Understanding Return on Equity

Idea In Short

Return on equity tells investors what percentage return they earn on invested money, and the DuPont formula breaks it into two levers: how well assets generate profit, and how much leverage amplifies that profit. Leverage helps until it doesn't, and every financial crisis retells the same over-leverage story.

The First Financial Formula Worth Memorizing

Return on equity ranks among the handful of financial metrics every business professional, marketers included, should carry forward from their financial literacy education. It is often the best starting point for analyzing a company's financial statements, since it tells investors, in simple terms, what percentage return they are earning on their invested money. The formula itself is simple and worth memorizing: ROE equals net income divided by shareholder equity, where net income is the bottom line on the income statement, revenue minus expenses, and shareholder equity is total assets minus total liabilities.1

Why the Formula Is Genuinely Useful

ROE draws simultaneously from both the income statement and the balance sheet, applies consistently across nearly every company and industry and, most usefully, can be broken into component parts for deeper analysis. That last property is what makes it more than a single headline number: it is a starting point for a real investigation.

The DuPont Formula Goes Deeper

A chemical company popularized a more articulate version of the same idea starting in the 1920s, expressing ROE as return on assets multiplied by leverage.2 The decomposition is elegant precisely because it separates two very different questions: how well is the business using its underlying assets, and how much is borrowed money amplifying the

equity return on top of that.

Return on Assets Comes First

Generating a solid return on assets is the heart of any business, whatever those assets happen to be, people, plant, equipment, intellectual property, real estate or investments. For a consulting firm specifically, that means projects need to be profitable and consultants need to stay fully utilized; unstaffed time on the beach directly drags return on assets down, since the underlying asset, the consultant, is not generating revenue.

Leverage Genuinely Helps, Up to a Point

This can feel counterintuitive to anyone outside finance, but taking on more debt, other people's money, produces a higher percentage return on the owner's own equity, since the same net income gets divided across a smaller base of invested capital.3 A simple illustration: two identical rental properties purchased for the same price, generating the same annual profit and therefore the same return on assets, will produce very different returns on equity depending on financing. Paying entirely in cash for one property caps the equity return at the asset return; financing the second property with a modest down payment can push the equity return dramatically higher, even though the underlying property performance never changed.

Leverage Can Also Turn Dangerous

The same mechanism that boosts returns on the way up magnifies losses and risk on the way down. Interest payments eventually become too costly, risk becomes too concentrated or lenders simply stop extending credit, and the same over-leverage story tends to repeat itself across financial crises, decade after decade. A high return on equity built primarily on heavy leverage, rather than genuinely strong underlying operations, deserves real scrutiny rather than applause.

What Counts as a Good ROE

Academic analysis of average ROE by industry puts the all-industry average somewhere around 15 percent, with considerable variation: some consumer categories running well above 25 percent while capital-intensive industries like airlines often sit below 2 percent.

That spread is exactly why comparing ROE only makes sense within a single industry, never across dramatically different business models, and why service businesses in particular can show unusually high ROE simply because they carry few assets on the balance sheet in the first place, inflating the ratio.

Putting It Together in Practice

A quick worked example ties the pieces together: two companies in the same industry both report a 15 percent ROE. Company A achieves it through a healthy 10 percent return on assets combined with modest leverage, while Company B achieves the identical headline number through a thinner 5 percent return on assets amplified by considerably heavier debt. On the surface the two companies look equivalent; underneath, Company A is the more resilient business, since Company B's return depends far more heavily on leverage continuing to cooperate.

A Practical Way to Practice

Comparing ROE between two similar companies in the same industry is a genuinely useful analytical exercise: are their returns similar, and if not, is the difference coming from profitability, asset efficiency or leverage. Looking for accounting adjustments that might be temporarily boosting a reported ROE, and treating any company with roughly double its closest competitor's ROE as a candidate for closer scrutiny rather than immediate admiration, is a habit worth building early in any finance career.

- 1Return On Equity
- 2DuPont Analysis
- 3Leverage [Finance]

Summary

ROE equals net income divided by shareholder equity, and the DuPont formula splits it into asset returns times leverage. Leverage boosts ROE without boosting operating performance, which is exactly why it turns dangerous past a point. Compare ROE within industries, and always ask what is driving the number.