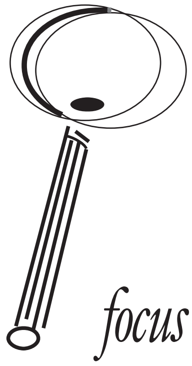
# 1

# Financial Decision Making and the Techniques Used in Financial Analysis




***Learning Objectives***

By the end of this chapter, you should be able to:

- Define financial analysis and discuss the financial analyst's role in the organization.
- List at least six financial management responsibilities and three areas of activity to be reported in financial statements.
- Describe how business strategy and the competitive environment affect financial management decisions.
- Identify analytical techniques that the financial analyst can apply to investment, financing, and operational decisions.
- Define the primary goal of financial analysis and describe how it is achieved in both the long term and the short term.
- List the four questions addressed by the balanced scorecard and the four management processes that link long-term strategies with short-term actions.

### A Manager Sets the Stage for Change

Alfredo, the recently appointed controller of a medium-sized public company with a number of divisions and subsidiaries, opened his first staff meeting—a gathering of all the divisional and subsidiary controllers. While all attendees were direct reports to their respective organizational managers, they had a dotted-line responsibility to him and his office.

"Welcome to our first monthly group meeting. I'm happy to see all of you here. We have all been charged with producing financial statements and reports for our different organizations, but I think there is more that we can do to help make our organizations more competitive in this challenging economy. I thought we should think as a group about how we can contribute to this effort."

"That's a great thought, Al, but I'm already out straight," interjected Jimmy, the controller of a small manufacturing subsidiary. Because of the slow economy, I'm already short-handed."

"I'm not seeking to have everyone do more, Jimmy," responded Al. "I want to have everyone rethink what we are currently doing in order to make it more proactive, more valuable. How many of you are being asked for more information by your managers after you deliver the financials?"

Everyone raised a hand.

"I think we can refine our reporting to be more valuable, without having to do so much firefighting. I'd like to get us a bit more out front, guiding the direction of our respective organizations."

"That sounds great, but how do we do that?" asked Florence. She managed all financial reporting for another division.

"I think we need to anticipate the issues and beat the managers to the questions. By incorporating analysis into our monthly reports, we can help our managers be more effective, avoiding some of the requests for urgent additional reports that disrupt our routines."

The group nodded in agreement. "Let's get ahead of the curve," someone said.

The accounting function quantifies the economic relationships of an enterprise; the finance function, on the other hand, is focused on future results; it manipulates those relationships to optimize the company's liquidity and profitability. The accounting model may be viewed as a set of specific rules and conventions designed to record, analyze, and report the historic experience of all aspects of a firm's operation. The financial model is a diverse set of techniques that are used to analyze and manage the future direction of the firm's investments and financing. The purpose of this course is to show how financial managers can use accounting information and reports to guide future decision making.

Managers at every level must make difficult financial decisions continuously. Analytical tools or techniques are important in decision making, analysis, planning, and control. Most managers today have at least some financial management responsibilities, and it is important that they be able to apply analytical techniques to their specific financial problems or decisions. It is impossible to say which of the various techniques of financial analysis is most relevant—they are all useful tools in decision making, and each should be applied according to the individual situation.

## FINANCIAL ANALYSIS

In order to make financial decisions, you must be able to identify potential financial problems and analyze the effects of alternative courses of action. As a decision maker, you must be able to use the analytical techniques of financial analysis. Managers involved in financial decision making may or may not perform the actual financial analysis. In either case it is essential to understand the techniques and tools used to arrive at the recommendations. This course is for both those managers who want to do their own financial analysis and those who delegate this responsibility. An array of financial analysis topics is listed in Exhibit 1–1.

## THE ROLE OF THE FINANCIAL ANALYST

Although this course is directed primarily toward managers who produce financial analyses, an overview of the role of the financial analyst in a large company provides some insights on the importance of financial analysis. The position of the financial analyst in the corporate structure and the scope of his or her work are interdependent. The needs of the enterprise govern the analyst's role and position in the company. The following sections describe the analyst's mission and assignments, as well as the corporate structures where the objectives of the analyst's mission can best be attained.

