

# EVA is the *Perfect* Non-GAAP Measure

By Bennett Stewart, CEO, EVA Dimensions LLC

Responding to a proliferation of “pro forma” measures and fearing their potential to mislead investors, the Securities and Exchange Commission issued “guidelines” in May 2016 about the procedures that companies must follow when they present investors with alternatives to the officially sanctioned GAAP measures of performance. This begs the question: How can companies that use EVA comply, and is it even worth the trouble? Does EVA provide benefits so significant that it warrants the extra effort?

Yes, it does. In this article, we show that EVA provides information that is significantly more valuable to investors and to managers than what is provided by GAAP, and in the process, we reveal just how incompetently GAAP measures a company’s wellbeing. While some managers are touting metrics they’ve jiggered to burnish their results, many more are understandably looking for legitimate ways to express the real value of their business performance. Our contention is that EVA offers the perfect solution to do that, and essentially for any business. We also find that complying with the regulations is not arduous. In fact, we show how to do it, and define the limited cases where action of any kind is necessary.

For example, companies are still able to use EVA for measuring and analyzing performance and guiding plans and decisions—as an internal management tool if you will—and they are free to tell investors how and why they use EVA in as much detail as they want, *and the SEC’s disclosure rules have no impact whatsoever*. The special disclosure requirements only kick in when a company chooses to reveal an estimate of its EVA profits or to tie compensation to it. Then it must reconcile EVA to the closest GAAP measure and explain how it uses EVA and why the adjustments that go into it are useful to investors.

Frankly, we don’t see presenting an EVA estimate to be at all essential. The market for the most part will pick up on a firm’s EVA and the value that it represents without a management disclosure. One reason: the value of a company’s EVA equals the value of its projected cash flows. Investors that use cash flow or an equivalent technique such as a dividend discount model are effectively valuing a company’s potential to earn EVA. Another reason: EVA Dimensions is a source of EVA data, statistics and valuation models on 20,000 global tickers, which are provided to money managers through an institutional equity research service and on-line portal called *Investor Express*. We also make EVA insights and stock ratings available to retail investors at Fidelity.com with reports covering the Russell 3,000 public companies. Granted, an estimate of EVA from management could be more accurate, given access to internal data, but unless compensation is tied to it, this disclosure step may be unnecessary.

If incentive compensation is tied to EVA—and there are very good reasons for doing that, such as to create a culture of ownership and a reliable connection between pay and performance—then

there's just no getting around it. EVA profit estimates must be disclosed, and the reasons for using it discussed. But the same applies to many other popular measures, such as return on capital, or EBITDA, or adjusted earnings-per-share. The obligation is not unique to EVA.

Nor is it as daunting to discuss EVA as it may seem. EVA is computed per a formula, a recipe, a set of rules. It's a question of explaining the recipe and showing the math. We will show how to do that with schedules and boilerplate language suited to the task, including a general-purpose template to reconcile EVA to GAAP net income, which you can edit.

In doing so, you will face a choice. You could narrow the schedules to the minimum required. That's a temptation, of course. But we counsel a different route. Why not turn the obligation into an opportunity? Why not voluntarily present an expansive discussion of EVA and management's motivations for using it?

Companies that do that are likely to find, as many others have, that investors, especially those that value the quality of management, will be impressed to find that EVA shapes the company's decisions, since there is no measure or management technique better than EVA. A public airing of EVA also can yield internal benefits. It's a convincing message that top management is seriously committed to it.

It's time to issue a caveat. Please do not construe our recommendations as legal advice. You must consult your counsel before making any moves.

### **The Disclosure Obligation**

Let's go into more detail on the SEC's concerns behind the disclosure rules and how EVA fits in. There's been an increasing reliance of companies on non-GAAP measures to tell their stories. The CFA Institute reports that alternative measures have become so ubiquitous that by 2015 only 31 companies in the S&P 500—just 6%—limited themselves to reporting just the GAAP results. One reason so many companies have turned to adjusted financials is that the ones they choose almost always make earnings look better—sometimes a whole lot better.

Factset, for example, found that the 20 Dow industrial companies that reported adjusted EPS figures for 2015 showed an average improvement of 31% over GAAP EPS. Similarly, S&P Dow Jones Indexes reported that the spread between GAAP and non-GAAP earnings for the S&P 500 was 25% in 2015, the biggest gap, so to speak, since the financial crisis. Given the mostly one-sided nature of the adjustments, it's hardly surprising that the SEC and some market observers suspect that companies have misrepresented performance by putting forth what one wag has called "earnings before the bad stuff."

