A Guide To Strategic & Financial Management

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How to Evaluate a Company: From Diagnosis to Financial Analysis

NEOFACULTY PUBLISHING

A GUIDE TO STRATEGIC AND FINANCIAL MANAGEMENT

HOW TO EVALUATE A COMPANY: FROM DIAGNOSIS TO FINANCIAL ANALYSIS

1st edition

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Paris, may 2015

PART I : STRATEGY

Strategy and organization

Strategy: what are we talking about?

Strategy refers to the way we govern an organization; all decisions involving resources and skills, which direct the company, as a leader of an army does with his soldiers. Strategy is a global process that takes time to set up and that brings together the organization's components around commonplaces. Three phases allow deploying the strategy:

- Choice of focus strategies (decision-making phase)
- Implementation of the strategy (operational phase)
- Strategic control (evaluation phase)

It is important to note that some emerging elements can interfere with the decision-making phase and (during) the operational phase; this latter never corresponds exactly to the strategy at the beginning. However, one of the strategy's qualities is to constantly adapt itself to the needs of the organization; and it will certainly be necessary to adjust the strategy many times.

The three phases of the strategic process will then be carried out according to the goals the organization wants to reach. We distinguish between:

- The organization's mission, which corresponds to the assertion of its basic intent, its reason for being; in other words: its profession.
- The organization's vision, that is, what it wants to become.
- The goals or the measurable results to be reached.
- The values, how our organization wants to act, which refers to the concepts of culture and social responsibility of the company.

Thus, throughout these three phrases, every component of the organization will implement the means necessary to go together in

The place of decision-making in the organization

Thanks to probability calculations, decision theories help understand the decision-making process of an agent (a person), and this, in accordance with choices and preferences.

Theoreticians agree that a choice situation will precede the decision-making process, and that the latter will correspond to the selection of one of the possibilities that are available to the agent. However, being cross-disciplinary and a subject of discussion, decision theories have developed several schools of thought.

According to Herbert Simon (American economist and sociologist), decision theory is composed of five phases:

- Acknowledgment of the existence of a problem
- Search for possible existing solutions
- Creation of possible innovative solutions
- Choice of a solution
- Application and setting up of this solution

Henry Mintzberg in turn goes further and observes the decision-making process through three stages within an organization:

- Identification phase: the agent acknowledges a choice opportunity as well as the necessity of a decision; thus, he will gather information and attempt to understand, to clarify and to define the problem.
- Development phase: the agent will search for solutions in his own environment.
- Selection phase of the solution to be applied.

However, Mintzberg warns us of the process's complexity. It rarely corresponds to a progression from phase 1 to phase 2, but rather to a process composed of constant feedback. Thus, once the decision is made, the agent will have the tendency of controlling and trying to justify his decision as being the best according to the context.

The individuals and the organization

The organization

The organization is considered as an ensemble of relations and interactions between different individuals. Among themselves, individuals will have behaviors that allow them to respond to a given situation.

To enable individuals to form a group and to act in its name, it is necessary that they have the opportunity to be brought together and that they are able to act in common. If the individuals were alone, their actions would not be sufficient and would not have a strong enough impact. This is where the real significance of an organization lies.
It will allow individuals to act together with well-defined goals. Each individual will have a role within the organization and, thanks to interactions with others, he could reach the organization's goals, while attempting to reconcile the latter with his own personal interests.

The structure of the organization will offer resources and obligations to individuals that allow them to meet the defined goals. These objectives can be created and evolve over time, following the changes of the organization. Thus, resources and obligations will also adjust to this evolution.

Therefore, the analysis of an organization has to take into account these different levels constituted by individuals and their relations, by resources and obligations as well as by the organization's structure.

The individual's role

The organization, by its very nature and just like any collective action, implies the actions of individuals. The behavior of an individual will be influenced at several levels, these are referred to as filters. The first one corresponds to what the individual feels, the individual builds up capital in order to reinvest it later and to develop production margins.

An organization, just like any individual, creates trust relationships with other organizations. This ensemble will form a network from which each organization can draw resources. To make this trust relationship work, it is necessary that the individuals in organizations also create such relationships between them. Thus, we could speak of a “meta-organization” where each organization stays intact, with its individuals and its goals, but will, however, rely on the help of other organizations in order to reach a common or a partially common goal.

Strategic analysis

The evaluation of an organization is a comprehensive work that not only consists in the application of financial valuation models. To carry out a valuation, we must understand the organization’s activity and issues. But a general diagnosis of the organization’s situation must also be made before starting the valuation phase itself.

This analysis aims to understand the organization’s working logic and its equilibrium on the market, in order to be able to make a judgment on its current financial position and its future prospects. It is essential for making decisions about funding (to grant a loan or not, to be financed by owner’s equity or by debt) or investment (to invest or not in this company).
It focuses on two points:
1. The economic understanding of the organization and the sector.
2. The accounting and financial analysis of the company.