### Exhibit 1–1
### Financial Analysis Topics

- Profit planning
- Cash management
- Capital investment
- Lease versus purchase (buy)
- Financing structure
- Cost of capital
- Dividend policy
- Mergers and acquisitions
- Tax management
- Measuring management performance
- Measuring corporate health

### Definition of the Analyst's Job

The financial analyst is a staff member who advises executives on the financial effects of management's proposals and decisions. Acting as an internal consultant, the financial analyst conducts studies, interprets information, and designs controls for profitability, cash flows, and diverse fiscal matters. The analyst does these tasks on behalf of decision makers; they do not usually make decisions. The analyst's role is generally to clarify and evaluate options, then provide recommendations for management action.

### Typical Assignments

Within a company, the role of financial analysis depends on perceived needs and the types of decisions its management makes. Although companies' needs differ, most analysts evaluate the firm's operating performance and identify opportunities for improvement. Specific tasks include long-range planning, profit planning and budgeting, capital investment decisions, mergers and acquisitions, and the administration of temporary corporate investments.

Financial analysts must perform many activities periodically, such as: analyzing the company's liquidity, assessing operating results, and supervising the company's day-to-day financial activities. In addition, the analyst has annual or semi-annual duties, including periodic sales analyses, analysis of the company's debt structure, ratio analyses on company financial statements and reports, and analysis of investment alternatives for liquid reserves.

Similarly, the analyst undertakes specific projects that are either self-initiated or, more often, requested by others. For example, if a financial analyst sees a marked change in a particular financial ratio, they may analyze the factors that would cause such behavior. Also, the analyst might assess how the economic environment affects the company or, more specifically, how various tax policy or economic changes will affect the company. However, most of the analyses conducted by the financial analyst are situation-specific and usually are requested by other departments. For example, management may want to know whether a certain asset should be leased or bought; or the company may be considering purchasing land and therefore need a location analysis. The analysis may be company-wide or narrower in scope, perhaps pertaining to a single division or function within the company.

Planning plays an important part in most assignments undertaken by financial analysts. By *planning,* we mean both short-term objectives as well as long-term strategic goals. Financial analysts must integrate the goals and objectives of their companies in their analyses. Consequently, most of a financial analyst's assignments implicitly or explicitly include and affect aspects of company plans.

## QUICK QUIZ 1–1

*Answers to QUICK QUIZ questions can be found starting on page 191.*

The financial analyst is responsible for:

a. Managing the recording and reporting of transactions.
b. Implementing the financial management policies of the company.
c. Directing the functions of the accounting staff.
d. Assessing the impact of management decisions.

## The Analyst's Position in the Corporate Structure

The position of the analyst in the corporate structure varies with the nature of the company and its administrative organization. In smaller firms, a single individual may handle all financial activities, including any necessary financial analyses. In larger firms, there generally is a staff of financial analysts reporting to a financial manager, who in turn reports to the controller, who is supervised by a vice-president of finance or chief financial officer. Financial analysts may be at the corporate or divisional level.

The analyst's position within the company is important, because the topics of financial analysis are used to help improve the value of the company; frequently, they are also sensitive, conflict-provoking subjects. For instance, after conducting a financial analysis, an analyst might recommend the dissolution of a certain division or department. To say the least, this recommendation would not be popular with the members of the department or division in question. Centralizing the position of the financial analyst indicates that the role is a service and is separate from the operational units for which most of the analyses are performed. Placing the position in a central service unit offers certain advantages: (1) it allows the grouping of financial analysts, thereby pooling expertise and encouraging cooperation among analysts; (2) it promotes flexibility and accommodates departments that do not need an analyst full-time; (3) it facilitates multidepartmental assignments; and (4) it increases the neutrality and objectivity of analyses.

There are also advantages to placing the financial analyst in a decentralized position in the company, with financial analysis attached to and integrated with operating units. A decentralized positioning is favored when: (1) the analyst's role is to help and advise locally; (2) the operating unit needs full-time analysts and the management of the unit is receptive to analytical services; or (3) the operations of the unit are highly complex and much research is necessary before financial analysis can be done. In many large organizations today the financial analyst serves as a key member of the divisional management and also as the provider of critical financial information to the central administration.