Some of the common adjustments used in pro forma results reinforce such suspicions. The SEC has singled out the tendency to set aside extraordinary charges while leaving in extraordinary gains, while many securities analysts have challenged the practice of excluding the cost of equity-based compensation, which can be a large chunk of labor costs and is a real expense to existing shareholders through the potential dilution of their ownership interest in the firm. The SEC has a point: Such practices are misleading, and they don't stop here.

Retailers, for example, sometimes boost earnings by excluding the costs of opening new stores. And lately companies apparently have become increasingly fond of adding back the costs of restructurings and asset impairments. It's true. Many companies are systematically overstating their true profits by not accounting for the full cost of the capital they invest.

EVA, though, is at the opposite end of the spectrum from the measures that worry the SEC. Far from buffing up the earnings picture, EVA tends to produce lower estimates of corporate profits than reported under GAAP rules, chiefly because EVA deducts a charge to cover the opportunity cost of equity capital. EVA does not start to count profits until a minimum market-competitive return on equity has been earned. And while EVA follows "pro-forma" earnings in eliminating non-recurring charges, it maintains the integrity of double-entry bookkeeping by adding the charges back to capital, which means they are subject to an on-going cost-of-capital charge. There's a huge difference between sweeping unusual charges under the rug as many companies do and treating them, as EVA does, as a form of capital investment to sustain the going-concern.

EVA also make an allowance for investments that take time to pay-off, whether for acquisitions or new store openings or for acquiring new customers—something that managers will appreciate. To take one example, a company's R&D spending is not immediately deducted from earnings as it is in the GAAP measurement. Instead, with EVA, R&D costs are spread over time, over an interval that approximates its economic life, but in exchange, the cost of capital on the outstanding balance of R&D that has yet to be expensed is also deducted. In this way, the present value of the charge is preserved, but managers are allowed the time needed for the investments to ramp up and bear fruit. This resolves a tension in corporate governance, namely, how can managers invest for the long term when short-term accounting profits don't support that? Use EVA. It optimally balances leniency and accountability.

If anything, the SEC should find much to like in EVA. It provides a more conservative, consistent, and comparable measure of profit performance, one that comes much closer to measuring the real economic value added over a period. Of course, no regulator will publicly endorse EVA, but there are absolutely no grounds for disapproval of it either. A CFO or board of directors needn't be concerned that they are going out on a limb by using EVA as a non-GAAP measure. EVA is truly and fundamentally a better way to measure real value added, one and that is well documented in books, articles, and academic studies. Its credentials are further certified by widespread use in business school curricula, in the CFA (Chartered Financial Analyst) course, and by corporate managers and investors.

As for the SEC guidelines, companies are free to stake out a position that favors EVA. They are under no obligation to buy into the SEC theory that GAAP numbers are the fairest measure of performance and provide a useful framework for valuing a business. Managements can explain how and why they use EVA, why in their view it is superior, and why it is meaningful to investors.

Early reports indicate that companies aren't cowed by the SEC tougher stance on non-GAAP measures, and will continue to publish adjusted numbers that they use to make decisions and evaluate performance. A company that chooses to disclose and discuss non-GAAP measures like EVA will find that it is in the majority. The question is how to do it?

What follows is suggested boilerplate language that can be used to explain the virtues of EVA to investors (followed by a standard template any company can use to reconcile its book profits to EVA). In the process of defending EVA, it exposes just how inept book profits are as a measure of value. If you are not familiar with the shortcomings and blind spots, your eyes will be opened, and you will gain a better appreciation for how EVA repairs the pervasive flaws in GAAP accounting.

Feel free to shamelessly plagiarize, edit and abbreviate the disclosures we've furnished to suit your preferences (the expressions in brackets will need special attention). But keep our suggestion in mind. Be bold, and use this as an opportunity to showcase the value of EVA, not just comply with the rules. Also, if you choose to refer to EVA Dimensions as an authority, please get our approval of the disclosure before releasing it. Here goes.

### **The Case for EVA**

Management uses EVA (for economic value added) as a key measure of corporate performance and as a framework to determine which decisions, strategies and allocation of resources will produce the greatest value. [The company also uses EVA as a metric in determining both short- and long-term compensation awards].

EVA is an estimate of the true economic profit that remains after deducting a full weighted-average cost of capital charge on the net assets employed in our business. This means that, in addition to deducting the interest expense on our debt financing, EVA effectively sets aside a charge to cover the opportunity cost of the equity capital that our shareholders have put or left in the business. Unlike reported net income, EVA ensures that our shareholders earn at least a minimum competitive return on their investment before it starts to count profits.

