

UDHNA COLLEGE

M.COM.SEM-II

FINANCIAL & MANAGEMENT ACCOUNTING-IV

UNIT-3 RETURN ON CAPITAL EMPLOYED (15%)

(Theory Only)

What Is Return on Capital Employed (ROCE)?

Return on capital employed (ROCE) is a financial ratio that can be used in assessing a company's profitability and capital efficiency. In other words, this ratio can help to understand how well a company is generating profits from its capital as it is put to use.

The ROCE ratio is one of several profitability ratios financial managers, stakeholders, and potential investors may use when analyzing a company for investment.

How to Calculate the Return on Capital Employed

The formula for ROCE is as follows:

$$\text{ROCE} = \text{EBIT} / \text{Capital Employed}$$

Where:

EBIT=Earnings before interest and tax

Capital Employed=Total assets – Current liabilities

Importance of calculating Return on Capital Employed

Return on Capital Employed is an indicator of a company's profitability based on how efficiently it uses its capital in its business operations. ROCE is an important ratio for an investor to make an investment decision based on a company's return-generating capacity.

1. ROCE ratio allows investors to hold a comparison between different companies of the market before making an investment decision. As an investor, one can use ROCE to find out which company most efficiently uses its capital to generate healthy returns.
2. ROCE is majorly useful comparing capital intensive businesses that require a bigger amount of heavy capital in its business operations. Such companies include car manufacturing units, airlines, railways, steel manufacturers, etc. These companies have massive investments in their capital, and hence, efficient use of this capital can prove to be a healthy investment opportunity for any potential investor.
3. ROCE is a useful measure of financial efficiency since it measures profitability after taking into consideration the amount of capital used to create that level of profitability.
4. Using ROCE and ratios such as Return on Assets (ROA) and Return on Equity (ROE) through the DuPont Analysis application can give a holistic view of the company's financial health and return generating capabilities to any potential investor.
5. ROCE is useful to compare companies that belong to the same industry.

6. Not just for investors, ROCE is a useful metric for the companies as well, as it helps them gauge their performance and point out their strengths and weaknesses, thus leaving scope for performance improvement.

Limitations of Return on Capital Employed

Like most other accounting ratios, the Return on Capital Employed (ROCE) ratio also has some limitations despite its many uses.

1. One of the major limitations of ROCE is that although it is highly useful in comparing the financial performances of two companies of the same industry, it doesn't provide accurate details when comparing companies of different industries.
2. Using ROCE as a single measure of performance is not effective as it will only provide insight into the company's capital usage. Hence, it is always advisable to team up ROCE ratio with other financial ratios to make better-informed investment decisions.
3. Companies with unused cash reserves will show lower ROCE, which can affect the actual result and impact the overall decision. ROCE is not the best measure for companies with large, unused cash reserves.
4. ROCE cannot be constant for a period of years, and it will fluctuate year to year, depending upon the company's annual performances in the market. Hence it becomes important to consider ROCE trends over the course of several years when comparing different companies.

Conclusion

The calculation of the Return on Capital Employed Ratio makes it easier to identify the companies that use their capital efficiently. It can be useful for an investor who wishes to invest in a particular industry and has to compare between the top performers of that industry. ROCE has been proven to be very effective in comparing between companies belong to highly capital-intensive industries.

However, ROCE alone cannot be the sole decision-making factor. It has several limitations, and just like other accounting ratios, ROCE cannot single-handedly provide the entire picture of a company's financial health. It has to be teamed up with other ratios such as ROA, ROE, and ROIC in order to procure the best possible and the most accurate insight into a company's performance.