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The 20% ROE Club: Admission Courtesy Of GAAP

Return on equity is a most basic financial measure, and is a tool used for assessing managerial performance as well as providing an input to valuation techniques like the dividend discount model. Companies with returns on equity exceeding 20% have been regarded as exceptional members of an elite "20% Club". Over the past four years, the equity component of ROE has been drastically altered by the restructuring wave and several pivotal accounting pronouncements. Net result: because of the slimmed-down equity denominator in the ROE fraction, there are companies that have joined the 20% Club that didn't have a remote chance of membership a few short years ago.

This study of the companies comprising the Dow Jones Industrial Average index reveals the surprising impacts of recent accounting standards and restructuring charges on the measurement of return on equity.

I. The "20% Club"

Return on equity is often used two ways: first, as a measure of management's effectiveness in allocating the resources of stockholders, and second, as an input into the valuation of equity. The dividend discount model is one such popular valuation tool that employs return on equity as an input. Naturally, the greater the return on equity, the better for stockholders: there's more reward for every dollar invested in the firm. Companies that have earned 20% in the past have usually been regarded as well-managed, unless return on equity was fattened by excessive leveraging. A company with a high ROE carries an implication of high growth reinvestment opportunities - assuming that the earnings are retained by the firm.

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Companies in this report:

Alcoa
Allied Signal Inc.
American Express Co.
AT&T Corp.
Bethlehem Steel Corp.
Boeing
Caterpillar
Chevron
Coca-Cola Co.
(Continued on back page)

Table 1. Return On Equity: Companies In The Dow Jones Industrial Average Index.

	-----Return On Average Equity-----					1990-94 ROE Chg.
	<u>1994</u>	<u>1993</u>	<u>1992</u>	<u>1991</u>	<u>1990</u>	
General Motors	58.0%	36.4%	-17.7%	-17.8%	-6.3%	64.3%
Coca Cola	52.0%	51.7%	46.3%	40.9%	39.2%	12.8%
Philip Morris	38.7%	29.5%	39.4%	32.1%	32.9%	5.8%
Caterpillar	37.4%	36.1%	-7.8%	-9.4%	4.7%	32.7%
AT&T	30.1%	22.0%	18.0%	1.1%	28.1%	2.0%
Merck & Co.	28.3%	28.8%	49.3%	48.5%	48.4%	-20.1%
Allied Signal	28.3%	28.3%	20.4%	-8.6%	13.6%	14.7%
Procter & Gamble	26.4%	2.1%	21.4%	22.4%	22.7%	3.7%
Union Carbide	25.8%	11.6%	6.2%	-6.7%	9.5%	16.3%
E.I. DuPont	23.0%	4.9%	6.9%	8.5%	14.5%	8.5%
General Electric	22.7%	17.0%	18.3%	18.2%	18.4%	4.3%
Goodyear Tire & Rubber	22.2%	23.1%	15.7%	3.1%	-1.8%	24.0%
Walt Disney Co.	21.1%	13.8%	19.1%	17.3%	25.2%	-4.1%
Minnesota Mining & Mfg.	20.0%	19.3%	19.2%	18.6%	21.7%	-1.7%
American Express	18.3%	19.7%	7.4%	8.6%	19.3%	-1.0%
McDonald's	17.7%	16.8%	17.5%	18.7%	20.9%	-3.2%
United Technologies	15.0%	12.2%	-0.2%	-22.8%	14.1%	0.9%
Eastman Kodak	15.0%	13.0%	13.3%	0.2%	8.2%	6.8%
International Business Machines	14.3%	-34.7%	-21.4%	-1.5%	14.8%	-0.5%
Exxon	14.0%	15.2%	13.8%	16.3%	15.6%	-1.6%
J.P. Morgan & Co.	13.0%	21.1%	17.9%	21.2%	17.2%	-4.2%
Alcoa	11.9%	0.1%	0.5%	1.2%	5.7%	6.2%
Chevron	11.8%	9.1%	15.5%	8.7%	15.0%	-3.2%
Texaco	9.7%	12.9%	10.5%	13.4%	15.2%	-5.5%
Boeing	9.2%	14.6%	19.2%	20.8%	21.1%	-11.9%
Sears Roebuck	7.4%	5.1%	-16.7%	1.2%	-0.3%	7.7%
International Paper	6.8%	4.7%	2.4%	7.0%	10.6%	-3.8%
Bethlehem Steel	4.1%	-41.9%	-23.9%	-52.1%	-24.4%	28.5%
Woolworth	3.5%	-29.1%	13.7%	-2.4%	14.4%	-10.9%
Westinghouse Electric	1.9%	-13.8%	11.0%	8.8%	19.4%	-17.5%
Composite total	<u>20.6%</u>	<u>11.3%</u>	<u>8.7%</u>	<u>7.2%</u>	<u>13.9%</u>	<u>6.7%</u>
Company average	<u>20.3%</u>	<u>11.7%</u>	<u>11.2%</u>	<u>7.2%</u>	<u>15.3%</u>	<u>5.0%</u>

