Because of the volatility of stock market values, evaluations of firm performance for the purposes of assessing the current strategy or evaluating management effectiveness tend to use accounting of performance. These are inevitably historical: financial reports appear at least three weeks after the period to which they relate. That said, many firms offer earnings guidance-forecasts of profit for the next 12 months (sometimes longer).

The Mckinsey valuation framework identifies three drivers of enterprise value: rate of return on capital, cost of capital, and profit growth. Among these, return on capital is the key indicator of the invested firm’s effectiveness in generating profits from its assets. Hence, ROIC and its equivalent, return on capital employed (ROCE), or its closely related rate of return indicators such as return on equity (ROE) and return on assets (ROA), are valuable performance indicators. Different profitability measures are related-the longer the period under consideration, the more they tend to converge. Over shorter periods, the key issues are, first, to be aware of the limitations and biases inherent in any particular profitability measure and, second, to use multiple measures of profitability so that their consistency can be judged. The greatest of these limitations concerns the use of historical measures of performance to indicate the success of the firm in creating future profits. Table 2.2 outlines some widely used performance indicators.

**TABLE 2.2 Profitability Ratios**

|  |  |  |
| --- | --- | --- |
| **Ratio** | **Formula** | **Comments** |
| **Return on**  **Invested Capital**  **(ROIC)** | **Operation profit before interest after tax**  **Fixed assets + Net current assets** | ROIC Measures the return on the capital invested in the business. ROIC is also known as return on capital employed (ROCE). The numerator is operating profit or earnings (EBIT), and can be pretax or post-tax. The denominator can also be measured as equity plus debt. |
| **Return on equity (ROE)** | **Net income**  **Shareholders’ equity** | ROE measures the firm’s success in using shareholders’ capital to generate profits that are available for remunerating investors. Net income is often measured net of income from discontinued operations and before any special items. |
| **Return on assets (ROA)** | **Operating profit**  **Total assets** | The numerator should correspond to the return on all the company’s assets-eg., operating profit, EBITDA (earnings before interest and tax). |
| **Gross Margin** | **Sales – cost of bought-in goods and**  **services**  **sales** | Gross margin measures the extent to which a firm add value to the goods and services it buys in. |
| **Operating Margin** | **Operating profit**  **sales** | Operating margin and net marginmeasure a firm’s ability to extract profit from its sales, but for appraising firm performance, these ratios reveal little because margins very greatly between sectors according to capital intensity **(see table 2.1).** |
| **Net margin** | **Net income**  **sales** |  |

**TABLE 2.1 The performance of some of the world’s leading companies in terms of different profitability measures, 2010**

Market capitaliza- Net income Return to

Company tion ($billion) ($billion) ROS(%) ROE (%) ROA (%) shareholders %

**ExxonMobil 354 30.5 15.2 20.7 17.5 10.1**

**Apple 338 14.0 31.2 29.3 29.0 53.1**

**PetroChina 226 22.9 10.6 15.3 11.7 -8.4**

**General Electric 155 11.6 12.7 9.8 18.9 23.9**

**JPMorgan Chase 108 17.4 28.5 9.9 11.8 2.3**

**Wal-Mart Stores 196 30.5 5.9 23.5 14.1 3.2**

**Volkswagen 64 9.1 7.5 32.9 3.6 123.2**