To compute EVA, we use an overall cost of our capital of [XX.X%]. We believe that rate provides a suitable premium over government bond yields to compensate our shareholders and lenders for bearing the risk of our businesses. EVA, then, shows the money amount by which our net operating profits after taxes exceed or fall short of earning that minimum return on capital. And we cannot increase EVA unless we increase our operating profits above the full cost of any capital we invest.

EVA has the following important properties:

1. It increases as we decrease balance sheet assets and release capital from our operations; EVA correctly recognizes the value of speeding asset turns, investing capital wisely, and developing leaner business models.
2. EVA *decreases* if we invest too much money, or in the wrong ways, or overpay for acquisitions; it holds us accountable as stewards of our investors' savings.
3. EVA accurately measures the value we create by growing our business with investments that yield more than the full cost of capital. It does not reward us for simply maintaining value. We are motivated to invest, innovate and grow to increase EVA.

4. The present value of the EVA profits that we forecast we will earn is identical to the net present value of the cash flows we expect to generate, net of investment spending. By aiming to maximize the value of EVA, we maximize the value of the net cash distributions we can make to our investors over time. That is mathematically true because EVA sets aside in each period the profit that must be earned to recover the value of the capital that has been or will be invested, and thus it always discounts to the value added to or deducted from our invested capital base.

We believe that the period-to-period *change* in EVA provides the most accurate measure of our progress in expanding the firm's intrinsic market value, which over time translates into a higher share price and a superior shareholder return. Our chief financial goal, therefore, is to increase EVA, and we measure our progress by the growth in EVA and not by its level.

When we measure EVA, we consistently apply the set of corrective adjustments described below to remedy distortions embedded in GAAP accounting rules. We believe the adjustments produce a profit measure that is more attuned to the realities of our business and that more closely tracks the value we are adding period to period. [NOTE: this section will need to be edited to cover the adjustments a company has chosen to make and the specific ways they are made]

1. **Treat strategic expenses as investments:** Under GAAP accounting rules, the money we spend on research and development, and on advertising and promotion, training programs, launching new products and services, and starting up new businesses must be expensed, immediately deducted from earnings, as if those investments never can have an enduring value. This puts undue pressure on current earnings when we make investments like these and it is at odds with our practice of investing to grow the firm's long-term value.

Under EVA, such outlays are evenly charged off over a period of years approximating their economic lives. We don't try to do this precisely or judgmentally. Instead, we write off R&D over [five years] and amortize advertising and promotion outlays over [three years], which we believe are in line with the interval over which the spending will support sales and cash flows. [other outlays, such as for training, product development, market entry, customer acquisition costs, and market entry, also may apply and require discussion]. In exchange for spreading the cost over time, the cost of capital is applied to the unamortized balances, that is, to the spending amount from prior periods that has not yet been fully deducted from earnings, and that capital charge also is deducted from EVA.

Measured this way, EVA holds our managers accountable for generating an attractive rate of return on the investments they have made and will continue to make in innovation and growth. On the other hand, EVA gives our managers the time they need to make investments like these bear fruit, which means they are better able to focus on adding value over longer horizons. It also discourages them from cutting the spending just to make a short-term earnings goal.

2. **Reverse impairment charges:** Rather than deducting asset impairment charges from profits, as GAAP requires, with EVA the charges are reversed. Impairment charges are added back to earnings and added back to our measure of capital, which means they are subject to an on-going

capital charge. An impairment charge thus is a non-event, and has no impact on EVA. Compared to book net income, EVA is a better indication of our underlying operating results.

Another advantage to this approach is that EVA ends up reflecting impairments in value even when the accounting records might not yet reflect it. If we make an investment that falls short of covering the cost of capital, then that shortfall translates into on-going reduction in the EVA profit that we record. It is EVA that is impaired, not a bookkeeping value. There are no mulligans with EVA accounting. We don't get to write off mistakes and forget about them.