Above includes restructuring charges in net income. Average equity excludes preferred equity issues.

Lately, there has been some concern over a perceived inflation in corporate ROEs. A recent *Wall Street Journal* article¹ mentioned that in the first quarter of 1995, the *average* ROE of the Standard & Poor's 500 companies reached 20.12% - the highest level of corporate profitability in the postwar era. That should raise concerns about the sustainability of such returns.

Table 1 at left presents the return on average equity for the companies in the Dow Jones Industrial Average index for the last five years. Clearly, 1994 was a tremendous year in ROE terms: looking at the companies as one composite firm, 1994's 20.6% ROE nearly doubled from 1993's 11.3% level, and is clearly in a different league from the 13.9% earned in the base year of 1990. The average ROE for the individual firms tracked the same pattern. Nine companies were members of the 20% Club in 1990; the membership expanded to fourteen by 1994. Seven new companies joined the club: **General Motors, Caterpillar, Allied Signal, Union Carbide, E. I. DuPont, General Electric,** and **Goodyear**. Two companies couldn't pay the dues and found themselves on the outside: **McDonald's** and **Boeing**.

ROE levels are much different in 1994 compared to 1990: but "Different in what way?" is not always the question asked. The ROE levels that investors have come to think of as "normal" were last calculated in 1990. The 1991 through 1994 period was rife with accounting adjustments and restructuring charges that carved away great slabs of common equity - which, all else equal, will raise a firm's return on equity. Those adjustments have rendered questionable any direct ROE comparisons between pre-1991 and post-1990 periods.

Restructuring charges are familiar to all observers of corporate activities; the most serious analytical problem they raise is the potential mis-matching of revenues and expenses. While analysts often filter away restructuring charge effects when analyzing operating earnings, the effects on equity - and return on equity - are less frequently analyzed. (For more discussion of restructuring charges, see "Restructurings: New Rules For The Game", Volume 4, No.4). The deployment of three new accounting standards from 1991 to 1994 also played havoc with current earnings. Again, their implementation effect on earnings was well understood by the financial community, but the related effect on equity and ROE may not have been as widely appreciated. Those three standards are:

- **SFAS No. 106 - *Employers' Accounting for Postretirement Benefits Other Than Pensions***. Before the FASB project on stock compensation arrived, this was the most-vilified standard in Corporate America. It called for liability recognition of the promises made to workers for providing postretirement health care and other benefits. Before companies adopted this standard, such a liability did not appear on the balance sheet. The associated expense was recognized on a cash basis, which didn't contain the time value - the interest cost - of the promises made to workers. Cash basis expense recognition also ignored the inflation implicit in such costs. Thus, prior to SFAS No. 106, expenses were understated - and consequently, stockholders' equity was overstated. Though SFAS No. 106 granted firms a choice of gradually recognizing the liability for postretirement benefits over twenty years or recognizing it immediately, most companies recognized it immediately - consequently vaporizing large chunks of common equity. (See Volume 3, No. 3 for more discussion.)

- **SFAS No. 109 - *Accounting for Income Taxes***. This standard produced mainly benevolent effects on common equity; it called for the revaluation of deferred tax assets and liabilities at the tax

¹See "The '20% Club' No Longer Is Exclusive", by Roger Lowenstein, *The Wall Street Journal*, May 4, 1995.

rate in effect at the balance sheet date. Companies that had accumulated tax liabilities at a marginal

rate of 48% enjoyed an equity boost when those liabilities were revalued at 34%, which was the rate in effect at the standard's initial adoption by most firms. (See Volume 1, No. 5; Volume 2, No. 9; and Volume 3, No. 10 for more discussion.)

