Guidelines for the Strategic Audit Report

Adapted and revised from: Wheelen and Hunger, (2008). *Concepts in Strategic Management and Business Policy*, 11th Ed., Pearson Education, Inc.

Purpose of the strategic audit assignment

The point of this assignment is to see how well you can research, interpret, and draw conclusions about the soundness and competitive position of a company. Opinions are not worth any more than the evidence on which they are based. However, simply locating facts is not sufficient; you also have to determine what those facts mean, and you have to report everything in a convincing manner.

A strategic audit is usually done to help the firm's management decide how to proceed, or to support a potential investment or loan. The purpose of a strategic audit is essentially to answer the question, "What condition is this firm in?" Because the audit is focused toward answering this question, there must be a conclusion about what the audit shows. Therefore, while this is mostly an objective, informative report, there is a persuasive twist at the end.

The strategic audit is not an exam where you simply type in the “right” response. The questions listed below serve as a basic guide for your efforts. These questions are a bare minimum, and you need to answer all of them. However, these questions are not intended to limit your research or limit what you report.

Think of the audit more like an investigative report. The reader wants to know something significant about the company. Are they on the right track, or not? Is this a good operation, or not? Are they worth an investment or a loan?

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Your assignment is to:

- Select a public company to review.
- Use the questions and instructions on pp. 4-10 to analyze the company.
- Use the prescribed format on p. 3 to prepare a written report.

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An effective report

This exercise is designed to make you think, not just about collecting company facts, but also about how to communicate what those facts mean in an effective, informative, persuasive manner. Please remember, this is a senior-level course. We expect a lot as you near the end of your studies.

The key to an effective report requires thinking about the purpose of the report. Remember, the purpose of a strategic audit is essentially to answer the question, “What condition is this firm in?” Therefore, everything in the audit should be directed toward answering this question. To help decide, you might ask yourself how you would prepare such a report if it were going to the CEO of your employer company instead of to your course instructor.

What would top level executives be looking for? First of all, they want something that is quick to read, easy to read, and easy to understand. They want something objective, that sticks to the facts, and does not ramble on about unimportant points. They want something that omits editorial comments or reflects editorial bias, at least until the conclusions at the end. They want it written without grammar, punctuation, or spelling errors (in fact, they tend to discard reports that contain such errors). They prefer an executive summary at the beginning, which is often done in bullet-format. (NOTE: Although this is not APA style, it does make good corporate sense, and bullets will be allowed in the executive summary.)

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Required format for the strategic audit report

The strategic audit report is divided into nine prescribed format sections as shown below. Your report must be formatted in the order shown. The main sections are highlighted in yellow. There are several questions in each section (see pp. 4-10 for details) which must be addressed in the report.

A few of the APA rules will be relaxed, as indicated in the writing guidelines section of this document. However, proper grammar, punctuation, and spelling are still required, and many of the APA rules will still apply, especially those concerning citations and references. Papers without proper citations and references will not be accepted.

Everything must be in the main body of your report, including the EFAS, IFAS, SFAS, and TOWS tables. Tables must be formatted to fit into the regular paper, which may require some creativity and editing.

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Required sections of the strategic audit report

Questions and information for completing each section appear on pp. 4-10. If you are completely unable to find information on a particular question, indicate that in your report.

The course assignments on Boards, EFAS, IFAS, SFAS, TOWS, Common-Size Statements, and Financial Ratio Analysis will form portions of the completed audit.

I - EXECUTIVE SUMMARY

II - CURRENT SITUATION
- Business model
- Business lines
- Business products
- Customers
- Value chain analysis
- Diversification
- Overall performance
- Mission statement analysis

III - CORPORATE GOVERNANCE
- Directors
- Management

IV - EXTERNAL ENVIRONMENT: OPPORTUNITIES AND THREATS
- Societal environment
- Task environment
- EFAS analysis

V - INTERNAL ENVIRONMENT: STRENGTHS AND WEAKNESSES
- Corporate structure
- Competencies
- Competitive advantages
- Financial analysis
  - Common-size statements
  - Financial ratio analysis
- IFAS analysis

VI - ANALYSIS OF STRATEGIC FACTORS (SWOT)
- SFAS analysis
- Mission statement

VII - STRATEGIC ALTERNATIVES AND RECOMMENDED STRATEGY (TOWS)
- TOWS analysis
- Recommended strategies

VIII - IMPLEMENTATION OF RECOMMENDED STRATEGY
- Programs needed
- Financial feasibility
- Operating procedures needed

IX - CONCLUSIONS

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CURRENT SITUATION

A. Briefly describe the company's business model. What is the company's basic approach to the business, e.g. diversification, growth by acquisition, globalization, low cost or differentiated niche? How does the company seek to add value to shareholders, customers, employees, and other stakeholders?

B. Does this company compete in a single line of business, or does it compete in multiple businesses? If the latter, what is the relative significance of the various lines of business (in revenues)?

C. What are the company's products? Who are the customers? What are the company's sources of competitive advantage (if any) and are they sustainable?

