Return on Equity

An equation used to measure profits is the ratio of return on the owner's equity. (Remember that owner's equity is also called the capital of the business.) This equation shows the return the owner received on the investment in the business. The return appears to be less for a corporation than for a business with a sole owner or a partnership of two or more owners. A **corporation** is a ***business that is separate from the owners and employees.*** The reason the return appears to be less for a corporation is that the owner-manager's salary is an expense rather than profit. The sole owner considers his salary as part of his investment profit. Notice that two equations, followed in order, are needed to compute the return on owner's equity.

$$\textbf{average owner's equity} = \frac{\textbf{owner's equity beginning of year + owner's equity end of year}}{\textbf{2}}$$

$$\textbf{return on equity} = \frac{\textbf{net profit}}{\textbf{average owner's equity}}$$

EXAMPLE 5

Tom Wilis is the sole owner of Corner Store. His owner's equity at the beginning of the year was \$56,400, and his equity at the end of the year was \$61,200. The net profit for the year was \$32,000. What was his return on owner's equity?

$$\text{average owner's equity} = \frac{\text{owner's equity beginning of year + owner's equity end of year}}{2}$$

$$\text{average owner's equity} = \frac{\$56{,}400 + \$61{,}200}{2}$$

$$\text{average owner's equity} = \frac{\$117{,}600}{2}$$

$$\text{average owner's equity} = \$58{,}800$$

$$\text{return on equity} = \frac{\text{net profit}}{\text{average owner's equity}}$$

$$\text{return on equity} = \frac{\$32{,}000}{\$58{,}800}$$

return on equity = .544 = .54 = 54%

$$\frac{32{,}0\cancel{00}}{58{,}8\cancel{00}} = \frac{320 \div 4}{588 \div 4} = \frac{80}{147}$$

$$\begin{array}{r|l} & .544 = .54 = 54\% \\ 147 & 80.000 \\ & \underline{-735} \\ & \quad 650 \\ & \quad \underline{-588} \\ & \quad\quad 620 \end{array}$$

1. Round the decimal to the nearest hundredth.
2. To express a decimal as a percent, move the decimal point two places to the right and add the percent sign.

   .54 = 54%

Example 6

Tom Wilis, Example 5, took a salary of $30,000 from his business. If this salary is subtracted from the net profit, what is his return on equity? How does this return compare with a savings account, certificate of deposit, or the stock market?

$$\text{return on equity} = \frac{\text{net profit}}{\text{average owner's equity}}$$

$$\text{return on equity} = \frac{\$2{,}000}{\$58{,}800}$$

return on equity = .034 = .03 = 3%

(Direct the discussion part of the example using current rates.)

Homework

Find the return on owner's equity to the nearest whole percent.

	Owner's Equity at Beginning of Year	Owner's Equity at End of Year	Net Profit	Return on Equity
1.	$62,300	$65,000	$16,300	
2.	$104,000	$135,000	$9,500	
3.	$150,000	$155,000	$5,800	
4.	$75,100	$87,000	$34,600	
5.	$66,200	$70,000	$14,300	

Solve the word problems.

6. The corporation of Tyler Toys had a net profit of $400,000 last year. The owner's equity was 1 million dollars to begin the year and 1.1 million dollars to end the year. Find the return on the owner's equity.

7. The owner's equity to end the year was $8,500 more than the $67,300 to begin the year at Teddie's Tires. The net profit was $6,000. Find the return on the owner's equity.

8. The gross profit for Timeless Treasures was $1,300,000, and its expenses were $890,000. The average of the difference between owner's equity at the beginning of the year and the end of the year was 10 million dollars. Find the return on the owner's equity.

9. Billy's BAR-B-Q had net sales of $300,000 and cost of goods sold was $75,000. The expenses were $125,000. The owner's equity at the beginning of the year was $280,000 and $286,000 at the end of the year. Find the return on the owner's equity.

10. Stylist Shoes had net sales of $435,000 with $23,675 in returns and allowances. The cost of goods sold was $113,500, and expenses totaled $217,600. The average of the difference between owner's equity at the beginning of the year and the end of the year was 500 thousand dollars. Find the return on the owner's equity.

11. The average owner's equity for Sarge's Seafood Sampler was $24,000. The net profit was $30,000, but the owner took $28,000 as his income. Find the return on the owner's equity by considering the income as an expense rather than profit.