• **SFAS No. 112 - Employers' Accounting for Postemployment Benefits.** The sequel to SFAS No. 106, this standard called for accrual recognition of the expenses related to benefits paid to ex-employees after their employment is over, but are not part of a pension or other postretirement benefit plan. Some examples: supplemental employment benefits, salary continuation, severance

Table 2. Yearly Equity Reductions Caused By Accounting Standards & Restructuring Charges.

(In \$ millions)	<u>1994</u>	<u>1993</u>	<u>1992</u>	<u>1991</u>	<u>Total</u>
Alcoa	--	\$75	\$1,285	\$57	\$1,417
Allied Signal	--	245	1,474	544	2,263
American Express	--	--	309	110	419
AT&T	--	9,927	41	2,863	12,831
Bethlehem Steel	--	290	365	635	1,290
Boeing	--	--	1,002	--	1,002
Caterpillar	--	--	2,217	224	2,441
Chevron	\$45	554	681	185	1,465
Coca Cola	--	54	219	44	317
E.I. DuPont	--	1,295	5,296	329	6,920
Eastman Kodak	254	2,002	40	934	3,230
Exxon	--	--	40	--	40
General Electric	--	1,540	--	1,799	3,339
General Motors	--	1,340	21,469	1,544	24,353
Goodyear Tire & Rubber	--	86	1,072	60	1,218
International Business Machines	--	8,114	6,400	5,163	19,677
International Paper	--	--	313	252	565
J.P. Morgan & Co.	--	137	(452)	--	(315)
McDonald's	--	--	--	--	--
Merck & Co.	--	525	463	--	988
Minnesota Mining & Mfg.	--	--	115	3	118
Philip Morris	--	934	--	1,196	2,130
Procter & Gamble	--	2,671	--	--	2,671
Sears Roebuck	--	--	3,618	--	3,618
Texaco	--	--	300	--	300
Union Carbide	--	127	360	10	497
United Technologies	--	--	374	1,210	1,584
Walt Disney Co.	--	100	--	--	100
Westinghouse Electric	51	251	362	115	779
Woolworth	--	347	--	363	710
Total	<u>\$350</u>	<u>\$30,614</u>	<u>\$47,363</u>	<u>\$17,640</u>	<u>\$95,967</u>
Cumulative total	<u>\$95,967</u>	<u>\$95,617</u>	<u>\$65,003</u>	<u>\$17,640</u>	

benefits, and continuation of life and health insurance benefits. The change to this kind of accounting

was recognized immediately by firms, resulting in more gouges to common equity. (See Volume 2, No. 12 for more details.)

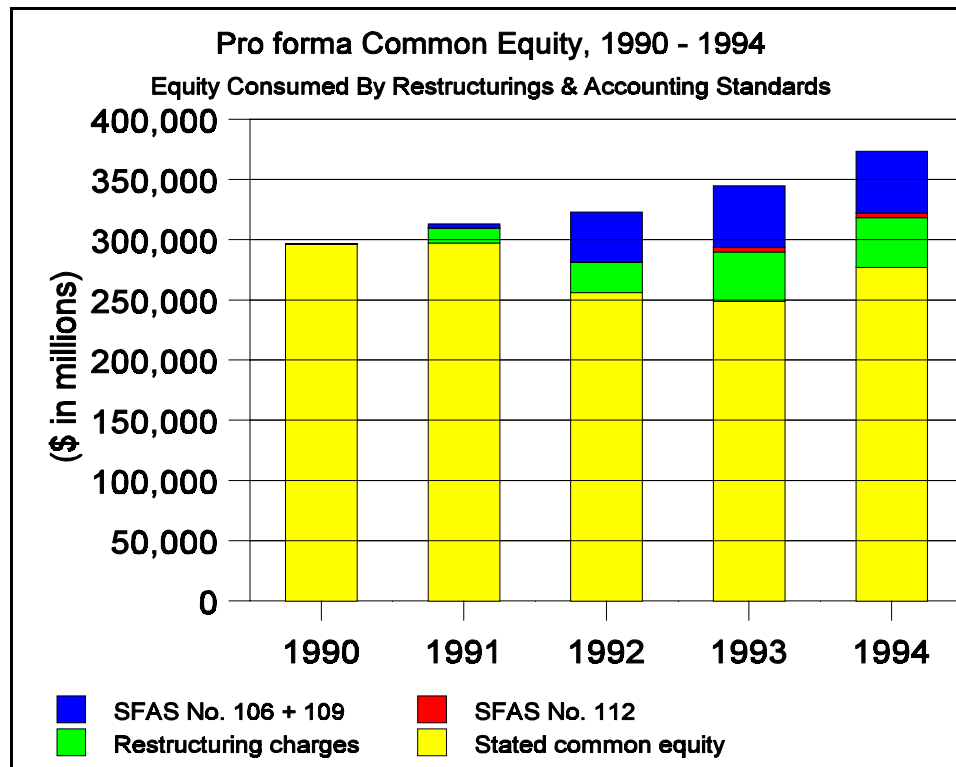
Table 2 summarizes the annual after-tax accounting and restructuring charges to earnings - and consequently equity - by each Dow company and the year in which the charges were taken. Table 3 summarizes the charges by type and year.