This analysis should be based on the collection of all available information on the organization: accounting and financial documents of the past 3 or 5 years (social balance sheet, auditor’s reports), other documents produced by the company (annual reports, investor presentations), the website, public information and news for large organizations, and possibly an interview with the head of business and a visit of the organization.

The first part consists in the analysis of the organization and its sector. The strategic analysis of the organization is carried out on several levels: commercial, legal, human, industrial, etc. It is about assessing the place of an organization on a market and in a sector, in order to diagnose its strengths and weaknesses that result from the economic situation, and the constraints related to jobs or business sectors.

These points are indeed essential to the assessment, and serve as an orientation to guide the development of the business plan, to increase or lower the value of the organization, or to disclose all of the risks which are specific to the company.

The strategic approach of the analysis requires two elements that are essential to the appreciation of the organization's diagnosis: its environment and its strategic capability.

External Analysis: Opportunities and Threats

As part of the strategic process, the environment in which the organization operates has to be taken into account in addition to its intrinsic goals. Indeed, the organization is part of an external environment of its own; it operates at the same time in a commercial, economic, political, technological, cultural and social context. In order to understand how this external environment affects the organization, we need both an analysis of past events and an estimate of future developments. Some of these variables are able to generate opportunities for the organization, while others may, conversely, represent threats. It is difficult to analyze all these variables, and that's why we have to extract from these environmental forces a synthesis of the variables that truly influence the organization.

The impact of contingent factors on the structure

Just like the agent is influenced in his decision-making, the organization too will be influenced by different factors when a solution to a given problem has to be found. Thus, the organization, its functioning, and the context in which it operates will all be linked.

Companies organize themselves and follow intentional or unintentional strategies. Woodward (1958) has shown in his work that structural organization was influenced by technology and other environmental factors. Continuing Woodward's work, Burns (1961) measured the impact of technology on the organizational structure of electronics companies. This study demonstrated that technology had an influence on the structure of organizations. This influence can take several forms, organic or mechanical, according to the organization and the management's needs.

Similarly, Lawrence and Lorsch (1967) demonstrated that a market environment as well as a techno-economic and scientific environment had a strong influence on the organization of companies. However, the less we know about the company's environment, the more we need to differentiate between its departments.

We can point out that uncertainty factors about the company's environment have a strong influence on the organization and that their analysis is essential to anticipate them, but also in order to maximize the company to better adapt and respond to market needs and to fight against its competitors.

The organization's control by the environment

The environment differs from one organization to another. In order to be effective and efficient, it is necessary for the organization to adapt to its environment. However, some factors, internal or external, will limit this adaptation. Among these are costs, the difficulty for

Traditionally, economists and managers have campaigned to create a nearly perfect competition between companies with easy access to the markets in which they wish to intervene. However, from the perspective of strategic management, the question is to understand the competitors' actions.
Organizations are affected by environmental conditions. Leaders must be aware of these conditions in order to embrace opportunities that can lead to higher profits and that can reduce the impact of threats which hover over the organization's future. Managers need information in order to know and develop an understanding of what is happening in the external environment.
The environment consists of all the factors outside the organization. It includes the macro-environment as well as the micro-environment. The environment is specific to each organization, but the current characteristics of the environment are the same: a complex, uncertain and unstable environment. Therefore, organizations which are open about their environment are forced to constantly adapt and evolve at the risk of being outdone by competition.
When the environment is favorable to the organization, we speak of opportunities (favorable economic conditions, legislation and dynamic market). On the contrary, if it is unfavorable, we will speak of threats. The company's strategy will therefore consist in seizing opportunities and in diverting or circumventing threats. The goal is to turn threats into opportunities.

The PESTEL analysis model

There are several tools for the analysis of the organization's environment. First, the PESTEL analysis refers to anything that might influence the organization (positively or negatively) and become a threat or an opportunity (or neutral) for it.

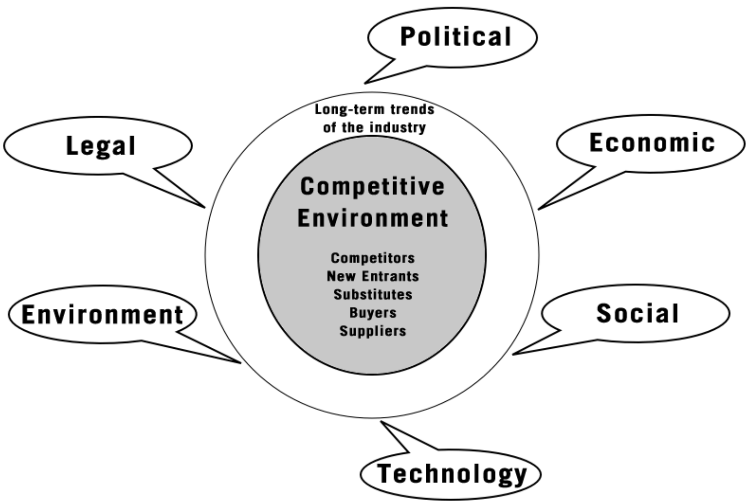
The macro-environment represents all the factors outside the company with which it has to comply and which constitute its framework. Depending on the organizations, this environment is more or less geographically remote:

- For many of them, especially the smaller ones, the environment is only local;
- For others, the environment is essentially national;
- Finally, larger companies operate in an international environment.