D. Does the company compete domestically, in a few countries, or globally?

E. Illustrate and explain the key components of the company's value chain, including domestic and international activities. In addition to the textbook, the following links provide information about value chain analysis.
http://tutor2u.net/business/strategy/value_chain_analysis.htm
http://www.quickmba.com/strategy/value-chain/

F. Briefly describe strategic advantages and disadvantages identified by the value chain analysis.

G. Explain the extent to which the company has vertically and horizontally diversified its activities, and outsourced its operations.
   1. What was the company's overall performance the past year (in terms of return on investment, market share, and profitability)? How well have the company's overall business strategies been working?

H. What is the company's current mission statement?
   1. What is the stated strategic vision and mission? Are they appropriate? Do they need to be revised or changed?
   2. Analyze the mission statement, using Campbell's 10 criteria for evaluating mission statements.
   3. Does the strategy or mix of strategies appear consistent with the vision and mission, and with the internal and external environments?

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CORPORATE GOVERNANCE

A. Board of Directors
   1. Who are the board members? What are their backgrounds? Where do they work, and what do they do? What qualifies them to be on the board?

2. Are they internal or external members? How long have they served on the board?
3. Do they own significant shares of stock? Are they paid in cash or stock options?
4. Does the company have an insider who controls a separate voting class of shares?
5. What do the board members contribute to the company in terms of knowledge, skills, background, and connections? If the company has international operations, do board members have international experience?
6. What is their level of involvement in strategic management? Do they merely rubber-stamp top management's proposals, or do they actively participate and suggest future directions?

B. Top Management

1. How is the company organized and governed?
2. What person or group constitutes top management? Who is leading this company in its drive to success?
3. How qualified are the managers running the company? What is their track record like? Is management rewarded for performance, or for just showing up to work?
4. What role do stock options play in executive compensation? How much stake (including options) do the CEO and top managers have in the company? Is it too small to matter?
5. What are top management's chief characteristics in terms of knowledge, skills, background, and style? If the company has international operations, does top management have international experience? Are executives from acquired companies considered part of the top management team?
6. Has top management been responsible for the company's performance over the past few years? How many managers have been in their current position for less than three years? Were they promoted internally or externally hired?
7. Is top management sufficiently skilled to cope with likely future challenges?
8. What kind of incentive structure is in place? How clear are the goals set out by the board's Compensation Committee for top management? Are they mostly short-term or do they address long-term building of investor value?
9. How transparent are the company's disclosures? Is the company any better than its competitors?
10. Does the company have a habit of showing one-time charges on their books?

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EXTERNAL ENVIRONMENT: OPPORTUNITIES AND THREATS

A. Societal Environment

1. What general environmental forces are currently affecting both the company and the industries in which it competes? Which ones present current or future threats, or opportunities?
    a. Economic
    b. Technological
    c. Political-legal

        d. Socio-cultural
    2. Are these forces different in various regions of the world?

B. Task Environment
    1. What forces drive industry competition? Are these forces the same globally, or do they vary from country to country? Rate each force as high, medium, or low.
        a. Threat of new entrants
        b. Bargaining power of buyers
        c. Threat of substitute products or services
        d. Bargaining power of suppliers
        e. Rivalry among competing firms
        f. Relative power of unions, governments, special interest groups, etc.
    2. Identify the company's key competitors within the industry, and briefly describe each company's competitive position (relative size, revenues, etc.) and likely future moves. You may summarize this data in a table. In what ways is the company stronger or weaker than key competitors, and what are the issues that management must address?
    3. What key factors in the immediate environment (i.e., customers, competitors, suppliers, creditors, labor unions, governments, trade associations, interest groups, local communities, and shareholders) are currently affecting the company most? Which are current or future threats, or opportunities?

C. Summary of External Factors (include the EFAS table in the body of your report, not in an appendix)
    1. Which of these forces are most important to the company and to the industries in which it competes at the present time?
    2. Which of these forces will be most important in the future?

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INTERNAL ENVIRONMENT: STRENGTHS AND WEAKNESSES

A. Corporate Structure
    1. How is the company structured at present?
        a. Is the decision-making authority centralized around one group or decentralized in many units?
        b. Is the company organized on the basis of functions, projects, geography, or some combination of these?
    2. Is the present structure consistent with current strategies, as well as with the company's international operations?
    3. In what ways does this structure compare with those of similar companies?

B. Competencies and competitive advantage
    1. What are the company's core competencies?
    2. Are any of these distinctive competencies (better than the competition)?

3. What are the company's competitive advantages? Do they appear to be sustainable, given changing conditions?
4. How are competitors reacting to the changing environment? Will they enjoy a relative advantage that may have an impact on this company's ability to succeed?

C. Finance (include the common-size statements and financial ratios in the body of your report, not in an appendix)
   1. Analyze the company's financial statements for the last three to five (3-5) years, and compare them to key competitors and industry averages. Explain how this information relates to current and future strategic initiatives
      a. Prepare comparative common-size statements for 3-5 years, including balance sheets, income statements, and cash flow statements.
      b. Are there any significant differences when statements are calculated as common-size versus reported dollars?
      c. Analyze the financial statements, including financial ratio analysis.
      d. What trends emerge from the financial analysis?
      e. What impact have these trends had on past performance and how might these trends affect future performance?
   2. How well is the company performing financially? Is the company's financial situation improving or deteriorating?
   3. How well does this financial analysis support the company's current strategy?