Table 3. Cumulative Equity Reductions Due To Accounting Standards & Restructuring Charges.

(\$ in millions)	-----1994-----		-----1993-----		-----1992-----		-----1991-----		1990
SFAS No. 106	\$53,114	14%	\$53,114	16%	\$43,367	14%	\$5,314	2%	--
SFAS No. 109	(2,269)	-1%	(2,269)	-1%	(3,721)	-1%	(233)	--	--
SFAS No. 112	3,982	1%	3,982	1%	62	--	--	--	--
Restructuring charges	<u>41,140</u>	<u>11%</u>	<u>40,790</u>	<u>12%</u>	<u>25,295</u>	<u>8%</u>	<u>12,559</u>	<u>4%</u>	--
Total equity consumed	95,967	26%	95,617	28%	65,003	20%	17,640	6%	--
Stated common equity	<u>277,323</u>	<u>74%</u>	<u>249,090</u>	<u>72%</u>	<u>256,285</u>	<u>80%</u>	<u>297,433</u>	<u>94%</u>	<u>\$296,229</u>
Pro forma common equity	<u>\$373,290</u>	<u>100%</u>	<u>\$344,707</u>	<u>100%</u>	<u>\$321,288</u>	<u>100%</u>	<u>\$315,073</u>	<u>100%</u>	<u>\$296,229</u>

Note: Restructuring charges not added to equity in 1990; it is the baseline for comparing 1991-1994 activity.

By 1994, nearly \$96 billion had been excised from the common equity of Dow Jones firms because of restructurings and accounting changes: to see what might have been, a “pro forma equity”



is derived by adding back the various charges. The accompanying chart shows the progression of those cuts. The sum of the stacks on the bars shows the equity that might have been, if not for the sundry charges. Notice that after 1991, stated equity didn't increase again until 1994. Equity growth was held in check by these non-operating events: held in check by \$96 billion. Stated equity in 1994 was actually less than in 1990, despite the profitability of the intervening years. When calculated on nominal equity, return on equity has had no place to go but up. By this time, inquiring minds should be asking "How much did firms' return on equity increase without any real change in the operations of their businesses?" A closer look at the Dow Jones Industrials provides some answers.

II. What If?

What if, one asks, restructuring charges had never been permitted under generally accepted accounting principles - how much equity would not have been removed from the equity denominator at one time? How would ROE differ from a calculation based on stated equity amounts - assuming the expenses would still be realized?

What if the accounting principles that caused the dissipation of equity had been applied *prospectively* - with only the current income effects being recognized and no "catch up" liability being recognized? (This is not suggested as good balance sheet accounting, by the way.) What would returns on equity look like under these circumstances? Answering these "what if" questions would show how much accounting pronouncements and restructurings contributed to increased returns on equity - by lowering the ROE denominator.

