CHAPTER 11: SUMMARY AND CONCLUSIONS

EVA has importance for companies as a performance measurement and controlling tool. First of all, it is fairly simple measure but still measures well the ultimate aim of any given company, the increase or decrease in shareholders' wealth. Maximizing traditional performance measures like return on investment is not theoretically in line with maximizing the wealth of shareholders. Therefore, EVA is superior to conventional performance measures. The premise behind EVA – that businesses must cover their capital cost – is neither new nor peculiar. Putting it into practice can still be eye opening. EVA shows financial performance with a new pair of glasses or offers new approach especially for the companies where equity is viewed as free source of funds and performance is measured by some earnings figure. At best, EVA helps with creating a mind-set throughout the organization that encourages managers and employees to think and behave like owners.

At operational level, this approach leads often to increased shareholder value through increase capital turnover. In many companies everything has been done in cutting cost but the capital efficiency has been ignored. EVA has been helpful because it forces to pay attention to capital employed and especially to excess working capital. Allocating the capital costs to their originators i.e. individual functions of organization can further reinforce this impact.

One of EVA's most powerful features is its suitability to management bonus systems. The good feasibility for this purpose is due to the nature of EVA as excess return to shareholders. When EVA is maximized, also shareholder value is maximized. The idea of EVA bonuses is that if management can be paid some bonuses, the shareholders have always earned higher return on their capital than can expect. This kind of bonus system is usually beneficial both to management and the shareholders, because the performance level is likely to rise after introducing EVA bonus system. EVA bonus is paid far from a cost to shareholders, because it is often a share in the discretionary value created. With well-designed bonus plan, the higher the bonuses that are paid, the better it is for shareholders. In order to be successful, EVA based system should be long term, based mainly on changes of EVA and offer considerable bonuses for considerable shareholder value improvements.

With implementation it is important to understand the EVA – concept thoroughly and tailor the concept to the unique situation of each company or business unit. EVA is at its best as an overall measure and organizational approach with strong link to payroll of managers and other employees. That kind utilization cannot succeed without deep commitment achieved with proper training.

Substantial shareholder value increases and true success stories arise always from outstanding strategy, quick response, great ideas and good predicting of future. EVA helps in quantitative assessing of different strategies but that is all. Wealth does not arise from EVA alone. EVA only measures changes of wealth. It is also as a short-term as all other periodic performance measures. Therefore, all companies should rely also on other performance measures. This is especially important for new growth phase companies. However, we have to bear in mind that the success or failure of any given company is measured ultimately as created shareholder value. Therefore, EVA is important measure also for those companies that use primarily other tools is assessing the achievement of their strategic goals.

The Securities Commission chairman En. Ali Abdul Kadir, in the opening address at the seminar on EVA on 26 April 2000 in Kuala Lumpur, said the EVA approach 'has been lauded as one of the successful methods to solve some of the major issues in managing a company. It offers a management system that helps define priorities and shape behaviour to focus on value. EVA instills capital discipline by forcing managers to consider the actual cost of capital they employ. It also boasts the merits of allowing pay schemes to be tied to performance and consequently, the change in mindset and motivation generated encourage managers to act as owners of the company, aligning shareholders and management interest alike'.

EVA is a much more powerful tool than free cash flow because EVA can be used to measure annual, quarterly or monthly performance, evaluate strategies, allocate capital, price acquisitions and divestitures, restructure balance sheets, and serve as the basis for incentive compensation. Although conceptually simple, EVA is sophisticated tool that provides highly accurate estimates of both total capital used and a firm's true cost of capital. Unlike traditional financial measures, including cash flow, EVA allows all decisions to be clearly modeled, monitored and communicated in terms of the value added to the shareholder's investment.

A major benefit of EVA is that it provides a common language for communicating performance and goals within an organization. The EVA approach is good news for a company's shareholders because it relates company performance directly to shareholder value. If a company maximizes EVA, it will improve earnings and all the traditional measures of value. A close concept related to EVA and supplementary technique to evaluate a company's performance is MVA. MVA is the present value of a company's future economic profit, which is the profit derived after considering all explicit and implicit cost for the company to generate that profit. In contrast to EVA, which is the value added over a given period, the MVA is forward looking method and is the present value or discounted value of all the company's future estimated economic profit.

Both EVA and MVA are viewed as improvements over other more traditional methods as they consider not only cash flow but also the cost of capital. The two methods also offer a clear and easily understood way to define targets and facilitate measurements and assessment of company operations.

In the United States (US), EVA framework has been credited as being almost supernatural improvements in profitability and performance. Today, more than 200 major corporations in the US, among them Coca-Cola, Eli Lilly, Monsanto and General Electric, swear by the EVA framework. Airways Corporation of New Zealand prepares its financial statements on EVA methodology. Extracts of its 1994 EVA financial statements is presented in Appendix 1.

The concept of EVA is becoming increasingly popular in Asia. It takes as long as 18 months for a large company to implement the EVA approach while, for medium to small companies, the implementation period may range between 6 and 12 months.

A useful lesson to learn from EVA is that it focuses at creating value to shareholders, something that CEOs have never really examined in the past. Generally, in a company, there are three numbers that a CEO should watch - customer churn, management churn and shareholder churn. The CEO tends not to look at the last one - how quickly the shareholders are actually turning. If there is an imbalance – institutions that have invested with the company and never left but have a high churn of shareholders who are coming in and they may only be there a day, a month, a week, very short compared to the customers and management. The CEO would be very influenced by this because it affects the company's stock price. Therefore, to have winning team, a company must have the right customers, right management and right set of shareholders. So the EVA process is good as an education process for management as well as investors.

Overall, the study highlights the need for companies to measure their performance by benchmarking their returns against their cost of capital rather than focusing on accounting measures.