D. Summary of Internal Factors (include the IFAS table in the body of your report, not in an appendix)
   1. Which of these factors are core competencies?
   2. Which, if any, are distinctive competencies?
   3. Which of these factors are the most important to the company and to the industries in which it competes at the present time?
   4. Which of these factors might be most important in the future?
   5. Which functions or activities are candidates for outsourcing?

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ANALYSIS OF STRATEGIC FACTORS (SWOT)

A. Situational Analysis (include the SFAS matrix in the body of your report, not in an appendix)
   1. Of the external (EFAS) and internal (IFAS) factors listed, which are the strategic (most important) factors that strongly affect the company's present and future performance?
   2. Will this be an attractive industry in the future? What is happening in the external macro- environment and competitive environment to change the competitive dynamics of the industry?
   3. Does the company's current strategy fit with the external environment? Are the company's activities and attributes appropriate for this environment?

B. Review of Mission Statement
   1. Are the current vision and mission appropriate in light of the key strategic factors and problems?
   2. What is the likely future of this company if it continues on its current path?
   3. Should the mission statement be changed? If so, how?
   4. If the mission statement is changed, what will be the most probable effects on the company?

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STRATEGIC ALTERNATIVES AND RECOMMENDED STRATEGY

A. Strategic Alternatives (include the TOWS matrix in the body of your report, not in an appendix)
   1. Does the current strategy need to be changed or revised. Why? What evidence supports changing?
   2. What are the major feasible alternative strategies available to the company? What are the pros and cons of each? Can scenarios be developed and agreed upon? (Alternatives must be compatible with societal environment, industry, and company for the next three to five years.)
      a. Consider stability, growth, and retrenchment as corporate strategies.
      b. Consider cost leadership and differentiation as business strategies.
      c. Consider any functional strategic alternatives that might be needed for reinforcement of an important corporate or business strategic alternative.
   3. Assess those alternatives that will be most likely to move the company forward, and will help them attain a sustainable competitive advantage. Discuss each in detail, and use evidence to support why each will be effective.

B. Recommended Strategy
   1. Specify which of the strategic alternatives recommended for the corporate, business, and functional levels of the company. Are different business or functional strategies recommended for different units of the company?
      NOTE: Be specific. General statements such as "The company should expand internationally" are not sufficient. Instead, you might state, "The company should offshore the manufacturing operations to Poland, the Czech Republic, or elsewhere in Central Europe."
   2. Support each recommendation by explaining why it is recommended, how it exploits the key strengths and opportunities and minimizes the weaknesses and threats, how it will help the company attain a competitive advantage, and why it is superior to the other alternatives.
   3. Justify recommendations in terms of their ability to resolve both long-term and short-term problems and effectively deal with strategic factors.
   4. What policies should be developed or revised to guide effective implementation?
   5. What is the impact of the recommendations on the company's core and distinctive competencies?

6. Project the impact of the recommendations on the future economics of the company and the industry. How will the changes improve the company's ability to add value to the shareholders, customers, employees, and other stakeholders?

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IMPLEMENTATION OF RECOMMENDED STRATEGY

A. What kinds of programs (for example, restructuring the corporation or instituting TQM) should be developed to implement the recommended strategy?
B. Are the programs financially feasible?
C. What new standard operating procedures will need to be developed?

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CONCLUSIONS

The purpose of a strategic audit is essentially to answer the question, "What shape is this firm in?" In essence, the final audit report should answer that question. Most of the report will be taken up with what you found, and what it means to the company. That is the objective, informative part.

The persuasive twist comes in the conclusion, where you want to persuade the company's management to take a particular action (continue, or change direction). The senior managers of any company will usually be reluctant to change their current strategies (which they put in place) unless you can convince them that change is necessary for the company to survive or thrive.

You should clearly state your conclusions and recommendations. You should also provide supporting evidence from your research. Supporting evidence would include key industry and company issues, trends, threats and opportunities, and why and how your recommendations will help the company survive and prosper, create value, and attain a sustainable competitive advantage in the marketplace. In short, the conclusion should be a strong statement, perhaps even a call for action.

You should also explain how the company should go about implementing your recommendations, and what the financial benefits will be (including the impact on assets and liabilities, revenues and costs, and profits and cash flow).

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EXECUTIVE SUMMARY

An executive summary is usually 1-3 pages of bullet statements highlighting the main points of the report. This part cannot be written until after you have finished your report, but it is placed at the beginning of the report, right after the title page. It should contain the main highlights of the report, and it should offer a succinct, compelling argument for your position!

The executive summary may be the only section of the report that top managers will read. Therefore, it should be a brief, persuasive document that compels action.

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Selecting a company for the strategic audit

First, it is always best to select a company you are interested in. This report is difficult and time-consuming. It is even worse if you are not interested in the company.

When deciding on a company to analyze, be sure that there is sufficient information available. This must include 3-5 years of financial statements (balance sheet, income statement, cash flow statement). Generally, you will do much better to select a public company, since they are required to make this kind of information publically available.

If you pick a company with a relatively narrow focus, it is easier to determine what business they are in, and who their competitors are. Large, complex companies (i.e., General Motors or General electric) make this assignment more difficult. However, if you try to select only one division, you will most likely find that the information you need is not available. Major companies rarely publish data on specific subsidiaries; such data is combined in the parent company information.

