

CALCULATING RETURN

How Not To Waste Capital

BY DAVID F. CARR

When a business initiative requires a heavy investment in technology or other capital equipment, a methodology called Economic Value Added (EVA) can help distinguish between illusory profits and real economic gain. By taking both operational and capital expenses into account when calculating profit, EVA better reflects the way investors estimate the value of a company's stock, proponents say.

EVA was created by consultancy Stern Stewart and Co., which helps customers such as Herman Miller (see story, p. 32) design employee incentive programs that reflect this measure. The calculation tries to keep management from weakening the balance sheet while chasing profits.

To do this, EVA treats capital investments differently than they are handled in Generally Accepted Accounting Principles (GAAP), the standard rules for financial reporting. GAAP removes capital expenses from the income statement used to judge profitability. But to generate positive EVA, a business must clear a higher hurdle—revenues must exceed operating expenses, taxes and a charge for the “cost of capital.”

Stern Stewart associ-

ate Karl Tichler says this boils down to weighing the benefits of acquiring a new server, say, against the financial drain of the purchase. Cost of capital is a factor of the debt or equity invest-

ment the company must attract, as well as the risk of spending money rather than saving it.

Taxes are also typically left out of a GAAP analysis of operating profit, but

EVA includes an assessment for taxes even when looking at a division that may have little control over corporate tax strategy. While EVA tends to produce a more conservative picture of profits and losses, that's not always true. EVA allows research and development expense to be treated as a capital investment spread over several years because the benefits presumably will be realized over many years.

Although it's not specifically a technology return on investment measure, EVA can be applied to information systems as well as to any other capital investment. But Bix Norman, a former Herman Miller executive who introduced EVA as president of the company's SQA division, cautions that the methodology should not be applied too narrowly.

“People can get risk-averse when they look at EVA on a project-by-project basis,” Norman says. When used properly, however, EVA creates an incentive to keep operations as lean as possible, “with no wasted capital anywhere.” ◀

TOOL: ADDING UP THE REAL VALUE

BigCorp Inc. invests \$1 million in a magic server that instantly produces \$100,000 in revenue each year while adding only \$50,000 in annual operating costs. After taxes, the operating profit is \$45,000.

But what about the \$1 million? That expense is categorized as a capital cost and is amortized over several years. If BigCorp is rewarded on the basis of operating profit, the new server looks like a clear win. The picture changes, however, if the project is evaluated through the lens of Economic Value Added (EVA), which tries to ferret out hidden costs. Although Stern Stewart, the methodology's creator, keeps some elements proprietary, the basic formula, below, is public. Fill in your numbers here or go to WWW.BASELINEMAG.COM/JAN03 for a digital version.

STEP 1: Net Operating Profit After Taxes (NOPAT)		This is variable
What Revenue did the system produce?		A
	Example: \$100,000	
How much do you pay annually to run and maintain the system?		B
	\$50,000	
Subtract A - B to obtain the system's Operating Profit.		C
	\$100,000 - \$50,000 = \$50,000	
Estimate the effect of taxes (here, 5% of Revenue). Multiply this percentage by the Revenue (Tax x A).		D
	5% X \$100,000 = \$5,000	
Subtract C - D to find the system's NOPAT.		E
	\$50,000 - \$5,000 = \$45,000	
STEP 2: Cost of Capital		
How much did you spend on equipment for this system?		F
	\$1,000,000	
What rate of return could have been earned by investing the money elsewhere?		G
	10%	
Multiply F x G to find your cost of capital.		H
	\$1,000,000 x 10% = \$100,000	
STEP 3: The Economic Value Added (EVA)		
Subtract E - H to see the adjusted return, or EVA.		EVA
	\$45,000 - \$100,000 = -\$55,000	