3. **Capitalize restructuring costs:** With EVA, the money spent on restructuring our business operations—for things like severance pay, cancelling contracts, or relocating assets—is not taken as an earnings charge. Restructuring costs are added back to earnings and to balance sheet capital, making them subject to an on-going capital charge. With this, restructuring charges do not hit and distort profits in the period incurred. Investors can more clearly perceive the value of the underlying business. At the same time, we must deliver improvements that cover the cost of any additional capital we invest in the restructuring—in streamlining our operations and mobilizing our assets—or else EVA will suffer. EVA thus gives us the incentive to restructure promptly and efficiently, and enables investors to judge if we have been successful.
4. **Use cash accounting for losses and gains on sale:** Losses on asset sales, after taxes, are added back to profits and to capital. With this adjustment, no charge deters us from selling assets that can only be sold for less than their accounting book values. We also are motivated to seek the highest sale prices and minimize losses because losses are added back to capital, which adds to the capital charge. Simply put, EVA gives us the incentive to sell all assets that are fundamentally worth more to others, ones for which the sale proceeds, net of tax, invested at the cost of capital, will produce more long-run EVA than continuing to own the businesses.

The treatment is symmetrical; gains on sales are *excluded* from profits and apply as a *reduction* in capital. There is no EVA benefit to harvesting a gain in one period that reflects the capitalized value of the EVA profits that the asset could produce in future periods. The incentive, though, remains the same. Regardless of bookkeeping gain or loss recognition, we are motivated to sell assets and businesses to buyers that see more value, and that will pay more value, than we see. Accordingly, we constantly review our portfolio to ensure we remain the best owner.

5. **Eliminate the impact of holding surplus cash:** Excess cash and marketable securities [above 2% of sales] are removed from capital, and the associated investment income is removed from earnings. EVA thus isolates the performance of our business, which makes it a more comparable indicator over time and versus peers.

Also, because EVA is measured as if excess cash had already been paid out, if it is paid out—either as a dividend or share repurchases—it is a non-event. With EVA, a distribution of cash to our shareholders—who own the cash in the first place— is considered equivalent to withdrawing money from a savings account. The depositor, or shareholder, is more liquid but

not wealthier, with the cash in hand instead of in the bank. Earnings-per-share, by contrast, often gets a powerful boost from a share buyback, which is a distortion that EVA avoids.

6. **Treat leased assets as if they were owned:** The interest component of rents is backed out of profits, after taxes, and the full cost of capital on the estimated present value of rents is deducted instead. EVA is thus measured as if all rented assets were owned. It depends on the quality of asset management and not how the assets are being financed. It improves comparisons of our results over time and against companies that employ a different mix of owning or renting assets.
7. **Smooth Taxes:** The tax on EVA is computed by applying a standard tax rate of [XX%] to our operating profits. The standard rate approximates the average effective tax rate we expect to incur on pre-tax, pre-interest operating profits. One-time tax settlements and penalties, shifts in tax reserves and temporary changes in effective tax rates thus do not obscure how well our business is performing. Those distortions are smoothed and accumulated in a special “created” deferred tax account we maintain to compute EVA (discussed below).
8. **Recognize the value of deferring taxes:** EVA is credited with the cost of capital that is saved by using tax deferrals (including the “created” deferrals from smoothing mentioned above) as an interest-free form of financing. It’s symmetrical: Deferred tax assets, which represent a pre-payment of tax and a use of cash compared to the book tax provision, are charged for the cost of capital. Our managers are motivated to take the timing of tax payments into account when making business decisions. They also look for legitimate ways to enhance cash flows by postponing tax payments.
9. **Recognize the tax benefit value of deducting stock options:** The value of stock options that our employees exercise is a tax-deductible expense that reduces our tax bill and effectively funds our business with interest-free capital. The cost of capital on the excess tax benefit of exercised stock options (excess to the expected cost) is thus added to EVA.
10. **Exclude hedge gains (losses) from capital:** With GAAP accounting, an increase in the value of a derivative instrument that is being used to hedge operations is recognized by an increase in its book value, until the hedge is closed out. The capital charge associated with marking hedges up to market value is not deducted from EVA, however. Derivative gains are presumed to be offset by losses not yet recorded on the offsetting positions they hedge. In economic reality, there is no more capital if the hedge is effective. The same applies to derivatives losses, in reverse.
11. **Eliminate retirement cost distortions:** Reported retirement costs are added back to earnings and service cost is deducted instead. Service cost is an estimate of the money sum we’d have to invest at a safe government bond rate of interest to cover the retirement benefits that employees earned due to the services rendered *in the current period*. It is the true incremental cost of sponsoring a retirement plan, and it is the cost that is deducted from EVA.

Reported retirement costs, on the other hand, offset service cost with forecast assumptions about the likely rate of return that will be earned on the company's retirement funding portfolio. GAAP rules thus incorrectly mix the true operating cost with decisions and assumptions about how to finance the cost, which is a distortion that EVA avoids.