You may be able to use your employer's company. However, if your employer is a private company the biggest problem is getting access to the financial statements. Another big problem for some students is remaining objective about their employer. The strategic audit is largely an objective exercise, and there is no place for editorial bias and PR hype.

Interim assignments during the course will draw on different parts of the audit. In other words, you will be doing the total audit in pieces, rather than waiting to do everything at the end of the course. This is intended to make the entire process easier.

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Evaluating mission statements

Source: Strategic Highlight 1.1, p. 13, from: Wheelen, Thomas L. and J. David Hunger (2008) Concepts in Strategic Management & Business Policy, 11 ed. Pearson Prentice Hall. Reprinted from *Long Range Planning,* Vol. 30, No. 6, 1997, Campbell, "Mission Statements," pp. 931-932. Copyright © 1997 with permission of Elsevier.

Andrew Campbell, a director of the Ashridge Strategic Management Centre and a long-time contributor to *Long Range Planning,* proposes a means for evaluating a mission statement. Arguing that mission statements can be more than just an expression of a company's purpose and ambition, he suggests that they can also be a company flag to rally around, a signpost for all stakeholders, a guide to behavior, and a celebration of a company's culture. For a company trying to achieve all of the above, evaluate its mission statement using the following 10-question test.

Score each question: 0 for no, 1 for somewhat, or 2 for yes. According to Campbell, a score of over 15 is exceptional, and a score of less than 10 suggests that more work needs to be done.

1. Does the statement describe an inspiring purpose that avoids playing to the selfish interests of the stakeholders?

2. Does the statement describe the company's responsibility to its stakeholders?

3. Does the statement define a business domain and explain why it is attractive?

4. Does the statement describe the strategic positioning that the company prefers in a way that helps to identify the sort of competitive advantage it will look for?

5. Does the statement identify values that link with the company's purpose and act as beliefs with which employees can feel proud?

6. Do the values resonate with and reinforce the company's strategy?

7. Does the statement describe important behavior standards that serve as beacons of the strategy and the values?

8. Are the behavior standards described in a way that enables individual employees to judge whether they are behaving correctly?

9. Does the statement give a portrait of the company, capturing the culture of the company?

10. Is the statement easy to read?

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Evaluating the Board of Directors

In the past, the Board's major responsibility was hiring the CEO. It was largely through their selection of a CEO that they influenced the direction of the company. The CEO and his team did most of the strategic planning, and the Board usually accepted it, many being little more than rubber-stamps for executive decisions. However, things change and evolve, and the role of the Board is now under scrutiny. Boards are being publicly indicted for complicity in a host of corporate fiascos.

The key to this exercise is to explain who the directors are and what they have to offer. If they were all well-known, famous names, we could understand who they are simply from their names. But how are we to know who they are if their names are not well-known? In other words, the names mean nothing unless we know what the names represent. Sam Smith means nothing. Sam Smith, CEO of IBM, means much.

This should not be a long, lengthy section, but a very concise one. It should not simply be a copy-and-paste from the company's literature. Photographs do not necessarily add anything. Think about how you can best present the information in a clear, concise, readable fashion.

You can save a lot of time and writing by placing data on directors in a table, such as:

Name Job Title Primary employer	Shares	Date Joined BoD Committees	Background Comments

Most people are in awe of credentials. Credentials have replaced competency as the criterion for selection. This is not to denigrate credentials, but not to revere them simply for their own sake. The credentials of the board members and top managers at failed firms are as impressive as those at successful firms (think Enron). Unfortunately, there is no credential for honesty, integrity, service, wisdom, common sense, judgment, commitment, and conscientiousness.

If all the boards and management teams were as great as the company literature claims, then why do we continue to have so many corporate problems? A key in evaluating board members and top managers is to try seeing beyond the hype promulgated by the company PR team, and understand what is actually happening. Admittedly, this is difficult, often impossible without inside information.

Do some thinking on your own, and come to some kind of reasoned conclusion. Old-fashioned common sense goes a long way. Learn to read between the lines, and beyond the apparent. Ask yourself questions: Does this make sense? How do I know this? Healthy skepticism is the order of the day.

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Preparing the tables: EFAS, IFAS, SFAS, and TOWS

Data is often presented in tables, and sometimes students assume that the tables of data will speak for themselves. They do not; data needs to be interpreted. It is a major mistake to assume that the reader will perceive the same thing you do in the data. Whenever you present the results of data analysis, you must interpret the data. What does it indicate? What does it mean? What are the implications?

When you prepare the EFAS, IFAS, SFAS, and TOWS tables, you need to add explanations. Whenever you prepare any table you also need commentary explaining the meaning behind the numbers. Explaining how the score is derived can be a good start, but that is not sufficient. What does the score indicate about the company's position in the industry? What does it indicate relative to the company's strategy? Is this a good, bad, or indifferent score? Why?

The reason for emphasizing the explanation is that people who read your reports are never as immersed in the data as you are, nor should you expect them to be. They have not studied the issues in depth as much as you have. Your reports (with tables, figures, and illustrations) should explain things so less-informed readers will know what it all means, and enable them can make informed decisions.