The nature of a company signals which position—centralized or decentralized—maximizes the benefits from financial analysis. Some companies even mandate that a financial analyst work at both a centralized corporate level and a decentralized division level prior to being eligible for an advanced position. The rationale behind this rule is that the analyst will gain broader experience and familiarity with the company's products, policies, and procedures. In this course, the most important point is not the position of the analyst within the company, but rather the uses and benefits of financial analysis.

**Think About It . . .**

Will your company be better served with a centralized or decentralized financial analysis function? Why did you answer as you did?

## FINANCIAL MANAGEMENT AND FINANCIAL ANALYSIS

The financial manager and the financial analyst may or may not be the same individual. As mentioned earlier, one major difference in their roles is that the managers make the financial decisions while the analysts recommend the best alternatives. The influence of the financial manager (and financial management in general) has increased substantially in recent years. Once, the manager's responsibilities were confined mainly to preparing financial statements, managing the company's cash position, and providing the means for paying bills and procuring additional funds. Now, financial management includes: (1) investing idle cash and liquid reserves; (2) synchronizing cash receipts and disbursements; (3) procuring financial sources of funds; (4) guiding operating decisions; (5) conducting analyses of suppliers, competitors, and customers; and (6) evaluating the financial impact of decisions and recommendations made by managers in other disciplines. As a consequence, the financial manager should be cognizant of external and internal user needs.

External users are primarily concerned about the liquidity, operating profits or losses, and business risk of the company. Business risks pertain to the relative volatility of the firm's expected net operating earnings. For example, a paper company experiences a business risk when its forests are exposed to losses due to fire or disease. Internal users are not only concerned about the day-to-day liquidity and profit/loss record from operations, but are also concerned about financing sources and the accompanying financial risk. A financial risk pertains to the likelihood of default on financial obligations.

The evolution of financial management and the increased use of financial analysis have been furthered by the availability of computers at every level in a business enterprise., The application of computers as analytical tools enables managers at every level to use sophisticated financial models and techniques in their decision making.

## ACTIVITIES AND FINANCIAL STATEMENTS

Companies use physical and financial resources to implement their business strategies. What a business does is the result of its business activities—its operating activities (e.g., producing and selling goods), its investment activities (e.g., acquiring and selling plant and equipment assets), and its financing activities (e.g., issuing and retiring long-term notes). These activities are reported in summary form in the financial statements through the company's accounting system. Because financial statements are usually prepared on an accrual basis, financial analysis is prepared to be consistent with regular financial reporting; thus it recognizes the full economic consequences of business activities.

## BUSINESS STRATEGY

A company must have a strategy to create and sustain a competitive advantage. One strategy is to differentiate a product or a service and make it unique because of its high quality or technological capabilities. Another strategy is to focus on costs by concentrating on product efficiencies or purchase discounts, or by outsourcing. Lower costs can lead to high sales volume through lower prices. Such operational efficiencies can be easily imitated, with the result that nobody has a clear advantage over others. Most companies try to implement both strategies.

Michael Porter of the Harvard Business School has written extensively on strategy and strategic decision-making. Porter (1996) notes that competitive strategy means being different—either performing different activities or performing activities differently from other companies. A company may specialize in producing just a few products, providing just a few services, or meeting the needs of a select group of customers. Strategic positioning means choosing activities that differ from your competitors'. The same activity set cannot be everything to everyone. To sustain a strategic position, trade-offs are required. But what activities will the company forgo? The whole system is important. We must not speak of key or critical success factors. One activity affects another. It is harder to imitate a whole integrated system than a single activity.

In a USG Corporation annual report some years ago, Chairman and Chief Executive William C. Foote stated the company's strategic objectives:

1. Increase operational excellence (through core values such as safety, quality, service, low cost, integrity).
2. Invest for growth (become a low-cost producer to maintain profitability throughout the economic and construction cycle).
3. Improve financial flexibility (achieve debt reduction, eliminate collateral on debt obligations).
4. Build the USG team (enhance the team's effectiveness by increasing diversity).