GAAP rules also err in how funding shortfalls (or windfalls) are handled. With GAAP, a deficiency in retirement fund assets relative to the accumulated liability is typically recognized as balance sheet liability, with an offsetting reduction in equity through a charge to Other Comprehensive Income. This introduces two distortions. One, the charge does not normally enter reported profits (the charge is deducted only if the liability is very large; otherwise it has no bearing on reported income). Second, the charges to Other Comprehensive Income reflect the *changes* in the value of the unfunded obligation. That misleadingly concentrates the liability cost that can be made up over many years in one period.

Rather than ignoring it or taking the charge up-front, EVA turns a funding shortfall into an on-going earnings charge by multiplying it times the cost of capital (and to be consistent, the funding shortfall is measured relative to the accumulated service cost, not the reported cost). A \$100 million shortfall at a 6% cost of capital, for example, leads to a \$6 million charge to EVA. This deduction ensures that the present value of EVA, net of the capital charge, fully subtracts the existing funding liability from a determination of the firm's value (and vice versa, it adds a funding surplus). It also sensitizes management to the risks in pension funding strategies, because swings in the value of the pension portfolio produce swings in our EVA earnings. Buffering or smoothing to hide the economic reality of the funding choices we make is not allowed in the computation of our EVA profits.

12. **Meter strategic investments into capital:** With EVA, a portion of the up-front capital invested in strategic investments, such as acquisitions or major plant expansions, is held back, and then it is metered back into capital over the time horizon we project is required for the returns on the investments to ramp up fully. In this way, EVA is not penalized with a capital charge that cannot realistically be covered during early stages, but in exchange management is accountable for eventually delivering a fully satisfactory return.

This is the one adjustment that is not based on a strict formula. It requires judgement. A company committee, chaired by the CFO, and reporting to the board's audit and finance committee, is responsible for reviewing and approving any such adjustments. The hold back rules are set for each qualifying investment at the time a new investment or acquisition is approved, and may include adjustments that are contingent on reaching key milestones. [if this adjustment is used it may require more elaboration and disclosure]

We believe that each of these adjustments that we apply to measure EVA makes it an even more accurate and consistent estimate of the firm's true profit performance. We also find that these adjustments give our managers better insights to how to make the best decisions for our shareholders.

All adjustments to income are measured post tax using a marginal tax rate of [XX%]. Deferred tax balances also are adjusted for the tax consequences of the adjustments described above.

As for our cost of capital, we compute the 12-quarter moving-average blend of the debt and equity components of our capital, and we apply those proportions to weight the prevailing after-tax interest cost of debt and our estimate of the opportunity cost of our equity capital. Thus, unlike earning-per-share and return on equity, which are influenced by the specific debt/equity mix a company uses, EVA is based on a long-run average capital structure mix. It is impervious to transitory changes in capital structure, such as when we might borrow to finance a major acquisition or to buy-back our stock.

As a practical matter, we simplify the market-derived cost of capital. We have settled on a [X.X%] cost of capital as a strategic hurdle. We intend to measure our EVA against this return goal until capital market conditions or changes in our financing strategies warrant a revision, in which case we will re-compute our EVA to provide a consistent foundation for assessing our progress over time.

We intend to apply these rules to measure EVA for the foreseeable future, and only will modify them as warranted by changes in our business or accounting rules. Moreover, to ensure the integrity of our EVA calculations, we use software provided by EVA Dimensions, a recognized authority in the field of EVA. The software has been thoroughly tested and is programmed to input our audited financial statements and convert them to estimates of EVA per the rules described above.

EVA is not just a metric for us. It weaves through our entire management system and keeps us focused on adding value in all these ways:

1. **Mission:** Our main financial goal is to *increase* EVA as much as we can on a sustainable basis over moving three-to-five year windows. This motivates us to pursue all available paths to improve our performance, which include:
  - a. Cutting wasteful costs and reengineering processes to make them more efficient
  - b. Earning the right to charge premium prices with products and services that delight customers
  - c. Trimming our need for working capital, including paring reliance on inventories
  - d. Maximizing the return that we derive from IT assets
  - e. Developing fundamentally leaner business models that require us to use less capital
  - f. Outsourcing assets and activities to more capable partners
  - g. Selling businesses and assets that are worth more to others, even if that requires taking a charge to GAAP profits
  - h. Pruning product lines and production functions that are incapable of covering the cost of capital
  - i. Investing capital sparingly, imaginatively, and accountably to meet our business goals
  - j. Seeking out all channels for profitable growth over the cost of capital, even if they lead to a dilution in our profit margin or return on capital
  - k. Optimally investing in enhancing brand value and customer loyalty, in innovative new technologies, and in developing and engaging our people
  - l. Minimizing our overall cost of capital through the prudent management of funding sources and effective communications with investors