There are three keys to using and understanding the EFAS and IFAS tables. First, there is the issue of identifying the most relevant factors. Second, there is the issue of how to assign accurate weightings. Both of these call for subjective judgment. However, once determined, the third key issue is to objectively use the data generated, regardless of how you feel about the company emotionally. Or, as one of my mentors used to say, "Call it like it is, not what you would like it to be."

Most of you are probably familiar with the classic SWOT analysis matrix. The SFAS and TOWS tables are simply a more focused extension of the classic matrix. These tables must also be explained. Why did you focus in on specific items? What does the table indicate relative to the firm's strategy? Why?

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Common-size statements

A common-size statement is one converted to percentages. Either total revenue (income statement) or total assets (balance sheet) are set equal to 100%. All other accounts are calculated as a percentage. Also, a common-size statement does not contain any dollar values, only percentage values.

Both a balance sheet and an income statement must be included whenever analyzing financial statements, whether common-size or dollar value. You cannot analyze a company without both a balance sheet and an income statement, and both must be included in the strategic audit. For a thorough financial analysis, you also need to evaluate the cash flow statement.

Here is an Internet site that provides an explanation of common-size statements: http://www.netmba.com/finance/statements/common-size/ .

To convert a dollar-value income statement to a common-size statement should only take a few minutes. To start, all you have to do is set the total revenue figure equal to 100%. Then, you simply divide each line item by the revenue figure to get the percentage for that item. When you are finished, all the line item percentages should add up to 100%. See the following example.

	Dollar-Value Income Statement	**Common-Size Income Statement**
Revenue	70,134	100%
Cost of Goods Sold	44,221	63.1%
Gross Profit	25,913	36.9%
SG&A Expense	13,531	19.3%
Operating Income	12,382	17.7%
Interest Expense	2,862	4.1%
Provision for Taxes	3,766	5.4%
Net Income	5,754	8.2%

Please check the following website for more information:
http://www.netmba.com/finance/statements/common-size/

To convert a dollar-value balance sheet to a common-size statement, you set the total assets equal to 100%. Then, divide each line item by the total assets figure to get the percentage for each line item. When you are finished, all the line item percentages should add up to 100%. See the following example.

	Dollar-Value Balance Sheet	Common-Size Balance Sheet
ASSETS		
Cash & Marketable Securities	6,029	15.1%
Accounts Receivable	14,378	36.0%
Inventory	17,136	42.9%
Total Current Assets	37,543	93.9%
Property, Plant, & Equipment	2,442	6.1%
Total Assets	39,985	100%
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities	14,251	35.6%
Long-Term Debt	12,624	31.6%
Total Liabilities	26,875	67.2%
Shareholders' Equity	13,110	32.8%
Total Liabilities & Equity	39,985	100%

Financial ratios are explained in another section of this document. You can also check websites, such as:

1. http://www.netmba.com/finance/financial/ratios/
2. http://faculty.philau.edu/lermackh/financial_analysis.htm#Steps%20to%20a%20Basic%20Company%20Financial%20Analysis
3. http://www.independent-stock-investing.com/Understanding-Financial-Statements.html

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Analyzing Financial Statements

This section presents a very basic, fundamental approach to the subject of analyzing financial statements. It draws extensively on information from two websites: http://faculty.philau.edu/lermackh/financial_analysis.htm#Steps%20to%20a%20Basic%20Company%20Financial%20Analysis and http://www.independent-stock-investing.com/Understanding-Financial-Statements.html.

The treatment here can be considered as a basic review of earlier accounting and finance classes. This is not intended to be a definitive statement for advanced understanding of the topics covered. An Internet search will uncover hundreds of excellent sources for those students who want a more complete explanation of the topics.

Financial statements
There are three financial statements which are most important for analyzing the performance of any organization. Click on the various links below for more information.

1. Balance sheet	(assets=liability-equity) What is our financial condition? What do we own, and what do we owe?
2. Income statement	(revenue-expenses=net profit) How much profit are we making?
3. Cash flow statement	How much cash flows in and out? When does the cash flow in and out? Where does the cash come from?

With the financial statements in hand, use the following 10-step approach to analyze them. This approach is based on suggestions from Professor Harvey B. Lermack. (http://faculty.philau.edu/lermackh/financial_analysis.htm#Steps%20to%20a%20Basic%20Company%20Financial%20Analysis).

1. Obtain the three basic financial statements for 3-5 years.
2. Review the notes accompanying the financial statements.
3. Examine the balance sheets for any large changes from year to year. Research anything that looks suspicious to find out why.
4. Examine the income statement for trends over time. Research anything that looks very suspicious to find out why.
5. Look for non-recurring or non-operating items, "unusual" expenses not directly related to ongoing operations. Research anything that looks suspicious to find out why.
6. Examine the cash flow statement for how cash was obtained and used. Research anything that looks suspicious to find out why.
7. Calculate financial ratios, and graph the ratios over time to spot any trends. See the

following section of this document for detailed information on ratio analysis.

