

Business strategic management process essay

[Business](#), [Management](#)



The ultimate objective of the strategic management process is to enable a firm to choose and implement a strategy that generates a competitive advantage. B. Competitive Advantage - when a firm is able to create more economic value than rival firms. 1. Whenever a firm has a performance advantage over its competition, it is said to enjoy a competitive advantage. This can be by higher perceived value by the customer or by lowering costs. C.

Economic Value - simply the difference between the perceived benefits gained by a customer who purchases a firm's products or services and the full economic cost of these products or services. 1. The size of a firm's competitive advantage is the difference between the economic value a firm is able to create and the economic value its rivals are able to create. D. Temporary Competitive Advantage - a competitive advantage that last for a short period of time. E. Sustained Competitive Advantage - last much longer. F. Competitive Parity - Firms that create the same economic value as their rivals. G.

Competitive Disadvantage - firms that create less economic value than their rivals. H. Factors That Can Contribute to Why Competitive Advantage Seem to Persist Longer in Some Industries. 1. Informationally Complex 2. Require customers to know a great deal in order to use an industry's products 3. Require a great deal of research and development 4. Have Significant Economies of Scale are more likely to have sustained competitive advantages compared to firms that operate in industries without these attributes. II. Measuring Competitive Advantage A. Simple Accounting Measures of Competitive Advantage 1.

Most popular way of measuring a firm's performance. 2. Regression analysis

$$z = .012(\text{working capital}/\text{total asset}) + .14(\text{retained earnings}/\text{Total Assets}) + .033(\text{EBIT}/\text{total assets}) + .006(\text{market value of equity}/\text{bookvalue of total debt}) + .999(\text{Sales}/\text{total sales})$$
 3. Profitability Ratios i. Return on Total Assets (ROA) a. Profits After Taxes/Total Assets b. A measure of return on total investment in a firm. ii. Return on Equity a. Profits After Taxes/Total Stockholder's Equity b. A measure of return on total equity investment in a firm. iii. Gross Profit Margin a. sales - COGS/sales b.

A measure of sales available to operating expenses and still generate a profit. iv. Earnings Per Share (EPS) a. (After Tax) Profit - Preferred Stock Dividends/ # of Common stock shares outstanding b. A measure of profit available to owners of common stock. v. Price Earnings (PIE) a. (Current market price/share)/After-tax earnings per share b. A measure of anticipated Firm's performance high PIE ratio tends to indicate that the stock market anticipates strong future performance. v'. Cash Flow Per Share a. After-tax profits + depreciation/# of common shares outstanding b.

A measure of funds available to fund activities above current level of costs. 4. Liquidity Ratios i. Current Ratio a. Current Assets/Current Liabilities b. A measure of the ability of a firm to cover its current liabilities with assets that can be converted into cash in the short term. ii. Quick Ratio a. Current Assets - Inventory/Current Liabilities b. A measure of the ability of a firm to meet its short-term obligations without selling of its current inventory. 5. Leverage Ratios i. Debt to Assets a. Total Debt/Total Assets b.

A measure of the extent to which debt has been used to finance a firm's business activities. ii. Debt to Equity a. $\text{Total debt} / \text{Total Equity}$ b. A measure of the use of debt versus equity to finance a firm's business activities. iii. Times Interest Earned a. $\text{Profits Before Interest and Taxes} / \text{Total interest Charges}$ b. A measure of how much a firm's profits can decline and still meet its interest obligations. 6. Activity Ratios i. Inventory Turnover a. $\text{COGS} / \text{Average Inventory}$ b. A measure of the speed with which a firm's inventory is turning over. ii. Accounts Receivable Turnover a. $\text{Annual Credit Sales} / \text{Accounts Receivable}$ b. A measure of the average time it takes a firm to collect on credit sales. iii. Average Collection Period a. $\text{Accounts Receivable} / \text{Average daily sales}$ b. A measure of the time it takes a firm to receive payment after a sale has been made 7. Limitations of Simple Accounting Measures i. Managerial Discretion a. Managers often have some discretion in choosing accounting methods. This can have an impact on these adjustments. b. Positive Accounting and four conditions which managers may choose to adjust their reported simple accounting performance. When the value of a manager's compensation depends critically on the reported accounting performance. (exaggerate performance) * When a firm's actual accounting performance violates capital market expectations. (exaggerate performance) * When a firm's actual level of performance would hurt might lead to government antitrust action. (reduce performance) * When a firm's actual accounting performance would hurt it in negotiations with labor or other key stakeholders. (reduce performance) 8. Short-Term Bias i. Most simple accounting approaches to measuring performance have a built-in short-term bias. . Valuing Intangible Resources

