Overall Performance EvaluationThroughEconomic Value Added

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It is a well-known fact of financial management, that profit maximization and wealth maximization are the primary objectives of any organization. However, several renowned economists and subject experts give precedence to wealth maximization over profit maximization. If an organization fails to create wealth then it is not only a burden on the internal resources of the organization but also a burden on the society and there is no reason to keep it running for an indefinite period of time.

Meaning ofEconomic Value Added

Economic value added (EVA) is a measure of a company's financial performance based on the residual wealth calculated by deducting its cost of capital from its operating profit, adjusted for taxes on a cash basis. EVA can also be referred to as economic profit, and it attempts to capture the true economic profit of a company. This measure was devised by Stern Stewart and Co.

Thus, EVA is the incremental difference in the rate of return over a company's cost of capital. Essentially, it is used to measure the value a company generates from funds invested into it. If a company's EVA is negative, it means the company is not generating value from the funds invested into the business. Conversely, a positive EVA shows a company is producing value from the funds invested in it.

Calculating EVA

The formula for calculating EVA is:

EVA= Net Operating Profit after Taxes (NOPAT) –[Capital Invested* Weighted Average Cost of Capital (WACC)]

The equation above shows there are three key components to a company's EVA. NOPAT, the amount of capital invested and the WACC. NOPAT can be calculated manually but is normally listed in a public company's financials. Capital invested is the amount of money used to fund a specific project. WACC is the average rate of return a company expects to pay its investors; the weights are derived as a fraction of each financial source in a company's capital structure. WACC can also be calculated but is normally provided as public record.

The goal of EVA is to quantify the charge, or cost, for investing capital into a certain project, and then assess whether it is generating enough cash to be considered a good investment. The charge represents the minimum return that investors require to make their investment worthwhile. A positive EVA shows a project is generating returns in excess of the required minimum return.

The Benefits of EVA

The purpose of EVA is to assess company and management performance. EVA champions the idea a business is only profitable when it creates wealth and returns for shareholders, and requires performance above a company's cost of capital.

EVA as a performance indicator is very useful. The calculation shows how and where a company created wealth, through the inclusion of balance sheet items. This forces managers to be aware of assets and expenses when making managerial decisions. However, the EVA calculation relies heavily on the amount of invested capital, and is best used for asset-rich companies that are stable or mature. Companies with intangible assets, such as technology businesses, may not be good candidates for an EVA evaluation.

Economic Value Added (EVA) is important because it is used as an indicator of how profitable company projects are and it therefore serves as a reflection of management performance.

The idea behind EVA is that businesses are only truly profitable when they create wealth for their shareholders, and the measure of this goes beyond calculating net income. Economic value added asserts that businesses should create returns at a rate above their cost of capital

The economic value calculation has many advantages. It succinctly summarizes how much and from where a company created wealth. It includes the balance sheet in the calculation and encourages managers to think about assets as well as expenses in their decisions.

However, the seemingly infinite cash adjustments associated with calculating economic value can be time-consuming. And accrual distortions can still affect the measure, particularly when it comes to depreciation and amortization differences. Also, economic value added only applies to the period measured; it is not predictive of future performance, especially for companies in the midst of reorganization and/or about to make large capital investments.

The EVA calculation depends heavily on invested capital, and it is therefore most applicable to asset-intensive companies that are generally stable. Thus, EVA is more useful for auto manufacturers, for example, than software companies or service companies with a lot of intangible assets.

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