

CEO PAY BULLETIN

Observations on the “EVA” Performance Measure

By **Joseph E. Bachelder***

Economic Value Added (EVA) is a measure of a business enterprise’s economic performance based on what is added to that enterprise’s value by its operating earnings (net of tax) reduced by the enterprise’s “capital costs.” The concept of EVA was introduced in the 1980s by the management consulting firm of Stern, Stewart & Co. In February 2018 Institutional Shareholder Services Inc. (ISS), the largest proxy advisory firm in the U.S., acquired EVA Dimensions LLC, an EVA-based research firm founded by G. Bennett Stewart III, one of the co-founders of Stern, Stewart & Co. Mr. Stewart currently serves as Senior Advisor to ISS.¹

Following is a statement of the EVA formula:

EVA	equals	NOPAT	minus	Cost of Capital multiplied by Capital
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Meanings given the terms used in the EVA formula (before taking into account suggestions by ISS in 2018 as noted below) generally have been as follows:

- **NOPAT**, which is the acronym for Net Operating Profit After Taxes, is (i) earnings before interest and taxes less (ii) taxes on the earnings described in (i). (In 2018, ISS modified some of the GAAP accounting rules on the basis of which NOPAT is calculated. This is discussed below.)
- **Capital** is the total capital, comprised of equity and debt, employed in the enterprise. (In 2018, ISS also introduced modifications to the traditional meaning of Capital, as discussed further below.)

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¹ The term “EVA” has been trademarked for a variety of uses. See discussion in **Attachment A**.

- **Cost of Capital** is the weighted average of (i) after-tax cost of debt (i.e., interest on debt net of tax deduction benefits) expressed as a percentage of total debt and (ii) Cost of Equity, expressed as a percentage of total equity. “Cost of Equity,” for this purpose has meant what a reasonable investor might expect as a return on investment in the stock of the company in question, a concept not included in GAAP accounting. Under the traditional formulation, the weighting of the after-tax cost of debt and Cost of Equity is based on the capital profile of the company. (Again, as noted below, in 2018 ISS introduced a change in the traditional meaning of “Cost of Capital.”)

After acquiring EVA Dimensions LLC in 2018, ISS published a report that made a number of changes from GAAP accounting in ISS accounting for EVA. See the ISS report, “The EVA Measurement Formula: A Primer on Economic Value Added (EVA)” (2018), authored by Mr. Stewart. The adjustments in the calculations of NOPAT and Capital are summarized in **Attachment B** to this Bulletin.

On March 18, 2019 ISS issued a report, entitled “Using EVA in Pay-for-Performance Analysis.” In that report ISS recommends the use of EVA as a tool to assess the alignment of pay and performance.

During the 2019 proxy season ISS has included in its proxy reports to investors a set of metrics based on EVA. ISS distributes to its subscribers proxy reports providing its voting recommendations in connection with shareholder meetings of public corporations, including recommendations on shareholder votes regarding executive compensation. In the March 2019 report noted above, ISS indicates that, at least during 2019, EVA-based metrics will not impact on its proxy voting recommendations and that it is not taking a position as to whether it favors or disfavors the use of EVA as a metric in executive incentive plans. A wholly-owned subsidiary of ISS, ISS Corporate Solutions Inc. (ICS), provides consulting services and products to companies on corporate governance and related issues, including EVA-related issues.²

One example of the adjustments in GAAP accounting made by ISS in its calculation of EVA, as noted above, involves the accounting for expenditures on research and development, advertising and promotion. (This is Item 1 in Attachment B.) Under GAAP accounting rules these expenditures ordinarily are charged to expense as they are incurred. Under EVA, these expenditures are to be capitalized and amortized over, respectively, five

² Question has been raised as to whether the consulting services provided by ICS to companies and the services that ISS provides to shareholders constitute a conflict of interest. ISS addresses the conflict of interest issue in its Code of Ethics (December 2018). In its Code of Ethics ISS takes the position there is not a conflict of interest, stating, among other things, that “[o]ne of the key steps the Company has taken to prevent and manage this potential conflict of interest is the implementation and maintenance of a Firewall which provides for the separation of ICS from ISS (and, in particular, Global Research).” “Global Research” refers to “the work of ISS’ proxy research and responsible investment research and analytics teams.”

years (research and development) and three years (advertising and promotion).³ Further, the amount of such expenditures capitalized is depreciated over the amortization period.

In addition to the adjustments noted, ISS, in its 2018 report, provides a formula for Cost of Capital that is different from the traditional formula for Cost of Capital as set out above. Cost of Capital, according to comments at page 11 of the ISS report, is to be determined as follows.

First, calculate the sum of:

- (i) the “prevailing yield on long-term government bonds” and
- (ii) “a premium varying from 1% to 8% to compensate for the risk in the firm’s principal line of business.”

Second, from the sum of (i) and (ii) a discount, also expressed as a percentage, is taken for the tax benefit attributable to the “tax deductibility of interest on the debt the firm employs.”

ISS states that it will use the same prevailing yield on long-term government bonds for all companies in a particular market and the same risk premium for all companies in a particular sector but the discount for the tax benefit attributable to the tax deductibility of interest on debt will vary by company. Companies that adopt the EVA formula presumably will tend to use their own cost of debt and their own “opportunity cost” for equity in calculating Cost of Capital for their own EVA.

Further Observations on EVA

1. Many companies have given, and others undoubtedly will be giving, careful attention to EVA as a possible corporate governance metric including use as a metric for incentive compensation plans. Some of these companies may adopt economic growth formulas that contain some but not all of the elements of ISS’s version of EVA. However, EVA is not a procrustean formula nor is it a legal rule or requirement. It is a metric of economic profits that companies may use at their discretion.