## COMPETITIVE ENVIRONMENT

Michael Porter of the Harvard Business School wrote two books in the 1980s that remain the guiding works in competitive and strategic management. Porter continues to be among the most visible advocates of competitive analysis as a guide to business decision-making. He wrote (Porter, 1985) that the average profitability of an industry is influenced by five forces. The first three—rivalry among existing firms, threat of new entrants, and threat of substitute products—relate to the degree of actual and potential competition. The fourth and fifth—bargaining power of buyers and bargaining power of suppliers—determine whether or not the potential profits are kept by the industry.

The degree of competition depends on factors such as the following:

- Growth of the industry (whether rapid or stagnant)
- Number and size of firms in the industry
- Differentiation among products
- Existence of economies of scale
- Amount of research and development needed
- Amount of brand advertising needed
- Existence of entrance and exit barriers
- Distribution networks established
- Threat of substitute products

The threat of new entrants—or conversely, barriers to entry—dictate many of the financial decisions a company makes. If entry is relatively easy, pricing flexibility is limited, and every market action must be carefully choreographed. If there are barriers to entry, the strategies of the company are far more flexible.

The bargaining power of buyers is important, because if the buyers are economically powerful compared to the company selling the product or service, prices can be kept low; therefore, the selling company's revenues are not as high as they could be. Similarly, if the bargaining power of suppliers is high compared to the company selling the product or service, input prices are higher; consequently, the selling company's costs are higher than they could be.

Different industries have different competitive environments. Exhibit 1–2 presents the competitive environments in the national trucking and cereal industries.

## THE APPLICATION OF ANALYTICAL TECHNIQUES FOR SPECIFIC PROBLEMS

Financial management may be separated into three main decisions: the investment decision, the financing decision, and the dividend decision. The application of financial analytical techniques likewise may be classified in terms of these three decision types.

The use of a specific analytical model, such as net present value or internal rate of return, depends on the question being asked. Many problems in financial management can be dealt with by employing more than one financial analysis technique. The purpose of applying an analytical technique is not necessarily to calculate a particular answer; rather, the purpose of a technique is to provide a more informed basis on which to make a decision.

## Exhibit 1–2
## Competitive Environments

National Trucking Industry:

- The industry is highly fragmented; no firm has a very large market share.
- There is intense competition for market share among competing common carriers.
- Competing services are very similar.
- Entrance barriers are relatively low.
- There is a great deal of price competition.
- There is enormous pressure to introduce new services and service improvements rapidly and to provide high-quality customer support.

Cereal Industry:

- Prices of top national brand cereals have dropped due to inroads made by private cereal brand names.
- Advertising is important for reinforcing established brand names.
- Developing new products to take advantage of the growing awareness of people about nutrition is important, although new product failure rates have been high.
- The two top companies selling ready-to-eat cereals have over 60 percent of the market share.
- Pressure to reduce prices has resulted in increased emphasis on reducing manufacturing costs.

An important consideration in financial analysis is timing. The timing of various financial policies is important in terms of interest rates, inflation, taxes, and the capital market. Most of the techniques used in financial analysis involve a time element. For example, when evaluating a capital investment proposal, the manager must be fairly certain of the time required for ordering, installing or building, and starting up a new investment. The following sections describe how specific techniques can be used under certain circumstances and describe how a financial analyst arrives at a particular decision.

### Investment Decisions

Investment decisions are perhaps the most important of the three types of financial decisions, because the outcome of these decisions determines the amount of cash flow in future periods. In this context, investment decisions relate to how the company uses its money and refer to both short- and long-term reallocations of corporate funds. Short-term investment decisions focus on the level of current assets (for example: cash, accounts receivable, and inventories) necessary for day-to-day operations. Long-term investment decisions refer to fixed asset purchases, mergers, acquisitions, and corporate reorganizations.

Techniques used for effective management of short-term cash and accounts receivable are different from those used for purchases of long-term fixed assets. For example, to gauge the proper level of cash, an analyst may develop a cash budget, use ratio analysis to determine the trends or variations of current assets and liquidity, or use pro forma income and balance sheets to plan income, investments, and overall cash flows. These analytical tools are interrelated and should be used together to manage current assets. Short-term investments and management of current assets are considered in Chapters 3 and 4 of this course.