2. **Management:** We subject decisions of all kinds to an EVA test, rejecting those that won't help us to increase the company's EVA over time. We look for ways to structure our business plans and stage our investment decisions to maximize their EVA potential. We won't pay more for an acquisition than we can see it is worth when valued through the lens of EVA, including an honest appraisal of the synergies we can realize. We employ a set of software tools from EVA Dimensions that enable us to simulate the EVA of a decision before we commit to it.
3. **Measurement:** We structure quarterly and annual performance reviews around measuring EVA and understanding the levers driving it and how we can improve it. We compare our EVA growth and sources of growth against our plans, prior results, and the performance of public peers. The feedback helps us to see if our plans and investments are working and the mid-course adjustments that might be needed.
4. **Motivation:** We have tied incentive compensation to EVA. We are rewarded through a profit sharing formula that carves off a percent of the increase in EVA achieved by the company and by our lines of business as a premium incentive award. This motivates us to focus on EVA and to work as a team to increase EVA as much as we can over long horizons.
5. **Key Indicators:** We use three ratio metrics derived from EVA to guide our decisions:
  - a. **EVA Margin**, or EVA as a percent of sales, is an indication of the profitability and productivity of our business model. It combines income efficiency and balance sheet asset management into a net profit margin score.
  - b. **EVA Momentum**, which is the change in EVA over a period divided by prior period sales. It is a measure of the rate of growth in EVA, scaled to the sales size of the business. The bigger it is, the more EVA we are generating, and the more value we are creating.
  - c. The third is **Trend EVA Momentum**. It is the slope of the least-squares regression line that passes through the past four years of EVA, divided by the average of sales in the first three years. It gauges our strategic success at adding economic value over time. It is less volatile and more fundamental than a point-to-point growth statistic. [We also use Trend EVA Momentum determining LTIP awards for senior managers.]

We track these metrics for each business unit and the consolidated company. We use them to study trends, identify strong points and gaps relative to peers, and to help us formulate more valuable plans. We aim to maximize EVA Momentum as our chief planning goal. We allocate resources and fund strategies that have the best likelihood of increasing it.

By focusing our efforts on increasing EVA and using it for making decisions, checking results, and metering incentive pay, we believe our management system is both simple to understand and administer and highly effective. EVA establishes a common mindset and shared language that unites all our team members in a "behave-like-an-owner" culture that helps us to make better decisions and create more value than we could without it.

This concludes the boilerplate explanation of EVA. Up next, reconciling EVA to GAAP.

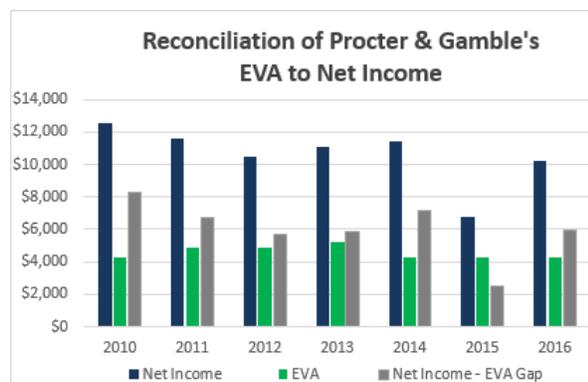
## Schedule Reconciling EVA to Net Income

As mentioned, we've developed a template to reconcile net income to EVA as required by SEC rules. The gap between the two is large for most companies, chiefly because book income is measured without a deduction for the cost of equity capital while EVA recognizes that as a legitimate cost of doing business. EVA also deducts a capital charge for the accumulation of unusual items, impairments, losses on sales and restructuring charges carried over from prior periods (in exchange, EVA ignores the charges in the period they occur). EVA also writes off R&D and ad spending over time, but with cost of capital attached to the unamortized balances, which means the total charges deducted from EVA exceed those deducted from accounting profits. In many ways, EVA is a more conservative measure than GAAP profits, but it also is a far more realistic and accurate indication of how well a company is doing.

