The common mistakes in implementing/using EVA

There are a few common mistakes that are often made in implementing or using EVA. Most of them are bound up with either misunderstanding and thus misusing the consept at upper levels (peculiar definition of EVA) or not training all the employees to use EVA and thus not using the full capacity of the consept

The common mistakes include:

- Defining capital costs intentionally wrong (usually too high for some reason)
- Using EVA only in the upper management level
- Investing too little in training of employees

These mistakes are explained better on the following slides

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Defining capital costs correctly

With EVA approach capital costs are intended to be defined as correct as possible (as all the other costs). Capital costs are not supposed to set to some kind of target level:

Some companies have understood EVA controlling in the same way than ROI-controlling; if an unit produces a good return then also capital costs are set to a high level. This kind of procedure is against the whole EVA approach: the challenges are supposed to build in EVA-targets and not into capital costs because the whole idea is to enable and encourage to make all the investments that offer a return greater than the alternative investments

Also all other kind of manipulating of capital costs is not wise:

Some companies have "simplified" the raporting by building the tax-costs into capital cost rate (so there is no taxes in reporting but capital cost percentage is a little bit higher than normally. This is not recommandable for two reasons:

- 1. Taxes are calculated wrongly because in this method they depend on capital base and not on the result
- 2. Capital costs are defined too high and thus in operating activities capital is viewed more expensive than it really is and thus optimal inventory etc. levels are not maintained

Defining capital costs correctly...

Capital costs and solvency ratio

Capital costs should always be defined with target solvency ratio and not with actual solvency ratio because otherwise units can improve their EVA with unproductive investments (by financing them with debt). The steering should operate as if every single dollar invested more in business would be financed with a target blend of debt and equity

All the assets cause capital costs

In order to calculate EVA correctly all the capital must be allocated to units. Usually ROI is calculated so that only capital affectable to units is taken into account. With EVA the same procedure can not be used. If all the capital is not taken into account then the EVA-figures are upward biased (with ROI this has not caused any harm since the level of ROI has not been important)

EVA is not used at its full potential

- Many companies use and train EVA only in the upper levels of organization
  - Thereby a lot of potential in lower levels is lost - especially at lower levels, in operating activities, the consept helps in finding the right actions
- Similar “undercapacity-situation” is likely if EVA is not trained properly and thus employees do not know how to use the concept or are reluctant to use it
  - Although EVA is a simple consept it will not be used properly if the advantages and justification of EVA is not told to employees
  - Nowadays **all** the employees are usually so well educated that they can easily understand and accept EVA if it is properly told to them - the capacity of ordinary employees is usually underestimated and therefore this kind of things are not even tried to explain to all employees

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