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Calculating Return on Assets

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Return on Assets is a measure of a company's profitability expressed as a percentage of its total assets, not to be confused with return on capital employed—a nebulous phrase demanding a definition of capital—or return on equity.

Return on Assets, also called return on investment, measures how effectively a company has generated profits with its available assets. The higher the Return on Assets, the better. But only when the percentage is compared with industry averages can meaningful conclusions be drawn—and only then when a definition of assets is uniform. And assets frequently need to be re-valued, so the definition is critical. Generally the measure reflects management's ability to generate profits during a given period, usually a year.

What to Do

Return on Assets is calculated by dividing a company's net income by its total assets, then multiplying by 100 to arrive at a percentage:

Net income / total assets × 100 = Return on Assets

So if net income is $30, and total assets are $420, the Return on Assets is

30 / 420 = 0.0714 × 100 = 7.14%

An alternative formula used to calculate Return on *Net* Assets is:

Net income / fixed assets + working capital = Return on Net Assets

And yet another alternative is to separate after-tax interest expense from net income:

Net income + interest expense / total assets = Return on Assets

Thus it can be seen how important it is to understand what each component of the formula actually represents.

What You Need to Know

Some analysts recommend using the net income value at the end of the given period, and the assets value from the beginning of the period—or an average value taken over the whole period, rather than at the end of it. The calculation will otherwise include assets that have accumulated during the year, which can be misleading. While a high ratio indicates a greater return, it must still be balanced

against such factors as risk, sustainability, and re-investment in the business through development costs. Some management teams will sacrifice the long-term interests of investors in order to achieve an impressive Return on Assets in the short term. A rising Return on Assets usually indicates a rising stock price, because it tells investors that a management is skilled at generating profits from a company's resources. In banking, for example, a Return on Assets of one per cent or better is a considered to be the benchmark of performance. In which vein, Return on Assets may be an effective measure of efficiency in the manufacturing sector, but can be suspect when applied in the service sector, in which primary assets tend to be people.

Where to Learn More

Web Sites:

Money Central: www.moneycentral.msn.com/investor

Online calculator: www.anz.com.au/australia/business/calculator/businessbenchmark/return.asp

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