Sure, your accountant asserts that you have earned a profit, but you could still be losing money! For example in Table 1, a privately-held seed company had revenues last year of $2.5 million on $2.4 million in expenses, giving it an accounting profit of $100,000. However, the owner has $1.5 million of equity invested and could earn 10 percent in other investment opportunities. Thus, the equity could have generated a return of $150,000. By choosing to invest in the seed company instead of the other investment opportunities, $50,000 of value was destroyed.

Economic profit or EVA measures the value created by a business after accounting for the cost of all resources, including both debt and equity capital. The difference between EVA and accounting profit is essentially the cost of equity capital (how much return your investors demand). Numerous businesses, such as AT&T, Briggs and Stratton, Coca-Cola, and the U.S. Postal Service, utilize EVA when measuring performance rather than accounting profit because it accounts for all costs and is thus more useful in measuring bottom-line performance.

**Computing EVA**

The mechanics of computing EVA for a seed business are relatively straightforward as reflected in Table 2. Once operating profit has been calculated, a charge for taxes and interest paid on debt is deducted to obtain net operating profit after taxes and interest. The cost of equity capital is computed as the equity of the business times the rate of return required by investors. This required rate is in reality a rate of return that could be obtained on the funds if they were invested with similar risk as the company. A positive EVA means the firm is generating a return to invested capital that exceeds the required rate of return on the invested capital. Negative EVA indicates that the firm did not generate a sufficient return to cover the cost of its equity capital and all other costs.

**Improving EVA**

What insight does EVA provide about financial performance of a business and how to improve it? Like any financial measure,
the trend over time may be more valuable than the absolute value of EVA. Even if EVA is positive, a declining EVA suggests that financial performance is deteriorating. If this trend continues, EVA will become negative and financial performance will be unacceptable.

So what are some corrective actions if EVA is negative? First, operating performance with respect to operating profit margins (reducing costs or increasing prices) and/or asset turnover ratios (expanding sales) could be improved to generate more revenue without using more assets. Second, capital invested in the business might be reduced by selling under-utilized assets. This strategy will simultaneously improve operating performance through a higher asset turnover ratio and reduce the capital charge against those earnings because of a reduced debt or equity capital investment. Third, capital may redeployed and invested in projects that have higher operating performance than current investments. Through the restructuring of assets, seed businesses may be able to reduce the proportion of poor-performing assets and reinvest the proceeds in higher-yielding assets. EVA analysis forces a business to identify a true rate of return for each of its profit centers as well as for the company as a whole.

Finally, if the business is not highly leveraged and the interest rate is lower than the required return to equity, changing the capital structure might be an option. Using debt as the primary source of funds to expand or grow the business in the future will increase the EVA. Even though this strategy may increase interest costs, it will improve the EVA because a larger proportion of lower cost debt and a smaller proportion of higher cost equity can be used to finance the business.

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