

# Assessing Economic Value Added

By BNET Editorial

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*Economic value added* (EVA) expresses a company's true profit, once taxes and the cost of supporting capital have been taken into account. It helps to identify whether a business (or project) is earning more or less than the capital originally invested in it.

If it's earning more, it's adding value—which is good for the shareholders. If it's earning less, they probably would have been better off putting their money elsewhere.

EVA advocates say the process of analysis itself encourages managers to concentrate on the business of creating wealth—making the most of shareholders' investments. An increase in EVA should lead to a rise in the enterprise's value as a matter of course.

## What to Do

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At its most basic, EVA is a straightforward calculation in which the cost of capital used to invest in a business or project is subtracted from its net operating profit. The formula is:

(net operating profit – tax) – cost of capital = EVA

### Example:

Suppose a business wants to develop a new operation that costs \$12 million in capital over the next five years. The expected return is \$3.75 million a year (\$18.75 million in five years). EVA is calculated as follows:

18.75 million – 12 million = \$6.75 million

Another method uses a more complex formula to measure difference in value:

(% return on invested capital – % cost of capital) × original capital invested = EVA

## What You Need to Know

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- EVA expresses value in dollars, rather than as a percentage.
- For investors, EVA could be regarded as the most accurate definition of profit. For example, shareholders only gain when their allocation of after-tax profit is greater than the expected return on the original capital invested.

- EVA can be used to evaluate individual units as well as whole businesses. It enables companies to identify how different departments or operations perform in terms of wealth creation, and helps them make best use of their assets to generate income. It's also useful for assessing the potential of new developments and opportunities.

## Where to Learn More

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### **Web Site:**

Stern Stewart & Co.: [www.sternstewart.com](http://www.sternstewart.com)

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