8. Review the market data to understand movements in the stock price.
9. Obtain financial data for the company's key competitors, and analyze it the same way for comparison. Compare the ratios for competitors and the industry to the company being studied.
10. Ask yourself: *"Based on everything I know about this company and its strategies, the industry and the competitors, and the external factors that will influence the company in the future, do I think this company is worth investing in for the long term?"*

Limitations of financial statements

As important as financial statements are, however, they do have several limitations. NOTE: Information in this section comes primarily from two websites:

1. http://www.independent-stock-investing.com/Limitations-Of-Financial-Statements.html
2. http://faculty.philau.edu/lermackh/financial_analysis.htm]

1. Financial statements represent the past.	Financial statements are both milestones and signposts. As milestones, they help assess the past performance and current condition. As signposts, they provide information about the past to predict future performance and condition.
2. Financial Statements ignore qualitative aspects	Aspects such as management quality and key competencies are not explicitly shown in financial statements.
3. Financial Statements don't directly show changes in structure	Changes in structure can be crucial for strategy decisions (i.e., new plant, new products, acquisitions, re-structuring).
4. Financial statements reflect costs but not value.	For example, fixed assets are usually shown on the balance sheet as the cost of the assets less their accumulated depreciation, which may not reflect the current market value of those assets.
5. Financial statements do not include all items.	For example, it is hard to put a value on human capital (such as management expertise).
6. Financial statements are not the same everywhere.	Accounting standards and practices vary among countries, and thus hamper meaningful global comparisons.

Because financial statements do not tell the entire story, you will also want to check many other sources to evaluate management and operations. Here are some good places to start. [Source: http://www.independent-stock-investing.com/Evaluating-Management.html]

1. *Company Website*
   Check the Investor Relations section, including recent press releases.
2. *Proxy Statement*
   Check the company website, Yahoo Finance, or MSN Money.
   The annual Proxy filing is also called Schedule DEF 14A. The proxy covers the board's activities, manager compensation, biographies of top management, ownership of shares, and any potential conflict of interest that the top management may have.
3. *Annual and Quarterly Reports*
   These reports are also called 10-K (annual) or 10-Q (quarterly).
   The section called "Management Discussion and Analysis" is very insightful.
   Look for how the top managers see the business and where they think they are going with it in the future. Also see how candid the managers are about their decisions, including those that led to failure.
4. *Articles*
   Do an Internet search for articles written by reliable business publications and stock market analysts.

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Analyzing financial ratios

Several categories of financial ratios are used to help analyze financial statements. Ratio analysis is especially useful for comparing performance over several years, comparing to competitors, setting benchmarks, and spotting areas to improve. On the other hand, ratio analysis does have several limitations. It is very subjective, past-oriented, not always comparable, and sometimes inconclusive.

Nevertheless, financial ratio analysis is still one of the most reliable sources of information about the financial condition of a company, especially when done over time. Therefore, students will be expected to calculate the following ratios, and provide an interpretation of what they mean for the company.

The most commonly used ratios are shown below.

CATEGORY	RATIO	HOW TO CALCULATE
Liquidity ratios	Current ratio Quick ratio	Total Current Assets/Total Current Liabilities (Total Current Assets – Inventories)/Total Current Liabilities
Leverage ratios	Debt to equity ratio Debt to assets ratio	Total Debt/Total Equity Total Debt/Total assets
Activity ratios	Gross margin Operating margin Net margin Return on assets Return on equity	Gross Income/Sales Operating Income/Sales Net Income/Sales Net Income After Taxes/Total Assets Net Income After Taxes/Total Equity
Efficiency ratios	Asset turnover Inventory turnover Average collection period	Sales/Total Assets Cost of Goods Sold/Inventory Average Accounts Receivable/(Total Sales/365)
Value ratios	Price-to-Sales Price-to-Book Price-to-Earnings	Stock Price per share/Sales per share Stock Price per share/Equity per share Stock Price per share/Earnings per share

Analyzing liquidity

Liquid assets are those which can be converted into cash quickly. Since these ratios indicate ability to meet short-term obligations, a higher ratio would indicate greater liquidity and lower risk for short-term lenders. The generally accepted standard is 2:1 for the current ratio and 1:1 for the quick ratio. However, standards for specific industries can vary.

Current Ratio = Total Current Assets/Total Current Liabilities

- This measures the number of times the company can cover its current liabilities with its current assets.
- A current ratio greater than 1 is a rough indication that a company has sufficient resources to pay its current liabilities.
- It assumes that both accounts receivable and inventory can easily be converted to cash, which is not always the case.
- It does not indicate how quickly non-cash current assets can be converted into cash.
- Ratios less than 1.0 are considered low, indicating financial difficulties.
- Ratios of more than 2.0 often suggest excessive liquidity from non-invested funds.

Quick Ratio = (Total Current Assets – Inventories)/Total Current Liabilities

- This is more conservative than the current ratio since inventory, the least liquid current asset, has been subtracted.
- The quick ratio is a better indicator of the company's ability to cover its current liabilities within the next 90 days.
- It assumes conversion to cash without excessive loss in value.
- Ratios of less than 1.0 can indicate the need for additional sources of liquidity.

Analyzing leverage (debt)

Leverage is just a fancy word for debt. Debt ratios show the extent to which a company is relying on debt to finance its operations and investments, and how well it can manage its debt. On the positive side, debt is beneficial, providing opportunity for growth and tax benefits. On the negative side, if the company cannot pay its debt it will be forced into bankruptcy.

