Review: Full, Anonymous: No

Table 2.1 compares companies according to different profitability measures:

1. Which two of the six performance measures do you think are the most useful indicators of how well a company is being managed?
2. Is return on sales or return on equity a better basis on which to compare the performance of the companies listed?
3. Several companies are highly profitable, yet have delivered negative returns to their shareholders. How is this possible?

Instructions: Enter or paste your written work and/or click "Attachments" to upload your files.

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Subject	*Submitted*	*Submission Score (100 pts)*	*Comments*

TABLE 2.1 Performance of the world's biggest companies using different profitability measures (2007)

Company	Market capitalization[a] ($ bn)	Net income[a] ($ bn)	Return on sales[b] (%)	Return on equity[c] (%)	Return on assets[d] (%)	Return to shareholders[e] (%)
ExxonMobil	453	40.61	17.42	33.35	29.69	24.30
PetroChina	424	20.75	24.48	19.99	18.85	28.90
General Electric	370	22.21	15.40	19.22	7.46	2.60
Gazprom	300	26.11	38.66	16.11	10.33	103.50
China Mobile	298	12.41	36.21	23.32	22.02	21.50
Microsoft	264	14.07	39.41	48.73	30.90	20.80
AT&T	231	11.95	15.31	10.36	7.40	20.50
Royal Dutch Shell	220	31.33	14.22	25.28	15.12	20.10
Procter & Gamble	216	10.34	19.25	17.38	11.86	16.60
Wal-Mart Stores	211	12.73	5.33	19.70	13.45	4.70
Berkshire Hathaway	207	13.21	17.05	10.94	8.08	28.70
Nestlé	197	10.72	12.57	20.99	13.10	31.60

Notes

[a] Source: *Financial Times*.

[b] Pretax profit as a percentage of sales revenues. Source: Hoovers

[c] Net income as a percentage of (year end) shareholders' equity. Source: Hoovers.

[d] Operating income as a percentage of (year end) total assets. Source: Hoovers.

[e] Dividend + share price appreciation during 2007. Source: *Fortune*.

Economic profit has two main advantages over accounting profit as a performance measure. First, it sets a more demanding performance discipline for managers. At many capital intensive companies seemingly healthy profits disappear once cost of capital is taken into account.

Second, using economic profit improves the allocation of capital between the different businesses of the firm by taking account of the real costs of more capital intensive businesses (see Strategy Capsule 2.1).

STRATEGY CAPSULE 2.1

Economic Value Added at Diageo plc.

At Guinness-to-Johnny-Walker drinks giant Diageo, EVA transformed the way in which Diageo measured its performance, allocated its capital and advertising expenditures, and evaluated its managers.

Taking account of the costs of the capital tied up in slow-maturing, vintage drinks such as Talisker and Lagavulin malt whisky, Hennessey cognac, and Dom Perignon champagne showed that these high-margin drinks were often not as