*Strategic Management*, 9e: Chapter 5 study guide

Guidance on using financial ratios in dynamic strategy analysis

*First*, one of the main problems for strategists with financial ratios is that they look *backwards*, not forwards.

They show a historical picture of the organisation. Strategy is concerned with the future. Admittedly, strategy is built upon the past and all organisations are bounded by their history (or lack of it). But financial ratios need to be used with caution in strategic analysis and dynamics.

*Second*, it is important to obtain *comparative data* for competitors and to analyse the trends over several years. It is also valuable, where possible, to make comparisons with the norms or averages across an industry. Comparative data means that you should find at least one competitor of the company and calculate the same ratios for the second company and then compare them with the first company. This is precisely the method used in Case 5.2 on L’Oréal where the company is compared with two rivals.

The purpose in using comparative data is that there are two reasons that a company’s performance might change: first, because of *competition* and, second, because of *changes in the industry*. For example, the profits of an airline might decline because it has a poor strategy versus its competitors. However, profits may also decline because the price of fuel has risen and affected all the companies in the industry. Financial ratios therefore need to distinguish between these two influences. They do this by a comparison with rivals. For example, if our profits went down but our competitor’s did not then this would suggest a problem with our *competitive strategy*. However, if our profits and those of our competitors *both* went down, then this suggests a problem in the *industry* rather than our own strategy.

*Third*, why do we use EBIT?

EBIT = Earnings before interest and tax

The reason for using EBIT rather than earnings after interest and tax relates to the *competitive* dimension of strategy. Companies compete in the market place by selling to customers and competing against their rivals. Interest and tax are important issues for each company but rarely relate to the *trading* position of companies: these two items are more concerned with the relationship of the company with its bankers and other financial institutions. Interest and tax are internal company matters unrelated to competition. Hence from a strategy perspective, it is more relevant to examine ratios before interest and tax are deducted from the earnings of the company.

*Profitability – for most companies, profitability is probably more relevant than liquidity from a strategy perspective*





Capital employed is important in strategy because it is a measure of the wealth owned by the company in relation to its strategy. ‘Total assets less current liabilities’ is the usual way of measuring this.

Importantly, the capital employed shown in the company accounts is very simplistic from a strategy perspective. Many crucial assets are hardly, if at all, measured by this number. For example, the company may own patents and brands which may – emphasise ‘may’ - have been valued crudely in the financial accounts. However, the real value to a company in a competitive environment may be significantly higher than a figure calculated by financial accountants and approved by the company’s annual auditors.

*Liquidity – measures the ability to survive and avoid default*





*Gearing – examines the financial strength and the different forms of finance*





*Investor ratios – measures the earnings available to those who own the company*

Usually uses profit after tax and interest, i.e. *net profit.*











*Trading activity*