2. As discussed, ISS’s version of EVA involves a complex system of accounting adjustments to a company’s GAAP-based earnings and to its calculation of its capital and modification of the traditional concept of “Cost of Capital.” If EVA is used as an incentive plan metric, it will bring added complexity to the reporting of executive compensation in proxy statements, which already are subject to complicated rules for reporting such compensation. Explanation to covered executives of how EVA works and affects their compensation will add complexity in administering it.

³ ISS provides special amortization periods for expenditures on research and development, advertising and promotion for pharmaceutical and biotech companies that differ from those noted in the paragraph to which this footnote applies.

3. How will executives react to having a second accounting system (which EVA is) for purposes of determining a significant element of their compensation? What will be their reaction if they have a period of performance that is successful according to GAAP accounting but might be reduced from target level (or even eliminated) because the EVA system of accounting did not record performance results as positive as GAAP did?

4. A positive feature of using EVA as an incentive plan metric is that it focuses executives on achievement of operating earnings. It also focuses them on the effective management of capital (by subtracting a charge for capital from operating earnings (net of tax) in the calculation of EVA). This distinguishes an EVA-based plan from plans such as stock option plans, restricted stock plans and plans based on “total shareholder return” (TSR).⁴ The values of the plans just noted are ordinarily based only on the employer’s stock price. An EVA-based plan encourages executives to “stay on track” with earnings performance, while focusing on capital management, which, in turn, will support the long-term market price of the company’s stock.

5. Another positive feature of EVA is that it provides a metric, whether or not part of an incentive plan, to test the effectiveness of other measures. For example, TSR during an award period may be good but is it sustainable based on EVA performance?

Conclusion

EVA represents a valid perspective on the profitability and economic growth of a company. It also is a complicated way of measuring such profitability and economic growth. EVA’s successful application as a measure of performance in executive incentive compensation plans will depend upon how successful its proponents are in explaining EVA to the executives, directors and shareholders of the companies considering adopting it.

⁴ TSR generally is the sum of (x) the change in stock price during the applicable performance period plus (y) dividends, if any, paid per share during that period, with the sum being divided by (z) the stock price at the beginning of the period.

Note on “EVA” Trademark

Trademarks for EVA include a trademark registered by Stern, Stewart & Co. in 1994 for use in connection with “financial management and consulting services in the area of business valuation,” according to the database of Trademark Electronic Search System (TESS) of the United States Patent and Trademark Office. The current owner of the trademark is listed in the database of TESS as Stern Value Management, Ltd.

In 2008 EVA was registered as a trademark by EVA Dimensions LLC for a number of uses. The current owner of that trademark is listed as Institutional Shareholder Services Inc.

**Summary of ISS's Adjustments to
GAAP Accounting in Applying the EVA Formula***

1. Capitalize and amortize expenditures on research and development, advertising and promotion.
 - Make adjustments in the accounting for such expenditures as discussed in the text of the Bulletin.
2. Capitalize impairment charges and expenditures on restructuring and unusual and non-recurring items.
 - Add these charges/expenditures back to earnings and to capital.
3. Account for gains and losses on sale of assets used in the business as follows:
 - In the case of gains on such assets, exclude such gains from earnings and reduce capital by the amount of such gains.
 - In the case of losses on such assets, add back the losses to earnings and to capital.
4. Eliminate the impact of holding excess cash.
 - Remove investment income attributable to excess cash from earnings.
 - Remove excess cash from capital.
5. Treat assets leased to the company as if they were owned by the company.
6. Smooth taxes by applying a standard tax rate (estimated by ISS to be 25% for U.S. companies) to operating earnings.
7. Recognize the value of deferring taxes by reducing capital by the amount of the tax deferrals, thus increasing EVA.
8. Recognize the value of the tax benefit of deducting stock options.
 - To the extent the value of the tax benefit (that is, the amount of taxes saved by the tax deduction for the option) exceeds the amount treated as expense (that is the charge to earnings; for example, the amount charged based on the Black-Scholes value), such excess is subtracted from capital, thus increasing EVA.

* This summary has been prepared by the author of the Bulletin. For the complete statement of adjustments see ISS's 2018 report noted at page 2 of the Bulletin.

9. Eliminate the impact on capital of unrealized gains/losses on hedging-related derivatives.

- In the case of unrealized gains, remove such gains from capital.
- In the case of unrealized losses, add such losses to capital.

10. Deduct net charge-offs for bad debts.

- Add the provision/allowance for bad debts back to earnings and to capital.
- Deduct the charge-offs for bad debts (net of recoveries) from earnings.

11. Convert LIFO (“last in, first out”) inventory costing to FIFO (“first in, first out”).

- Add “LIFO reserve”¹ to capital.
- Add change in LIFO reserve to earnings, after taxes.

12. Eliminate cost distortions relating to retirement benefits.

- Add reported retirement costs back to earnings.
- Deduct the retirement-related “service cost”² from earnings.
- In the case of a retirement funding shortfall, add the amount of such shortfall to capital.
- In the case of a retirement funding surplus, subtract the amount of such surplus from capital.

13. Eliminate the impact of non-controlling interests. (This references a situation in which the company in question (the “parent”) owns a majority interest but not the full interest in another company (the “subsidiary”).)

- Deduct from earnings of the subsidiary otherwise attributable to the parent the portion of such earnings allocable to the non-controlling interest(s) in the subsidiary.
- Deduct from parent’s equity the equity in the subsidiary provided by the non-controlling interest(s) in the subsidiary.

¹ ISS states that the “LIFO reserve” is “the difference between the value of [a company’s] inventories using a [FIFO] costing assumption and [LIFO] assumption.”

² ISS states that “service cost” “measures the money sum that a company would have to set aside and invest at a low-risk rate of interest to cover the future benefit payments that employees earned due to employment *in the current period.*”