Capabilities i. Accounting measures of firm performance is that they generally do not fully value a firm's intangible resources and capabilities. it. Intangible Resources and Capabilities - productive assets that are difficult to observe, describe, and value but that can have a significant effect on a firm's performance. Limitations Effects OF Accounting i. Simple accounting measures of performance are limited, but if these limitations are inconsequential, accounting numbers may still be an extremely accurate and convenient measure of firm performance. it.

However research has stated that it is very likely that these limitations are the cause of many of the difference of these firms. A lot of research states it can be inaccurate but it should use and Judgment applied. B. Adjusted Accounting Measures of Competitive Advantage 1 . Adjusted accounting numbers take advantage of the broad availability of accounting numbers but do so in a way that avoids many of the limitations of simple accounting measures of firm performance. 2. Three Adjusted Accounting Measure of a Firm's Economic Performance i. Calculating Net Operating Profits Less Adjusted Taxes (NOPLAT) a.

It is necessary to calculate three numbers from a firm's profit and loss statement and balance sheet: (1) earnings before interest and taxes (EBIT) (2) Taxes on EBIT (3) Changes in deferred income taxes. * $EBIT = \text{net sales} - (\text{COGS} + \text{selling, general, and administrative expenses} + \text{depreciation expenses})$ * $\text{Taxes on EBIT} = \text{provisions for income taxes} + \text{tax shield on interest expense} - (\text{tax on interest income} + \text{tax on non-operating profit})$ * $\text{Changes in deferred taxes} = \text{deferred tax t-1} - \text{deferred tax}$. * $NOPLAT = EBIT -$

Taxes on EBIT + Changes in deferred income taxes
 ii. Calculating Invested Capital
 a.

Invested capital is the amount of money a firm has invested in the operations of its businesses.
 b. Invested Capital = (operating current assets + book value of fixed current assets) - (net other operating assets * non-interest bearing current liabilities)
 * Operating Current Assets = operating cash + Accounts receivable + inventory + other current assets
 * Book Value of Fixed Current assets = gross property, plant, and equipment - accumulated depreciation
 * Net operating other assets = other operating assets - other long-term liabilities
 * Non-interest-bearing current liabilities = accounts payable + accrued liabilities
 iii.

Calculating the Weighted Average Cost of Capital
 a. A firm's WACC is the weighted average of the MC of all of a firm's sources of capital, including its debt and equity.
 b. The Cost of Debt * Different kinds of debt have different costs. The cost of a firm's debt can be estimated based on the quality of that debt as evaluated by services etc.
 * If a firm's interest payments are tax-deductible then the pretax cost of debt must be adjusted to reflect the tax benefits of debt.
 After-Tax Cost of debt = (1 - marginal tax rate) cost of debt.
 If a firm has many quasi debt forms (leases, preferred stock, etc) then additional work may be necessary.
 c. The Cost of Equity * CAPAM * cost of Equity = $R_{FRt} + \beta_j [R_{FRt} - R_{FRt}]$
 * R_{FRt} = the risk-free rate of return in time t
 * β_j firm J's systematic risk
 * $E(R_m, t)$ the expected rate of return on a fully diversified portfolio of securities at time t
 * $\text{var}(R_m)$ * Where $\text{COV}(R_j, R_m) =$ the covariance between returns from firm J's securities and the overall

securities market. * $\text{Var}(R_m)$ = the variance of overall security market returns
iv. calculating A Firm's Return on Invested Capital a.