Procter & Gamble Co		2016
<b>EPS to EVA Reconciliation</b>		
Net Income (Loss) - Available for Common		\$10,253.000
Net Income (Loss) Per Share		\$3.80
Net Income (Loss) % of Sales		15.7%
Income and Capital Charge Adjustments		-\$5,972.268
Adjustments Per Share		(\$2.21)
Adjustments % of Sales		-9.2%
1. Deduct the Full Cost of Capital		-\$5,198.253
2. Eliminate Surplus Cash		\$487.015
3. Eliminate Other Non-Operating Items		\$145.994
4. Capitalize Intangibles		-\$1,074.825
5. Capitalize Goodwill Impairments		-\$96.736
6. Capitalize Special Items		-\$295.523
7. Eliminate Retirement Cost Distortions		\$12.858
8. Smooth Taxes		\$47.202
<b>EVA</b>		<b>\$4,280.732</b>
EVA Per Share		\$1.59
EVA % of Sales		6.6%

The table at left is a summary schedule that ties EVA to net income using Procter & Gamble as an example. The table was generated by EVA Dimensions' software. It is coded to convert conventional GAAP financial statements into EVA according to the rules a company sets in the software, which include options to follow GAAP closely or to invoke any or all of the suggested EVA adjustments outlined in this memo. The software also enables users to select specific parameters for things like the cost of capital, tax rates, and the amortization period for R&D spending, for example. It's easy to personalize the rules to fit a company's business model and preferences.

The table shows that P&G's net income available to its common stockholders in 2016 was \$10.253 billion and its EVA, using our estimate of 5.4% for P&G's cost of capital, was \$4.281 billion, *\$6 billion lower!* The gap is explained in the schedule using 8 of the available 12 categories (a sample of these are discussed in more detail later in this memo).



The blue bars in the chart at left plot P&G's reported net income for 2010 to 2016, and the green bars depict its EVA. The gray bar is the gap between the two, which has been quite sizable, typically \$6 to \$8 billion. Said differently, reported profits generally are more than twice as large as EVA.

EVA trends also diverge in important ways from the reported results. Net income declined over the 2010-2012 period, *but EVA increased*; Net income improved significantly in 2016, *but EVA was flat*. In each case, the EVA trend is more meaningful for all the reasons we have discussed.

## Examples of Reconciliation Details

Let's step through a few of the line items in the P&G reconciliation schedule as examples.

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5. Capitalize Goodwill Impairments		-\$96.736
6. Capitalize Special Items		-\$295.523
7. Eliminate Retirement Cost Distortions		\$12.858
8. Smooth Taxes		\$47.202
<b>EVA</b>		<b>\$4,280.732</b>
EVA Per Share		\$1.59
EVA % of Sales		6.6%

**1. Deduct the Full Cost of Capital:** Replacing GAAP financial charges with the full cost of capital reduces EVA by \$5.2 billion compared to reported net income, and involves the following steps:

- ✓ Add back the financing charges that were deducted from GAAP net income; add back interest expense (after taxes) and preferred dividends
- ✓ Deduct the full cost-of-capital charge on the quarterly average balance of reported net assets
- ✓ Net assets are reported total assets less accounts payable, income taxes payable, accrued expenses, other liabilities, and minority interests.

**2. Eliminate Surplus Cash:** Setting aside surplus cash increases EVA by \$487 million, with these steps:

- ✓ Deduct investment income, after tax, from GAAP net income
- ✓ Rebate, or add back, the [5.4%] cost of capital on the average quarterly surplus cash balance.
- ✓ Surplus cash is deemed to be cash and marketable securities holdings above [2%] of sales over the prior 4 quarters].

**4. Capitalize Intangibles:** Amortizing R&D and advertising & promotion spending over time instead of expensing it, and deducting the cost of capital on the unamortized balances, after taxes, reduces EVA by \$1.1 billion, for two reasons. One: The amounts spent in 2016 were considerably lower than the amortization of the spending sum over the prior 5 years. Two: EVA is charged for the cost of capital on the unamortized balances carried over from prior years. Unlike net income, EVA imposes the obligation to generate an attractive return on the stream of investments.

- ✓ Add back the R&D and advertising and promotion expenses of the period to profits
- ✓ Evenly amortize R&D spending over 20 quarters and ad and promo over 12 quarters, after taxes
- ✓ Deduct the [5.4%] cost of capital on the average quarterly unamortized balances, after tax.

**6. Capitalize Special Items:** Adding back unusual losses (net of gains) to earnings and applying the cost of capital to the accumulated balances since [2003] reduces EVA by \$295.5 million.