In general, with either of the leverage ratios, the lower the ratio, the more conservative (and probably safer) the company is. However, if a company is not using debt, it may be foregoing investment and growth opportunities.

Debt to Equity Ratio = Total Debt/Total Equity

- This shows how much the company relies on debt.
- A high ratio indicates a more aggressive approach to financing, a high risk strategy, less protection for creditors, and possible difficulty paying interest and principal.
- A low ratio indicates a more conservative approach to financing and a wider safety cushion.
- The upper acceptable limit is usually 2:1, with no more than one-third of debt in long term.

Debt to Assets Ratio = Total Debt/Total Assets

- This indicates the extent to which assets are encumbered with debt.
- Some analysts prefer this ratio, which also shows how much the company relies on external financing to purchase assets.
- A ratio over 65% indicates excessive debt.

Analyzing activity

These ratios show how well the company utilizes its resources to earn profits and create shareholder value.

Gross Margin = Gross Income/Sales

- This shows the profit margin after direct costs (cost of goods sold) have been subtracted from sales.
- Any downward trends in the gross margin over time could indicate problems such as increasing competition, rising inventory costs, or poor pricing.

Operating Margin = Operating Income/Sales

- Operating income includes indirect operating costs, i.e., wages, supplies, legal expenses, research and development expenses, and depreciation.
- A downward trend that cannot be explained by the gross margin getting worse means that operating expenses have increased over time without a proportional increase in sales.
- The next step under such conditions would be to examine which operating expenses increased and if this increase was justified.

Net Margin = Net Income/Sales

- This is the "bottom line" — the percentage of sales that the company keeps as profit.
- A low ratio indicates that expenses are too high relative to sales.
- A downward trend, despite a healthy gross and operating margin, would indicate that interest expense, loss on sale of assets, taxes paid, or other extraordinary expenses might be responsible.
- The next step would be to dig deeper to figure out which of these increased, and why.

Return on Assets = Net Income After Taxes/Total Assets

- This indicates how well the company's management uses total assets to create profits.
- A high ratio indicates effective, efficient management and a good chances for future growth.
- Since this calculation is based on total assets, capital intensive businesses will have very different ratios compared to businesses with very small investment in assets. Therefore, companies being compared need to have similar product lines and business types.

Return on Equity = Net Income After Taxes/Total Equity

- This indicates how much the shareholders earned on their investment in the company.
- The higher the ratio, the better for the shareholders.

- This is highly affected by the amount of debt used by the firm (equity = assets – liabilities). Therefore, for the same net income, an increase in the company's debt will reduce its equity base and increase its ROE. The bump in the ROE comes at the price of higher debt.

Analyzing Efficiency
These ratios indicate how well the company's assets are being managed.

Asset Turnover = Sales/Total Assets
- Shows the amount of sales generated for every dollar invested in assets.
- A high ratio generally reflects overall good management.
- A low ratio may indicate flaws in the company's overall strategy, poor marketing efforts, or inappropriate capital expenditures.

Inventory Turnover = Cost of Goods Sold/Inventory
- This ratio shows how fast the inventory is being sold and replenished.
- This is a good indicator of how well the company manages its inventory.
- A higher ratio implies the company is more efficient in managing inventories by minimizing the investment in inventories.
- A ratio of 12 would mean that the inventory turns over 12 times, or the average inventory is sold in one month. Whether a ratio is good or bad, however, depends on the nature of the industry.

Receivables Turnover = Total Revenue/Accounts Receivable
- This ratio shows how well a company collects money.

Average Collection Period = Average Accounts Receivable/(Total Sales/365)
- This measures how long it takes to convert a credit sale (internal store credit, not credit card sales) into cash.
- It shows the company's efficiency in collecting cash from its credit sales.
- While a low ratio is good, it could also indicate overly restrictive credit-granting policies, which may not attract customers.
- High average collection periods usually indicate many uncollectible receivables.

Analyzing value

Price-to-Sales = Stock Price per share/Sales per share
- Sales per share = Sales divided by the total number of outstanding shares.
- This is cleaner and less volatile because it is free of various accounting tricks sometimes used to boost earnings.
- It is less volatile because there is nothing like one-time charges that can really depress the earnings of a company.
- It does have one big flaw — sales don't provide a picture of the company's profitability.

What if the company is losing money on every sale?
- This is a quick valuation ratio to compare how a company has done historically.

Price-to-Book = Stock Price per share/Equity per share
- Equity per share = Equity divided by the total number of outstanding shares.
- This was more important in the past when there were a lot of capital-intensive companies. It made sense then to value companies based on their accounting book value.
- Now, there has been a huge increase in service companies and other non-capital-intensive companies.
- Wealth is created by these companies in terms of intangibles like brand names, processes, and databases, which never show up in the book value of the company.
- Be cautious about the amount that companies book as goodwill, which is typically, very subjective, and which can distort the reading.
- This ratio is closely tied to ROE (Return on Equity). Given two companies that are similar, a higher ROE typically commands a higher P/B. The reason is because a company with higher ROE can compound its equity at a much higher rate resulting in a faster increase in its equity over time. Such a company would be worth more and would therefore trade at a higher price increasing its P/B.