ROIC equals a firm's operating profits divided by the amount of capital invested in a company and characterizes a firm's return on its capital for a given time period. b. If a firm's ROIC is greater than its WACC, that firm is generating profits in excess of the capital required to generate these profits. (Excellent performance) c. If $\text{ROIC} < \text{WACC}$ it is achieving inferior economic performance. d. Goodwill in Calculating ROIC * Is defined as the difference between the market value of an asset and the price a firm paid to acquire that asset. Calculating ROIC including goodwill measure how well the firm has invested its capital, whether it has generated a return on its capital in excess of the cost of its capital. * If a firm has overpaid for several assets, then that firm could have an ROIC, excluding goodwill, greater than the cost of capital, but an ROIC, including goodwill, less than the cost of capital. v. Calculating a Firm's Economic Profit . A firm's EP and its ROIC are closely related. b. EP calculates the actual economic value created by a firm in a given time period in dollar terms. . A firm with superior performance, the difference between ROIC and WACC will be positive. This is an indication of how much wealth they have created. d. A negative shows how much they have destroyed. v'. Tobin's Q a. Defined as the ratio of a firm's market value to the replacement cost of its assets. b. A q greater than 1 is an indicator that a firm is generating superior performance . Less than 1 indicates the firm has low levels of performance. C. Weakness of Adjusted Accounting Measure of Firm Performance 1.

Measurement Problems in Estimating Beta. Betas calculated in these different ways can vary. The estimate of Beta typically requires a relatively long data series both for the returns of an individual firm's securities and for expected market rates of returns.

2. Theoretical Mis-Specification of the CAPM

i. There is growing consensus that this model is an incomplete explanation of how returns on a firm's securities are generated.

3. Intangible Resources and Capabilities and Adjusted Accounting Measures of Performance.

One of the important limitations of simple accounting measures of firm performance is the inability of these measures to incorporate information about the cost of acquiring or developing intangible resources and capabilities in a firm.

D. Other Measures of Firm Performance

1. Events Study Measures of Performance

i. It is possible to use the stock market's reaction to the implementation of a particular strategy to gauge the value created (or destroyed) by that strategy.

ii. Semistrong Form - the price of a firm's debt and equity fully reflects all publicly available information about the economic value of the firm.

iii. Event - implementation of a new strategy marks the beginning of an event.

iv. Event Window - the period of time between the beginning of an event and the end of an event is called the event window.

v. Cumulative Abnormal Return - A measure of the total value created by a strategic event.

vi. If $XR_{j,t}$ is less than zero, then a firm will have earned less than its historically expected return on its new strategy in each time period.

vii. If a firm's $XR_{j,t}$ is greater than zero they earned a greater than historically expected return.

viii.

Equal to zero, the firm would have earned just its historically expected return in each time period.

E. Sharpe's Measure

1. In Sharpe's measure of firm

performance, a firm's stock market performance is compared to a firm's total risk. 2. A measure of a firm's return dollars per unit of risk. 3. The higher the value of S , the greater the dollar return per unit of risk and the greater the economic performance of a firm. F. The Treynor Index 1. Treynor's index compares returns to the firm's systematic risk. G. Jensen's Alpha 1. This measure is computed by comparing a firm's stock market performance to its risk adjusted expected performance. . Greater than zero suggest the firm is outperforming the market 3. Less than zero suggest that a firm is underperforming the market. 4. Equal to zero suggest that a firm is performing at market levels. III. Stake Holder' Alternatives A. Residual Claimants - Shareholders receive any cash in excess of what is required to pay off a firm's other claimants. 1. Those other claimants largely determine a firm's costs. B. Stakeholders - are those institutions and groups that provide a firm with resources and thus have an interest in how a firm performs.