On the other hand, capital investment—investment in expensive, long-lived assets—is a major aspect of the long-term investment decision. It is the allocation of capital to investment proposals that will realize benefits in the future. Investment proposals necessarily involve risk, because future benefits are uncertain. Consequently, investment proposals should be evaluated both for their expected return and for their risk to the company. Capital investment proposals include both investment in new assets and the relocation of capital and assets within the company.

The evaluation of capital investment proposals involves a number of different techniques and types of financial analysis, all of which are interrelated. A *risk analysis* determines the investment's risk as compared to the company risk. A *cost of capital analysis* determines the correct discount rate to use in the cost analysis. A *cash flow analysis* determines the expected net cash flow from a new investment. The determination of a predicted cash flow could involve a *sales analysis* to predict future sales from the investment, an *economic analysis* to study future trends, or a *financial forecasting analysis* to determine cash income and expenses. Once the cash flow analysis has been completed, it is necessary to conduct a *cost analysis* to determine the returns of the new investment or the allocation of capital. The areas commonly studied in cost analysis include: net present value, internal rate of return, cost-benefit ratio, and the payback period. Cost of capital and capital budgeting are considered in Chapter 5 of this course. When this evaluation is complete, a *sensitivity analysis* may be performed to test the validity of the analyst's original assumptions..

Mergers and acquisitions or failures and reorganizations should also be subjected to financial analysis. Appropriate techniques would include: determining certain financial ratios such as the price-earnings ratio, determining the exchange ratio, and analyzing the possible negotiation range for mergers and acquisitions. Once the cash flows with either a merger or a reorganization has been predicted, the net present value technique could be applied.

## Financing Decisions

The financing decision, which relates to where the company gets the money it needs, varies with the size of the firm, the financing options available to the firm, the needs of the firm, and the location of the firm. Small firms generally do not have the same financing options as larger firms; consequently, small firms are more likely to experience difficulties financing growth and/or avoiding bankruptcy.

Funding sources frequently depend on the size of the firm and the length of time it has been operating. Small, newer firms have limited sources of funding; they are often restricted to family, friends, and suppliers for start-up funds and working capital. Well-established firms, even if small, may be able to access bank loans and Small Business Administration (SBA) support. Large firms, especially if well-established, have a much wider array of financing alternatives, including banks, insurance companies, stock and bond issues, and even commercial paper and other market-based options.

When making financial decisions, the manager must determine the best financing mix or capital structure for the company. In this sense, the best choice is the capital structure that allows optimal valuation of the company for the shareholders. The important elements to consider in making financial decisions include: (1) the nature and riskiness of the business operation; (2) the capital structure (debt-to-equity ratio) desired; (3) the length of time the assets will be needed; and (4) the cost of alternative financing.

Alternative sources of financing are an important subject of analysis. Businesses need short-, medium-, and long-term financing at various times to remain liquid and profitable. To analyze sources of short-term financing, the analyst must study the costs of each source, applying techniques such as present value analysis, compounding analysis, and interest factor analysis.

To evaluate alternative sources of long-term financing, security markets, types of securities (such as debt or preferred stock), common stock values, and sales should be added to the sources considered for short-term funding. Any analysis of a source of long-term financing would have to analyze the effect of the financing on the company's capital structure, as well as the costs and benefits of the financing.

Other forms of financing that could be the subject of financial analysis include term loans and lease financing. For either case, the analytical techniques used would include a comparison of that type of financing's present value costs or benefits with the present value costs or benefits of the alternatives.

A number of the analytical tools used for assessing performance are also pertinent when the subject of analysis is the optimum capital structure of the company. A *financial leverage analysis* determines the company's financial leverage and how it can use financial leverage in its capital structure. Capital structure and alternative sources of financing are explored in Chapter 7. *Trend* and *historical analyses* examine the company's past capital structure. *Ratio analysis* determines the current financial structure and other financial indicators. In addition to conducting the above analyses, the analyst could perform an analysis to determine the *current cost of capital* and ways to decrease this by changing the financing mix. All these analyses are concerned with the total valuation of the company.

