EVA Framework – Best Practices

List of Corrective Accounting Adjustments

Source: Best-Practice EVA, G. Bennett Stewart

1. Capital is the total sum of debt and equity funds raised from investors or retained from earnings and invested in net business assets.

Managers manage capital, not equity. EVA is based on an entity, not equity, view. It is unaffected by the debt/equity mix but depends solely on the quality of capital management. It values shares by valuing the business's enterprise and franchise value and measuring share price as the residual claim on that value.

2. Noncontrolling interests are excluded from the capital and from earnings.

Noncontrolling interests are viewed as suppliers or trade creditors, not owners. EVA measures the economic profit attributable to the parent company shareholders, and the present value of EVA is the value added to their investment in the business.

3. Surplus cash is discharged from capital, and the associated investment is excluded from earnings.

Marketable securities invested at market prices are assumed to be EVA neutral, by definition. EVA is unaffected by cash hoarding or distributions; it accurately measures the underlying business performance.

4. Leased assets are treated like owned; the present value (PV) of rents is added to capital; the interest component of rent expense is added back to earnings and the weighted average cost of capital on the PV of rents is deducted in its place.

The lease/buy mix is neutralized so that the management of the assets matters and not how the assets are financed. Also, this treatment gives a more accurate reading of leverage.

5. R&D and ad spend are added to capital and amortized over time (default for R&D is over five years, except 10 years for pharma and biotech; default for ad spend is over three years, except over five years for pharma and biotech); interest at the cost of capital on the unamortized balance is included in the capital charge.

EVA does not rise When managers cut the spending to make a short-term budget goal, nor does it plunge When managers invest more funds to create intangible assets; it neutralizes buy or build decisions for technology and brands; EVA is value-neutral — same present value by writing off over time with interest as expensing.

6. Impairment charges are reversed, added back to earnings and to capital as if the charges never occurred.

EVA is impaired, not the balance sheet, by investments that cannot cover the cost of capital.

7. Restructuring costs are considered to be investments that add to balance sheet capital.

Nonrecurring charges do not obscure underlying business performance. A restructuring is EVA positive if the benefits outweigh the incremental costs. Losses (or gains) on asset sales are irrelevant—What matters is whether the after-tax proceeds, invested at the cost of capital, generate a greater profit than would retention of the asset—which is the question EVA answers.

8. Tax provision is smoothed by applying a standard normal corporate tax rate.

One-time tax rate fluctuations (from refunds, penalties, judgmental changes in deferred tax asset valuation reserves, and the like) are smoothed and booked into a created deferred-tax account.

9. Interest saved by the net balance sheet deferral of tax, including created deferred taxes from above, reduces the tax on EVA.

Net business assets exclude deferred tax assets, making things simpler. All tax issues are consolidated into one truly effective, time-value-adjusted tax rate.

10. Operating reserves and deferrals (bad debt reserve, LIFO reserve, warranty reserve, deferred income) are included in capital, and the period changes are booked into NOPAT and EVA.

Penetrates earnings management and reveals the timing of recurring cash flows from operations.

11. Accumulated other comprehensive income (AOCI) hedge gains or losses are excluded from capital.

There is no gain or loss in a true hedge and no impact on EVA.

12. Retirement cost/liability distortions are purged.

Service cost replaces the reported retirement cost; the net funding deficit times the cost of capital reduces EVA, so that the present value of EVA fully deducts the funding gap to the firm's value (and vice versa for a funding surplus).

13. The weighted average cost of capital to measure EVA is based on a three-year average D/E blend, not the proportions recently employed.

Unlike EPS and ROE, EVA does not mix operating and financing decisions, and it is impervious to transitory changes in capital structure, such as when a firm borrows to finance a major acquisition.

14. The weighted average cost of capital to measure EVA is based on the average unleveraged beta for the company's principal line of business (industry).

Betas for individual companies are measured with error. The industry average unleveraged beta is generally a more accurate estimate of the underlying business risk that enters into the cost of capital.

15. The weighted average cost of capital to measure EVA is based on an expected 4 percent market risk premium (MRP) over the rate prevailing on 10-year government bonds as a relatively risk-free reference point.

Studies for U.S. market show a 4 to 6 percent MRP, but past averages likely overstate the future. Over the past 85 years, the United States has been a survivor, outlier market; liquidity, information flow, and wealth increased, which likely reduced the actual demanded risk premium but misleadingly increased the measured premium; the United States is coming to the end of its demographic baby boom times.

Learn more about Best-Practice EVA: https://amzn.to/3P23Hlb