Table 4 answers the "what if" questions. In computing return on average equity, the cumulative amounts of non-operating charges are added back to common equity in each year for each company. The income is still burdened by restructuring charges - just as it was in Table 1 - and the increased operating costs associated with the new accounting standards remain in income. It is true that this penalizes the ROE calculation by recognizing the cost in the numerator, without lowering the denominator. It *does* provide the gross ROE effect of the restructuring charges on the denominator, which is the goal of this exercise. To be completely fair, it would be desirable to spread the costs of restructuring charges to their more economically precise accounting periods, adding back the cumulative charges and subtracting the cumulative costs associated with each period. That's not possible with any kind of accuracy. Leaving them in income as stated at least recognizes the cost, even if the period in which they are recognized is questionable, and keeps the ROEs consistent with the way they are calculated in Table 1. In short, income is stated as properly as it can be under existing accounting standards. The pro forma equity derived closely resembles common equity in pre-1991 days. Comparing the ROEs of 1994 to 1991 is not an exercise in perfect comparability, but it's close. The worst one could say is that the definition of income is now more keenly honed for the effects of the new accounting standards, just as it has been refined over the years prior to 1990. It's important to remember that the *only* difference between the ROEs calculated in Table 1 and Table 4 takes place in the ROE denominator, thus measuring the gross change in ROE due to "one-time" non-operating charges on the denominator. (Appendix 1 shows an experiment in spreading restructuring charges over the earnings and equity for the 1991-4 period, and the consequences to return on equity.)

Table 4 shows some startling changes in the 20% Club's membership. 1994 membership was revoked for **3M, Goodyear, DuPont, Union Carbide, Procter & Gamble, Allied Signal, AT&T, Caterpillar, and General Motors**. The membership roll dropped from fourteen members to five.

Return on equity for the thirty companies as a composite plummeted from 20.6% to a more 1990-like 15.1%; compared to 1990's 13.9%, the current rate of return doesn't look nearly as impressive as before. In fact, seventeen companies - over half - saw their ROE *deteriorate* from 1990 to 1994 by an average of 7.2%. In Table 1, before adjustment, fourteen companies saw declines in ROEs from 1990 to 1994, in smaller magnitude: an average of 6.4%.

Table 4. Dow Jones Companies "Equalized" Return On Equity.

	<u>1994</u>	<u>1993</u>	<u>1992</u>	<u>1991</u>	<u>1990</u>	<u>1990-94 ROE Chg.</u>
Coca Cola	48.9%	48.3%	44.7%	40.7%	39.2%	9.7%
Philip Morris	33.0%	25.9%	36.0%	30.6%	32.9%	0.1%
Merck & Co.	25.9%	26.3%	47.1%	48.5%	48.4%	-22.5%
Walt Disney Co.	20.7%	13.6%	19.1%	17.3%	25.2%	-4.5%
General Electric	20.1%	15.4%	17.0%	17.5%	18.4%	1.7%
Procter & Gamble	19.8%	1.8%	21.4%	22.4%	22.7%	-2.9%
Minnesota Mining & Mfg.	19.6%	18.9%	19.0%	18.6%	21.7%	-2.1%
Union Carbide	19.3%	8.8%	5.5%	-6.7%	9.5%	9.8%
Caterpillar	19.1%	15.7%	-5.3%	-9.2%	4.7%	14.4%
McDonald's	17.7%	16.8%	17.5%	18.7%	20.9%	-3.2%
American Express	17.3%	18.8%	7.2%	8.5%	19.3%	-2.0%
AT&T	16.5%	15.0%	15.6%	1.0%	28.1%	-11.6%
General Motors	15.9%	7.2%	-10.2%	-17.3%	-6.3%	22.2%
Allied Signal	15.3%	14.7%	13.7%	-7.9%	13.6%	1.7%
Goodyear Tire & Rubber	15.0%	14.9%	12.5%	3.0%	-1.8%	16.8%
E.I. DuPont	14.5%	3.2%	5.7%	8.4%	14.5%	--
Exxon	14.0%	15.2%	13.8%	16.3%	15.6%	-1.6%
J.P. Morgan & Co.	13.4%	22.1%	18.6%	21.2%	17.2%	-3.8%
Chevron	10.8%	8.4%	15.0%	8.7%	15.0%	-4.2%
United Technologies	10.5%	8.5%	-0.1%	-20.2%	14.1%	-3.6%
Texaco	9.4%	12.5%	10.3%	13.4%	15.2%	-5.8%
Alcoa	8.6%	--	0.4%	1.2%	5.7%	2.9%
Boeing	8.3%	13.1%	18.1%	20.8%	21.1%	-12.8%
Eastman Kodak	8.2%	9.3%	11.6%	0.2%	8.2%	--
International Business Machines	7.3%	-20.7%	-16.9%	-1.4%	14.8%	-7.5%
International Paper	6.2%	4.3%	2.2%	6.9%	10.6%	-4.4%
Sears Roebuck	5.4%	3.7%	-14.5%	1.2%	-0.3%	5.7%
Woolworth	2.3%	-22.1%	11.7%	-2.2%	14.4%	-12.1%
Bethlehem Steel	1.7%	-16.3%	-13.0%	-43.5%	-24.4%	26.1%
Westinghouse Electric	1.2%	-10.1%	10.0%	8.6%	19.4%	-18.2%
Composite total	<u>15.1%</u>	<u>8.6%</u>	<u>7.6%</u>	<u>7.0%</u>	<u>13.9%</u>	<u>1.2%</u>
Company average	<u>14.9%</u>	<u>9.8%</u>	<u>11.1%</u>	<u>7.5%</u>	<u>15.3%</u>	<u>-0.4%</u>

