accounts and to undertake a large-scale education project for affected employees. Companies opt to make the transition into EVA a gradual one, generally starting with a select division or by taking a top-down approach. A strategy such as this tends to be less disruptive to the company as a whole, but can spread the implementation phase of this system out over a number of years, which can be quite expensive.

(c) One of the greatest barriers for companies to overcome in implementing EVA is the education process. EVA can be a very complex system to individuals who are not familiar with using financial tools. Whereas some measurement tools are not directly used by everyone throughout an organization, EVA, when tied to an incentive program, is a concept that everyone involved must understand. For everyone in an organization to make EVA a way of life, they must understand how it is calculated, what factors will impact it, and most importantly, how their actions are impacting the bottom line. Every individual in an organization has some way of creating value for the firm. However, taking the time to train each person in the areas where he/she can make the maximum impact is not an easy task. If all of the participants in an EVA-based compensation system do not understand how their actions tie in with their compensation package, employee buy-in of the program may be jeopardized.

10.2 The main problems with EVA in measuring operating performance

EVA is poor in periodizing the returns of a single investment. They underestimate the return in the beginning and overestimate it in the end of the period. Some growth phase companies or business units have a lot of new investments. Such growth phase companies are likely to have currently negative EVA although their true rate of return would be good and so their true long-term shareholder wealth added (true long-term EVA) would be positive. That is also the reasons why EVA is criticized to be a short-term performance measure. Ceasing investments can indeed increase short-term EVA. Some companies have concluded that EVA does not suit them because of their focus on long-term investments that do not occur in a continuous stream.

However, it should be remembered that the ultimate aim is still to create value for shareholders. Only earning higher rate of return than the cost of capital in the long run can do this. The fact that the required good financial performance is not expected now but only in the future is not a reason to leave out financial measures. Therefore, periodic financial performance measures are always important no matter what business field the company operates at. The periodizing problem of financial performance measures has to be managed with focus on long-term. Even though current financial performance is poor, there is no reason to view things with narrow, short-term perspective. This wrong periodizing will even out in the long run, if the investments really are profitable. Furthermore the extent of this problem can be estimated; the average age of company's asset portfolio can be taken into account in interpreting periodic EVA. It can be expected that companies with a lot of new and thus undepreciable assets have negative EVA in the near future.

The companies that have invested heavily today and expect positive cash low only in a distant future are extreme examples. For these growth companies – facing profitable long-term opportunities with negative short-term cash flows – EVA is probably not a suitable primary performance measure. The performance of growth companies like some telecommunication operators (heavy investments in infrastructure with very long payoffs) and other high-tech companies is perhaps measured better with market share, change in market share, sales growth etc. That is because the current financial performance of these companies cannot be very attractive measured with any metrics.