

Calculating Return on Investment

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Return on Investment is one of several profitability ratios, one of the four basic classes of financial ratios—the others being liquidity ratios, activity ratios and debt ratios. This, the Return on Investment, often called a company's return on total assets, measures the overall profit made on an investment expressed as a percentage of the amount invested. Like return on assets, or return on equity, Return on Investment measures a company's profitability and its management's ability to generate profits from the funds investors have placed at its disposal.

It is often said that if a company's operations cannot generate net profit as a percentage of the amount invested greater than the interest rate on financial markets, its future is grim.

What to Do

The basic Return on Investment can be found by dividing a company's net profit (also called net earnings) by the total investment (total debt plus total equity), and multiplying by 100 to arrive at a percentage:

$$\text{Net profit} / \text{total investment} \times 100 = \text{Return on Investment}$$

So if net profit is \$30 and the total invested is \$250, the Return on Investment is:

$$30 / 250 = 0.12 \times 100 = 12\%$$

A more complex variation of Return on Investment is a formula known as the Du Pont formula, which allows a company to break down its Return on Investment into a profit-on-sales component and an asset-efficiency component, and is:

$$(\text{Net profit after taxes} / \text{total assets}) = (\text{net profit after taxes} / \text{sales}) \times \text{sales} / \text{total assets}$$

So if net profit after taxes is \$30, total assets \$250, and sales \$500, then:

$$30 / 250 = 30 / 500 \times 500 / 250 = 6 \times 2 = 12\%$$

This formula was developed by the Du Pont Company in the 1920s, and helps to reveal how a company has deployed its assets and controlled its costs, and how it can achieve the same percentage return in different ways.

For stockholders, the variation of the basic Return on Investment formula used by investors is:

$$\text{Net income} + (\text{current value—original value}) / \text{original value} \times 100 = \text{Return on Investment}$$

So if somebody invests \$5,000 in a company and a year later has earned \$100 in dividends, while the value of the stock has risen to \$5,200, the return on investment would be:

$100 + (5,200 - 5,000) / 5,000 \times 100 = (100 + 200) / 5,000 \times 100 = 300 / 5,000 \times 100 = 0.06 \times 100 = 6\%$ Return on Investment

What You Need to Know

Investors can use an alternative Return-on-Investment formula, which is: net income divided by common stock and preference stock equity, plus long-term debt. Meanwhile, it is vital to understand exactly what a return on investment measures, for example assets, equity, or sales. Without this understanding, comparisons may be misleading. A search for “return on investment” on the Internet, for example, harvests sites detailing staff training, e-commerce, advertising and promotions. Be sure to establish whether the net profit figure used is before or after provision for taxes. This is important for making accurate comparisons of Return on Investment.

Where to Learn More

Web Site:

Investopedia: www.investopedia.com