Price-to-Earnings *= Stock Price per share/Earnings per share*
- This is the most popular valuation ratio.
- It compares the current stock price to company earnings.
- This ratio is useful when comparing a company's current P/E with its historical P/E.
- A solid company, roughly growing at the same rate with about the same business prospects as the past, but now trading at a lower P/E, is definitely worth analyzing further.
- This ratio can help compare companies in the same industry with each other and the industry benchmark.
- The P/E ratio suffers from certain drawbacks. The EPS is based on accounting practices that require assumptions when determining earnings. The earnings calculation is also subject to manipulation at times. For instance, the E could be inflated if the company just sold a business or asset recently.
- A lower P/E does not necessarily mean an attractive buying opportunity. A company that is growing faster without much debt might have a higher P/E than an average company, but may still be an attractive buy based on its potential to produce future cash flow.

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Writing guidelines

Your grade will be based on several factors.

- Were the Strategic Audit questions adequately addressed?
- Was the content well-organized, accurate, and relevant?
- Was there a strong conclusion, based upon the facts in the report?
- Was this an objective report, without displaying any editorial bias?
- Does the report display proper grammar, punctuation, and spelling?
- Does the report comply with the relevant APA guidelines?

The first three points are covered extensively in this document. This section will comment on the last three points, discussing several writing problems which cause students to lose points.

1 Many reports suffer from inadequate organization. It is a common problem, but one that is easily fixed. The key is to outline your paper before you start writing, and then write to the outline. Most students do not do this, usually preferring to jump right in and start writing. While this may be acceptable in conversation, the result is a rambling, disjointed paper which diminishes the points you are trying to make.

2 Students often choose emotional words, and often add various editorial comments which display either positive or negative bias. This is inappropriate since this report is supposed to be writing a factual, objective statement. Doing this weakens the report, and will definitely cost points in this class.

3 Many students prepare the EFAS, IFAS, SFAS, and TOWS matrices on a spreadsheet, which is okay. However, the final strategic audit report must be done as a Word document (.doc or .docx). Matrices may need to be treated as tables and formatted accordingly. Or the spreadsheets may need to be imported into the word document as a graphic (more difficult for some students).

4 Students often incorporate wild color schemes in the tables, which makes them difficult to read. It is best to not use any color schemes.

5 Twenty percent of your grade will be based on APA style, including grammar, punctuation, and spelling. Two things are strongly encouraged. First, pay attention to the signals from your word processor. While they are not perfect, spelling and grammar checkers at least offer some guidance. Second, ask someone else to look over your work before you submit it. The writer is often the worst reviewer.

6 Please double-check your final draft against the APA rules (especially acceptable fonts, using quotations, citations in the text, and reference listings).

7 If in doubt, cite things.

8 Text must be written in complete sentences and paragraphs. Bullet-item reports will not do, except for the executive summary. However, the bullet items in the Executive Summary must still be written in complete sentences.

9 Do not write in first-person or second-person narrative.

10 Do not place EFAS, IFAS, SFAS, and TOWS tables in an appendix. These tables must be included in the text of the report, which may require some editing and creativity.

11 All tables and figures must be properly identified and sourced.

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Relaxed APA rules

As for APA issues, you should plan to write your paper using complete sentences and paragraphs. All tables must be properly identified and sourced. If in doubt, cite things.

- The APA rules for the title page will not apply. You may be creative with the title page.

- The APA rules requiring an Abstract will not apply. The Executive Summary goes where the abstract would normally appear.

- The APA rules for page headers will not apply. You may use a page header if you like, but it will not be required. However, all pages must still be numbered appropriately.

- The APA rules for bold fonts, italic fonts, and bullets will not apply. Used judiciously, these devices can be very effective in producing a persuasive report. However, please exercise caution. Students sometimes go overboard and produce a garish, confusing report which can cost points.

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Useful resources

In addition to the Hunt Library and your own Internet searches, here are some useful resources.

Association of Southeast Asian Nations (ASEAN) Booz Allen Hamilton Inc. Bureau of African Affairs Bureau of East Asian and Pacific Affairs Bureau of European Affairs Bureau of South Asian Affairs Business Plan Archive for Internet Startups, University of Maryland Business Roundtable CEOExpress.com CIA World Factbook CNNMoney.com Conference Board – Corporate Governance Corporate Governance Corporate Library Corporate Watch Duke University Resources for Industry Analysis Economist Intelligence Unit Edgar Database Free Edgar European Union FindArticles.com Glassdoor.com Harvard Business School Publishing How to Learn About an Industry How to Read a Financial Report	Knowledge at Wharton Locating Company Information on the Internet McKinsey & Company Morningstar MSN Money Office of Trade and Economic Analysis NAFTA Secretariat NASDAQ Corporate Governance Proposals National Association of Corporate Directors New York Stock Exchange Reuters Investors Reuters / Marketguide Smith Barney Research The Asia Society The Corporate Library U. S. State Department U.S. Business Reporter University of Delaware, Weinberg Center for Corporate Governance Villanova Center for Responsible Leadership & Governance Wall Street Journal World Bank Data and Research Yahoo Finance Industry Browser

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