## Dividend Policy

The dividend policy that the company chooses is also a subject of analysis in financial management. Dividend policy relates to how the company rewards its shareholders. The four standard dividend alternatives—the stable dividend policy, the constant payout ratio, moderately increasing annual dividends, and the regular low dividend policy plus extra—must be evaluated according to the company's specific situation. In recent years, the repurchase of the firm's outstanding common stock has become an increasingly popular alternative to dividends as a way to further management objectives while providing funds only to those shareholders who wish to receive them. The aim of the dividend or repurchase analysis would be to determine which type of policy would maximize the value of the company's stock. To determine this, the analyst would compare the effects of different policies on the company's valuation. Choosing the dividend policy is a strategic decision, usually made by senior-level managers, with final approval subject to the board of directors.

## PRIMARY GOAL OF FINANCIAL ANALYSIS

Criteria used in financial decision making should be based on the anticipated benefits to the present owners of the company. The primary goal is to increase the owners' wealth. The way to increase the owners' wealth is to increase the market value of their investment (equity) in the enterprise. Consequently, the decision criteria used in this course are those that maximize the market value of the shareholders' equity.

An obvious question is what criteria to employ for companies that do not have an observable market price. The answer lies in the characteristics that cause any earning asset to have value. The rule, then, is to optimize the expected return and to minimize the risk of the equity. Such optimization refers to the balancing of the risk and the return in an attempt to maximize what the decision maker believes would be the market price of the owners' equity if it were traded in the market.

## LONG-RANGE VERSUS SHORT-RANGE GOALS

It is important to note that decisions are analyzed differently, according to the decision maker's point of view. Different levels of management treat financial decisions in different ways. For example, the board of directors and top management take a long-range view of the company and, therefore, of the effects of various decision alternatives on the company. Generally, top managers are more concerned with long-range strategic planning, and their decision criteria reflect this. Consider the dividend decision, which usually is made by the board of directors or top management. Their overriding consideration in choosing a dividend is the dividend's long-range impact on the company's stock price.

In contrast, the managers at the operating level of a company generally are more concerned with short-term goals and the short-term effects of various decision alternatives. For example, operating management is concerned with cash management decisions. Short-term objectives, such as cash liquidity and inventory control, are of primary concern in the financial analysis of cash management decisions.

### ? Think About It . . .

Very often management is focused on short-term performance and achieving immediate results. The financial analyst must satisfy this need for current information while maintaining a long-term perspective as well. What steps must be taken to keep the long-term perspective in view?

## THE BALANCED SCORECARD

Over the last business generation there has been a dramatic refocusing of management attention toward efficiency and cost management. Since the 1980s a series of developments in business thinking have concentrated on managing rather than merely controlling operations. This is most evident in the area of Managerial Accounting. In the 1980s focus transitioned from standard costs, which distributed costs across products by allocating overhead to specific products based on the product's material or direct labor costs, to value, where overhead was assessed on the benefit (to the customer) it added to the product. The effort was to trace as much as possible of the overhead directly to the product, based on the factor responsible for the cost.

This discussion, initiated by Robert Kaplan and Thomas Johnson, (1987) led to a comprehensive examination of value, what the customer will pay for, and value-added, how much the contribution was worth to the customer. Johnson (1992) expanded on the ABC analytical approach in his later book. Later, by combining financial and operational measures, the balanced scorecard offered management a comprehensive view of the business. According to Kaplan and Norton (1992), the balanced scorecard provides answers to four basic questions that enable management to focus on the most critical measures, tied to key operational disciplines.

- How do customers see us? (a customer perspective) (Marketing)
- What must we excel at? (an internal perspective) (Operations)
- Can we continue to improve and create value? (an innovation and learning perspective) (Human Resources)
- How do we look to shareholders? (a financial perspective) (Finance)

The balanced scorecard represents a fundamental change from traditional performance measurement systems by putting strategy, rather than control, at the center. In this view, everyone in the company should be moving along the path toward the overall vision of the company.