- ✓ Add back the unusual and non-recurring charges (less gains) of the period, after tax
- ✓ Deduct the [5.4%] cost of capital on the average quarterly balance of the unusual charges (less gains), after tax, accumulated since [2003]
- ✓ Deduct the earnings of discontinued operations
- ✓ Add back the [5.4%] cost of capital on the average quarterly balance of the net assets of discontinued operations.

Procter & Gamble Co		2016
<b>EPS to EVA Reconciliation</b>		
Net Income (Loss) - Available for Common		\$10,253.000
Net Income (Loss) Per Share		\$3.80
Net Income (Loss) % of Sales		15.7%
<b>Income and Capital Charge Adjustments</b>		
Adjustments Per Share		(\$2.21)
Adjustments % of Sales		-9.2%
1. Deduct the Full Cost of Capital		-\$5,198.253
2. Eliminate Surplus Cash		\$487.015
3. Eliminate Other Non-Operating Items		\$145.994
4. Capitalize Intangibles		-\$1,074.825
5. Capitalize Goodwill Impairments		-\$96.736
6. Capitalize Special Items		-\$295.523
7. Eliminate Retirement Cost Distortions		\$12.858
8. Smooth Taxes		\$47.202
<b>EVA</b>		<b>\$4,280.732</b>
EVA Per Share		\$1.59
EVA % of Sales		6.6%

**8. Smooth Taxes:** Setting tax to a rate of [XX%] on operating profits and adding back the cost of capital on the net deferral of taxes increases EVA by \$47 million.

- ✓ Add back the tax provision on pre-tax, pre-interest operating profit (EBIT) (which is the reported tax provision, plus tax at a marginal rate of [YY%] on the gap between EBIT and pre-tax income)
- ✓ Deduct a tax on EBIT at the rate of XX%
- ✓ Add the [5.4%] cost of capital on the net deferred tax liability (measured relative to the standard tax).

This concludes the sample descriptions of the reconciliation adjustments. Once again, a full description of all adjustments is available from EVA Dimensions and the full reconciliation report revealing all the computation logic is coded into our software.

*EVA Dimensions is a financial technology company that provides its clients with access to a set of software tools that automate the best practices in using EVA for analyzing and benchmarking performance, setting goals, measuring and improving business plan value, and finding and pricing winning acquisitions. Please contact us for a demo or trial, including a reconciliation analysis.*

## Miscellaneous Adjustments to EVA

Depending on the company, other adjustments, such as those listed below, can enter the measurement of EVA. Even with these, the list is not exhaustive. EVA Dimensions can help you think through the rules you'll want to establish to measure EVA in a way that strikes an optimal balance between keeping it simple and making it effective as a management tool.

1. **Convert certain accruals to cash flow:** Instead of deducting a provision for bad debts as GAAP mandates, bad debt charge-offs net of recoveries occurring in the period are deducted. EVA switches from a bookkeeping estimate to realized events. Other similar adjustments include folding deferred revenues into profits as the cash is received, and deducting warranty costs and self-insurance costs as cash outlays are incurred instead of as a forecast expense that is accrued. In each case the related balance sheet reserve is added to capital, which increases the capital charge. With EVA, it is as if cash accounting had been used for these items. [Discuss with us the relative merits of these adjustments for your business]
2. **Convert LIFO inventory costing to FIFO:** The LIFO reserve is the difference between the value of inventories using a first in, first out (FIFO) costing assumption and a last in, first out (LIFO) assumption. Under EVA, the reserve is added to capital and the change in the reserve is added to profits, after taxes. This shifts capital from reflecting a LIFO inventory valuation to a FIFO value, which generally better approximates current replacement costs. It also effectively shifts cost-of-goods sold from LIFO to FIFO costing while preserving the tax benefit of deducting the generally more expensive LIFO costs. Another benefit is that it cancels illusory GAAP profits that are recorded when inventories are depleted and outdated LIFO inventory layers are liquidated.
3. **Exclude gains and losses on debt retirements:** These are considered financial in nature and not part of operations. They are backed out of reported income, but are *not* included in capital. They adjust financing flows on the EVA version of the cash flow statement.
4. **Capitalize unusual and non-recurring items:** Reported profits can be affected by settlements, acquisition and merger related costs, discontinued operations, and other extraordinary and non-recurring items. Under EVA, all material and identified non-recurring charges like these, less gains, after tax, are excluded from earnings, and to be consistent, are added to balance sheet capital as another form of investment that is required to sustain the going-concern.