

EY Center for Board Matters
**Five considerations
as ISS looks
at economic
value-added metrics**

Recently, proxy advisory firm ISS announced that it will include economic value-added (EVA) metrics in its proxy research reports this year, and may consider incorporating EVA as part of its performance analysis beginning in 2020. This development comes on the heels of ISS' 2018 acquisition of EVA Dimensions LLC, a business intelligence firm that measures and values corporate performance based on EVA.

The addition of EVA to traditional GAAP-based financial performance ratios and total shareholder return will provide insights into long-term performance measures rooted in value creation. Given that EVA and value creation measures will likely be a relatively new topic for many companies, we have compiled a list of common questions that boards are likely to have.

1. What is EVA?

Economic value add or economic profit represents the returns generated above and beyond the cost of capital. While this is not a new concept in the world of finance, the use of EVA represents a departure from the focus on total shareholder return (TSR) as a metric of "success" for a company or an executive. EVA conceptually is an unadulterated measure of value creation that encourages companies to take a longer-term view than quarter-to-quarter stock price appreciation. TSR can be driven by investor or market sentiment that,

in the short term, may not be reflective of a company's economic performance; EVA, in comparison, solely measures a company's ability to create economic value.

Like all financial metrics, EVA has pros and cons, but those in the corporate finance world would likely applaud the inclusion of EVA in measuring performance, as it is a true measure of value creation, which is one of the key drivers of a stock price.

2. What is the impact of ISS' announcement?

It is unclear what, if any, impact the inclusion of EVA will have on ISS' assessments of company performance. During the 2019 proxy season, ISS research reports on companies in the US and Canada will feature EVA data as a supplement to GAAP-based measures, and moving into 2020, it will consider the inclusion of EVA-based measurements as part of its financial performance assessment methodology.

Still, ISS' decision to include EVA data is driving renewed attention toward its potential value in measuring long-term value creation at a time when many investors are pushing companies to look beyond quarterly results and focus on long-term value.

3. What should boards and compensation committees do?

Boards and compensation committees may want to assess the benefits and limitations of utilizing EVA as a performance measure. Any such assessment should be part of ongoing efforts to challenge the executive pay program and ensure that the company is using the right metrics to drive long-term value and execute on long-term strategy.

Notably, while most companies are capable of calculating EVA at a corporate level, they may not be able to drive meaningful changes based on the results. For example, if a company is solely calculating EVA at a corporate level and a mid-year review shows negative EVA, many companies don't have the necessary information to drill down into the results at a business unit, geographic or product level to accurately identify the source of the value leakage. In order for management to make agile decisions, it is imperative that leadership has the ability to analyze key metrics at a granular level.

Best practices include the use of executive-level dashboards that not only allow the monitoring of EVA, but provide leadership with the ability to evaluate economic performance and conduct portfolio reviews by drilling down to lower levels of EVA within the company and

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identify the key drivers of underperformance. Establishing systems and processes to extract the needed information can be a complicated process, as most companies do not have fully burdened income statement and balance sheet data at granular levels. However, enabling technologies and solutions now allow for this data to be created systematically at lower levels and are enabling companies to more efficiently and accurately collect financial data required to provide higher quality analytics.

4. How should management calculate EVA? Are there best practices to follow?

The EVA formula is relatively simple – net operating profit after taxes (NOPAT) minus weighted average cost of capital (WACC) times invested capital (capital charge). However, the calculation has many nuances and there can be differences or it can even be subjective in practice. As such, boards need to have a working knowledge of EVA and its key drivers to effectively engage with management on this metric and understand any judgment that was applied, along with potential risks.

Should operating profit be based on accounting measures or should it be adjusted for nonoperating items?

Certain adjustments should be made to accounting operating profit to arrive at a normalized and reliable EVA so that it more closely adheres to economic principles rather than accounting measures. However, this is, unfortunately, not a simple exercise as the adjustments can range in practice and can be complicated. For example, ISS suggests adjustments ranging from capitalizing investments in intangible assets and impairments, eliminating the impact of excess cash, treating leased assets as owned assets and inventory methods/reserves.

Specifically, according to ISS, the following corrective adjustments should be considered:

- ▶ Capitalize investments in intangible assets
- ▶ Capitalize impairment, restructuring charges, losses on sales and nonrecurring items, net of unusual gains
- ▶ Eliminate impact of excess cash

- ▶ Treat leased assets as if owned
- ▶ Smooth taxes
- ▶ Recognize value of deferred taxes
- ▶ Deduct the net charge-offs of bad debts
- ▶ Switch from LIFO to FIFO
- ▶ Eliminate retirement cost distortions
- ▶ Apply non-controlling interests adjustments

What is a capital charge?

The cost of capital is not a cash cost, but rather an estimate of the blended rate of return of all sources of capital, including common equity, preferred stock and debt. Hypothetically, this can be thought of as the rate of return investors could expect to earn by purchasing a stock and bond portfolio that matches the risk profile of the company's debt and equity.

The capital charge is determined by multiplying the cost of capital times the amount of capital invested in the business (i.e., net business assets).

Is there a specific way I should be calculating my cost of capital?

The cost of capital should reflect long-term risk-free rates and a firm's sector risk, less the strategic tax benefit of debt.

ISS specifically estimates a company's cost of capital as the prevailing yield on long-term government bonds (market specific), plus a premium to compensate for the risk of the firm's principal line of business (sector specific), less a discount for the tax deductibility of interest on the debt the firm employs (company specific).

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SCORE no. 06296-191US
CSG no. 1905-3155166

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