Kaplan and Norton (1996) wrote that four management processes link long-term strategies with short-term actions:

1. Translating the vision into an integrated set of agreed-upon objectives and measures that are stated in meaningful terms.
2. Communicating management's strategy and linking it to departmental and individual objectives.
3. Through business planning, integrating business and financial plans and moving the company toward management's long-term strategic objectives by selecting measures of progress from each of the four balanced scorecard perspectives (listed above) and then setting targets for each of them.
4. Enabling a company through feedback and learning to see whether it and its components have met their financial goals and evaluating strategy in light of recent performance.

The balanced scorecard allows strategy not only to be implemented but also to evolve in response to competitive and technological changes. It also focuses the financial analysis activities on directing future performance rather than merely reporting on past performance.

## TECHNIQUES PRESENTED IN THIS COURSE

This course presents several specific financial analytical techniques. Chapters 2 and 3 explain financial statement analysis and the use of ratio analysis. Chapter 4 provides a discussion of current asset and liability management. Chapter 5 describes several different techniques used to evaluate capital investment proposals. Chapter 6 examines forecasting and valuation. Chapter 7 discusses business and financial risk and optimum capital structure. Chapter 8 explores mergers and acquisitions.

*recap*

This chapter described the role of the financial analyst, the criteria for financial decision making, the various financial decisions that most managers must make, and the specific analytical techniques that managers can use to make more informed financial decisions. Some techniques for analyzing three different financial decisions (investment, financing, and dividend) were explained. The interrelationship of various topics in financial analysis was introduced.

The scope of financial analysis and its location in the organization varies. Financial analysis is the responsibility of all the company's fiscally and economically oriented staff. It is performed not only financial analysts but also all managers who must make financial decisions. The subjects and the specific analytic approaches presented in this course are the basics upon which managers may expand their decision-making capabilities.

A company's strategy creates and sustains its competitive advantage. Most companies try to differentiate their products or services from their competitors and to control their costs. Profitability in an industry is a function of the rivalry among existing firms, threat of new entrants, threat of substitute products, bargaining power of buyers, and bargaining power of suppliers. Profitability in a company is often a function of how managers respond to internal signals included in financial results.

This course will enable managers to use financial analysis in a number of specific areas. More importantly, it presents sound financial analysis techniques that may be applied to most financial decision-making processes.

## Review Questions

*INSTRUCTIONS: Here is the first set of review questions in this course. Answering the questions following each chapter will give you a chance to check your comprehension of the concepts as they are presented and will reinforce your understanding of them.*

*As you can see below, the answer to each numbered question is printed to the side of the question. Before beginning, you should conceal the answers in some way, either by folding the page vertically or by placing a sheet of paper over the answers. Then read and answer each question. Compare your answers with those given. For any questions you answer incorrectly, make an effort to understand why the answer given is the correct one. You may find it helpful to turn back to the appropriate section of the chapter and review the material of which you are unsure. At any rate, be sure you understand all the review questions before going on to the next chapter.*

**1.** An advantage of placing the role of financial analysis in a decentralized position is that it: — 1. (d)
(a) increases the objectivity of analyses.
(b) pools expertise and encourages cooperation among analysts.
(c) facilitates multidepartmental assignments.
(d) allows for necessary research to be conducted for a unit's operations that are highly complex.

**2.** Financial management is not concerned with: — 2. (d)
(a) increasing the overall valuation of the company.
(b) the investment of funds in capital assets.
(c) obtaining the best mix of financing.
(d) preparing financial statements.

**3.** The main decisions in financial management do not include: — 3. (c)
(a) the investment decision
(b) the dividend policy.
(c) the personnel policy.
(d) the financing decision.

**4.** A company's operating activities include: — 4. (a)
(a) producing goods or services.
(b) retiring long-term notes.
(c) acquiring plant and equipment.
(d) following GAAP.

**5.** Whether or not potential profits are kept by the industry is partly determined by: 5. (c)
(a) threat of new entrants.
(b) rivalry among existing firms.
(c) bargaining power of buyers.
(d) threat of substitute products.