Putting ROE in such equalized terms squeezes the gross denominator ROE inflation out of

the comparison. Looking at the ROEs in a DuPont analysis adds even more to the story. In a DuPont analysis, return on equity is broken down into components which help to analyze the sources of return on equity. An abbreviated DuPont analysis can disaggregate return on equity like this:

$$\begin{array}{rcccl}
 \text{Financial} & & \text{Aftertax Net} & & \text{Asset} & & \text{Return} \\
 \text{Leverage} & & \text{Profit Margin} & & \text{Turnover} & = & \text{On Equity} \\
 \hline
 \frac{\text{Average assets}}{\text{Average common equity}} & \times & \frac{\text{Net Profits}}{\text{Revenues}} & \times & \frac{\text{Revenues}}{\text{Average assets}} & = & \text{ROE} \\
 \\
 \frac{\text{Average assets}}{\text{Average common equity}} & \times & \frac{\text{Net Profits}}{\text{Revenues}} & \times & \frac{\text{Revenues}}{\text{Average assets}} & = & \text{ROE} \\
 \\
 & & \frac{\text{Net Profits}}{\text{Average common equity}} & & & = & \text{ROE}
 \end{array}$$

By isolating the components of the return on equity, an analyst can uncover the sources of the improvements or declines in ROE. Table 5 presents such an analysis on the Dow Jones companies treated as a single composite firm.

Table 5. DuPont Analysis On Composite Dow Jones Companies.

(All ratios based on reported amounts)	<u>Financial</u> <u>Leverage</u>	X	<u>Aftertax</u> <u>Net Profit</u> <u>Margin</u>	X	<u>Asset</u> <u>Turnover</u>	=	<u>Return</u> <u>On</u> <u>Equity</u>
1994	5.037		5.757%		0.709		20.6%
1990	3.719		4.576%		0.818		13.9%
Change							6.7%

Bear in mind that an increase in a component of ROE will increase the overall return on equity. Also bear in mind that financial leverage is total assets divided by total equity. Given the chunks of equity removed from 1990 to 1994, one would expect the 1994 financial leverage to increase dramatically from 1990 levels because so much has been removed from equity - and it did. Given the oft-stated rationale of cost reduction for restructuring charges, one would expect aftertax net profit margins to increase - and they did. One would have expected the restructuring charges to have lowered the asset base; given the favorable business conditions of the past four years, revenue growth would be expected. In turn, this should have increased asset turnover - revenues divided by average assets. There's the surprise: asset turnover *decreased*. For the four year stretch, the composite revenues of the Dow companies increased less than half as fast as assets - at an annual average rate of 1.8% per year for revenues, while assets increased at a 5.5% annual clip. Given the increase in profitability, the implication is that the assets purchased provide cost savings more so than they produce revenues. If not for the concurrent increase in profitability, one might call into serious question the capital allocation policies of the Dow 30; it remains to be seen how much of these fresh assets will be cast into restructuring charges the next time business slows. Table 6 shows the changes in the components of asset turnover and financial leverage from 1990 to 1994.

Table 6. Selected Components For ROE DuPont Analysis.

