Return on Capital Employed and Return on Equity

by Jim Shoesmith

Return on Capital Employed and Return on Equity are so interlinked that both these terms will be considered. These Returns are, basically, simple and useful concepts; they have however been so manipulated (abused, some people would say) over the past few decades that they now more often confuse rather than illuminate the evaluation of company performance.

The concept of the Returns is intuitively valid and useful: what Return is being made on Capital Employed and on Equity? In particular it is important to know whether the company is earning more than its cost of capital.

Simplistically, the Return on Capital Employed is the profit before interest and taxation (ie turnover less costs) as a percentage of the capital employed in the business (ie fixed assets and net current assets) irrespective of whether financed by shareholders equity or borrowings. It is a measure of the profit earned by the business irrespective of how that business is financed.

Also simplistically, the Return on Equity is the profit *after* interest but before taxation (ie turnover less costs and less interest paid) as a percentage of shareholders equity (capital employed less borrowings). It therefore only differs from Return on Capital Employed as it takes account of the gearing achieved by borrowings.

The following simple example illustrates these definitions.

	Return on Capital Employed		Return on Equity
Tangible Fixed Assets *(Land, buildings, fixtures and fittings, plant and machinery etc)*		80	80
Net Current Trading Assets *(Inventories, trade debtors, working balance of cash at bank less trade creditors)*		20	20
Capital Employed		100	100
Borrowings	ignored		40
Shareholders Equity Funds	ignored		60
Profit before Interest *(Turnover less costs)*		20	20
Interest Paid on Borrowings *(at 5%)*	ignored		2
Profit after Interest			18
Return on Capital Employed/Equity		*20%*	*30%*

Even with very simple examples there have always been differences of calculation. For example: should Capital Employed be at the start or end of the year or an average, and if an average of how many different dates (2, 3, 5 or 13 point averages)? Could be crucial with growing businesses.

Warren Buffett prefers Return on Equity but without undue borrowings and without accounting gimmickry (all references to Buffet are sourced from The Warren Buffet Way by Robert G. Hagstrom Jnr page 87 onwards). This raises the question of what is 'undue' borrowings and what is 'accounting gimmickry' (such gimmickry is like many things, easy to recognise when it is obvious but hard to define). Buffet makes matters difficult when looking at companies in general as he advocates valuing marketable securities at cost rather than market value; something which is almost impossible when assessing public companies.

But over the past decade or so financial reports and their interpretation have become more complex and this has greatly increased the scope of possible different definitions and interpretations.

Capital Employed is derived from published balance sheets which now very often include substantial intangible assets, mainly goodwill arising on acquisitions (the amount that the purchase consideration exceeds the fair value of assets acquired). Intangibles can be:

> included in Capital Employed at original value - *difficult without access to unpublished information:*
>
> written off against shareholders funds - *has the attraction of ignoring an asset that, in a way, does not exist but produces distorted returns;;*
>
> or a combination of both by taking the written down value on the balance sheet - *simple but does make comparison between companies difficult.*

Cadbury Schweppes illustrates the issue: recently it had capital employed of £5,277 million but including intangibles, at written down value, of £3,721 million. The original value information is not published and therefore the first option is not possible. Writing the intangibles off against shareholders funds would reduce the capital employed very substantially from £5,277 million down to £1,556 million; as the profit was £919 million the Return on Capital Employed would either be 17% or an ‘absurd’ 59%. The normally well-respected CompanyRefs went for the 59%! Other analysts went for the ‘more reasonable’ 17%.

There are other major issues within Capital Employed: provisions, especially for deferred taxation and pension fund deficits, these are now often very significant within the context of Capital Employed. Are these:

> liabilities to be deducted when calculating Capital Employed, *intuitively correct but does reduce Capital Employed and therefore flatter the Returns.*
>
> or are they interest free borrowings, *legalistically incorrect but the approach that many, including credit rating agencies, often take; producing more realistic Returns.*

Profit should be a simple concept but again the concept of ‘exceptional’ items introduces considerable confusion. The basic idea is to separately identify exceptional gains or losses so that the underlying, or normalised, profit can be identified and used in, for example, the Returns being considered here; many analysts, including CompanyRefs, use normalised profit when calculating the Returns. But companies tend to highlight exceptional losses but not exceptional gains and therefore normalised profits are often consistently higher than reported profits; Returns would therefore be overstated. Emap provides a good example over the five years 2000 to 2004.

Years to 31st March	2000	2001	2002	2003	2004	TOTAL
Reported Profit £m	157	-527	-69	140	144	-155
Normalised profit £m	115	72	139	149	166	+641

Warren Buffet ignores such capital gains and losses; so what would he make of Emap?

Other profit considerations arise around amortisation of goodwill (practice varies widely within the same accounting principles).

Each of the Capital and Profit issues discussed above are difficult in themselves, but when combined there is great scope for different analysts arriving at different views and calculating different Returns; the permutations are not limitless but they are so varied as to make any consensus impossible.

As the long established definitions set out in the first table above have effectively been abandoned and as accountants and financial analysts have not, after many years of debate, yet arrived at a new standardised definition of these returns, then this paper is not going to resolve the matter and provide universally acceptable definitions. Even Buffet only has answers for Berkshire Hathaway companies as he has the knowledge and the authority to make adjustments his way. All that is possible here is to highlight the issues and leave each individual reader to form their own views.