CVP news
Corporate Finance Insights

What Gets Measured Gets Managed

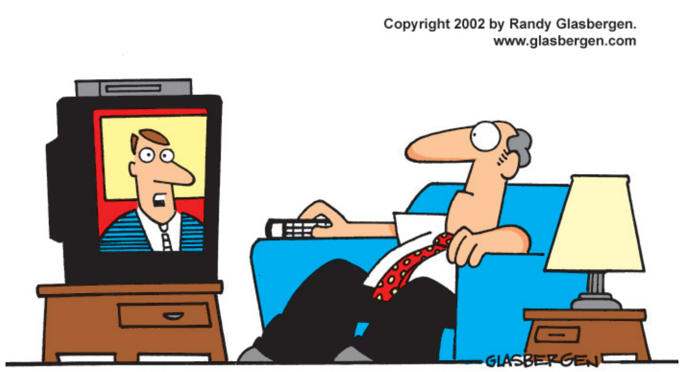
The last few newsletters have focused on a measure of corporate performance called return on assets ("ROA"). We dug into it and looked at what makes it work and then we made some adjustments to make it a better measure of operating performance. In this newsletter let's take a look at another way to measure corporate performance called residual income ("RI"), which is also called economic profits or economic value added ("EVA"), a term coined by Bennett Stewart.

Residual Income

Similar to ROA, RI is a way to measure the performance of an entire business or a business segment (such as a division). While conceptually similar to ROA it is clear that RI goes about its measurement task differently. It is because of these differences that many experts have been recommending RI as a better way to measure corporate performance even when I first started working (oh, so many years ago).

In calculating RI, a capital charge is deducted from after-tax operating profits. Here's how it looks:

Operating profit	$1,500
Less income taxes	525
Operating profit, after tax	$975
Net operating assets	$5,000
Less operating liabilities	500
Net capital employed	$4,500
Multiplied by the cost of capital	20%
Capital charge	900
Operating profit, after tax	$975
Less capital charge	900
Residual income	$75



"Stocks plummeted today on forecasts that the sun will rise again and tomorrow will be another day."

There are lots of ways that you can measure each part of the formula, but here are some of the general assumptions that are often used in practice:

1. Operating profit should include depreciation expense. This is done to capture the "using-up" and replacement of fixed assets. But you should

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know that there is a debate as to which method of depreciation best reflects how assets are "used-up."

2. Income taxes should be actual cash taxes you expect to pay without considering deferred tax issues or the shield that comes from interest expense.

3. Operating assets should exclude things like LIFO reserves, deferred tax assets and cumulative goodwill amortization. Non-operating assets (such as excess cash and marketable securities) should also be excluded. While fixed assets are included net of accumulated depreciation, there could be reasons to include them at gross book value or even replacement value. Other adjustments to operating assets are sometimes made in practice.

4. Operating liabilities should be only those non-interest-bearing current liabilities that are tied to operations, such as accounts payable and accruals. Interest-bearing and deferred tax liabilities should be excluded.

5. The cost of capital can be a difficult thing to estimate for privately-held companies (for a lot of reasons). You might need some help determining it, and even after you get comfortable with a number always keep in mind that it is a changing estimate. It's a good idea to make sure that you have the right cost of capital at least annually. Also, it might be a good idea to estimate the cost of capital as a range (let's say plus or minus 2% to 5%).

How Do You Use It?

Reading the results is pretty straightforward. If RI is positive then the business created corporate value to that extent. In the example in this newsletter the business had a $75 increase in corporate value. If the result is negative then corporate value was reduced to that extent.

As we discussed in prior newsletters the magic really is in the details. There are many different ways that executives have measured each of the line items in the formula. It depends on each company and what they are trying to achieve.

Some companies use RI (and to a lesser extent ROA) as a management bonus tool. If you are using RI for management bonuses remember that the measure of performance should be appropriate for the level of responsibility of the manager being evaluated. A mid-level manager with little or no input in investment decisions should not be evaluated in terms of RI. The better measures would probably be related to sales or certain expenses alone or some activity measure (such as customer complaints or product defects), or profitability if they can have an impact on it. RI is a comprehensive way to look at a business and reflects the performance of the highest levels of management.

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporatevaluepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

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