(\$ in millions)	<u>Revenues</u>	<u>Average Assets</u>	<u>Average Equity</u>
1994	<u>\$940,384</u>	<u>\$1,325,696</u>	<u>\$263,215</u>
1990	<u>\$874,850</u>	<u>\$1,069,384</u>	<u>\$287,556</u>
Average annual change	<u>1.8%</u>	<u>5.5%</u>	<u>-2.2%</u>

Table 7 summarizes the contribution given to the 1994 ROE for each change in an ROE component; as one should expect by now, the largest contribution came from the increase in financial leverage, accomplished by the accounting charges discussed. Without the effect of the charges to equity - that is, holding financial leverage constant at its 1990 level, but allowing for 1994 levels in all other ROE components - the return on equity in 1994 would have been only 15.6% - which is actually not bad when you consider that the 1994 earnings carry the full burden of accrual accounting for postretirement and postemployment benefits. Still, a 15.6% return on equity is a far cry from the 20.6% level based on nominal amounts.

Table 7. Sources Of Incremental ROE.

	<u>Financial Leverage</u>	X	<u>After-tax Net Profit Margin</u>	X	<u>Asset Turnover</u>	=	<u>Return On Equity</u>	<u>Incremental ROE</u>
1990, from stated amounts:	3.719		4.576%		0.818		13.9%	--
Adjusted for 1994:	<u>5.037</u>		4.576%		0.818		18.9%	5.0%
	3.719		<u>5.757%</u>		0.818		17.5%	3.6%
	3.719		4.576%		<u>0.709</u>		12.1%	-1.8%
Total incremental return on equity (differs from Table 5 due to rounding)								<u>6.8%</u>

The improvement in ROE due to the leveraging effect of the restructuring charges and accounting standards is not of the same quality as say, an improvement in aftertax returns or increased asset efficiency that improves the ratio of revenues to assets. Leveraging is a quick and dirty way to increase return on equity. It may not have been done intentionally by firms over the last four years, but it does provide an explanation for much of the gain in ROE by the Dow Jones firms. To be sure, increases in profits and profitability have also helped. (See Appendix 2 for the net income information used in computing returns on equity in Tables 1 and 4).

III. What Does It Mean?

- It means that the old norm of 20% being an exceptional return on equity is gone, and is not likely to soon return. Just as price inflation in goods and services over the years means that one can't make meaningful nominal comparisons, the "de-linking" of common equity values from pre-1991

(when firms began implementing SFAS No. 106) periods to post-1990 periods make simple comparisons misleading. Put baldly, equity was overstated in periods before 1991 because it didn't take into account a firm's liability for promises paid to employees for all benefits provided; pre-1991 earnings were overstated because they didn't include the full annual cost of such benefits. In those days, return on equity was not a very good signal of management's performance: but the heuristics that have developed (among them, 20% ROE is excellent; ROE has been stuck at 12% for years; ROE of 15% is average) were based on flawed information. The equity values found on today's balance sheets at least take into account what remains after all postretirement and postemployment benefit obligations have been taken into account, and the earnings which include such annual costs are a more faithful representation of what occurred during the year. Current returns on equity, then, are at least made of the right stuff.

- It means that it's critical to look at current returns on equity with a wary eye and recognize the amount of the gains come from leveraging. For instance, is a cyclical automaker like General Motors now a growth company because it sports a 58% return on equity? Check your premises; contradictions cannot be allowed to exist. A glance at the DuPont analyses in Appendices 7 and 8 shows that GM's 1994 financial leverage increased nearly fourfold from 1990. Obviously, this is not a transformation into a growth company.

Interpretation is now imperative with regard to assessing the sustainability of ROEs. With such thin denominators in the ROE fraction, increasing profitability can thicken them quickly - which would lower the ROE in short order.

- It means that DuPont analysis, as old a technique as it is, is still worth employing when it comes to evaluating historical return on equity as a scorecard of management performance.

- It means that investors have to challenge their assumptions in using ROE in valuation tools like the dividend discount model. If analysts and investors are basing their valuation decisions on the old levels of return on equity, they may not be discriminating enough and may be accepting too low of a return on equity in their valuation models. It means that those who pay attention to price to book value ratios might be willing to accept a higher ratio than in the past if a higher sustained ROE is expected.

- It means that those folks who really miss evaluating the trends in ROEs in the context of the old norms will have to perform the same kind of tortured exercise done in Part II - restate current equity for the major accounting changes since 1990, recalculate ROE and compare it to prior levels.

It makes much more sense, though, to deal with returns as they are stated now and think of them in that context. Put it this way: if 20% ROE is no longer a great hurdle, perhaps joining a "30% Club" might be the mark of a highly profitable firm?

Continued from front page:

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General Motors
Goodyear
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