

Calculating Return on Sales

GETTING STARTED

Although return on sales (ROS) is another tool used to analyze profitability, it is perhaps a better indication of efficiency. In some business environments, it is also called margin on sales percentage, or net margin.

What It Measures

A company's operating profit or loss as a percentage of total sales for a given period, typically a year.

Why It Is Important

ROS shows how efficiently management uses the sales dollar, thus reflecting its ability to manage costs and overhead and operate efficiently. It also indicates a company's ability to withstand adverse conditions such as falling prices, rising costs, or declining sales. The higher the figure, the better a company is able to endure price wars and falling prices.

Return on sales can be useful in assessing the annual performances of cyclical companies that may have no earnings during particular months, and of companies whose business requires a huge capital investment and thus incurs substantial amounts of depreciation.

How It Works in Practice

The calculation is very basic:

operating profit / total sales × 100 = percentage return on sales

So, if a company earns \$30 on sales of \$400, its return on sales is:

$$30 / 400 = 0.075 \times 100 = 7.5\%$$

Tricks of the Trade

- While easy to grasp, return on sales has its limits, since it sheds no light on the overall cost of sales or the four factors that contribute to it: materials, labor, production overhead, and administrative and selling overhead.
- Some calculations use operating profit before subtracting interest and taxes; others use after-tax income. Either figure is acceptable as long as ROS comparisons are consistent. Obviously, using income before interest and taxes will produce a higher ratio.
- The ratio's operating profit figure may also include special allowances and extraordinary non-recurring items, which, in turn, can inflate the percentage and be misleading.

- The ratio varies widely by industry. The supermarket business, for example, is heavily dependent on volume and usually has a low return on sales.
- Return on sales remains of special importance to retail sales organizations, which can compare their respective ratios with those of competitors and industry norms.