The PESTEL analysis allows characterizing a market, assessing the different elements that may affect the business and identifying the environmental opportunities or threats of the organization. This analysis indicates the environmental influences based on an analytical chart that allows the identification of current and future structural trends and helps put into perspective the different development scenarios for the organization.

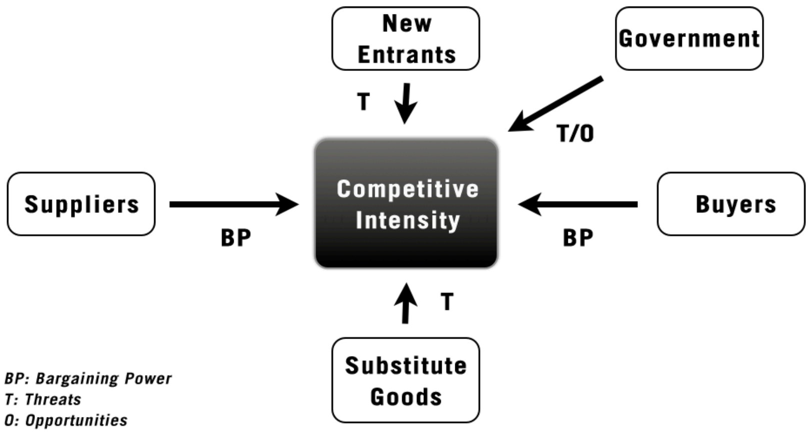
The PESTEL analysis completes the sections of the external diagnosis to have a global picture of the company's general environment. PEST stands for: Political, Economic, Socio-Cultural and Technology. It becomes PESTE when we add Ecology, and PESTEL when a sixth axis, Legislation, is added to the analysis.

The analytical chart we have just established is divided into six categories, as shown in the following diagram:



Adapted from Johnson G., Scholes K., Fréry, F., 2008

Porter's 5 forces model



The main objective of the organization is to achieve a competitive advantage on its market, thus, it is necessary to measure the intensity of competition that will surround the organization and to measure its ability to face this competitive environment. We will use Porter's five forces model to which a force (the government) was added later on, hence the name "Porter's 5 (+1) forces method".

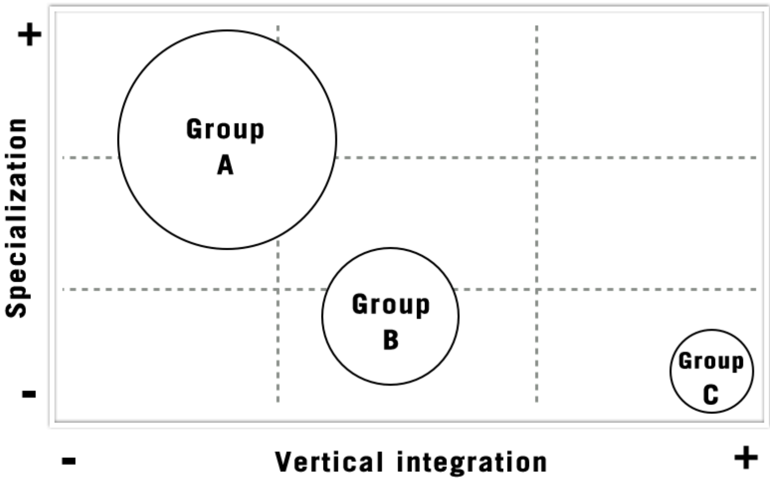
M. Porter's 5 (+1) forces model is a method used to study the structure of an industry, that is to say the nature and intensity of the competitive forces that shape its long-term profitability. The purpose of the analysis is:

- To evaluate the long-term attractiveness or profit potential of the industry
- To identify and understand the 5 (+1) structural forces that influence this profitability

Strategic groups

This concept was identified by Hunt in 1972 and was then taken over and developed by Porter in 1980. The concept of strategic groups was introduced to characterize the combination of similar supply systems. It is used to explain differences in the performance of competitors within the same sector and refers to the concept of competitive intensity. Indeed, a given company does not compete in the same way with all other companies in its sector (Soumana, 2010).

The term “strategic groups” (SG) defines the combination of organizations which adopt the same strategy in one sector. A strategic group is a group composed of all the organizations that have chosen the same strategic action variables.



An example of strategic combination

PART II: COMPETITIVE INTELLIGENCE

Competitive intelligence as defined by the strategic lenses

In this context, competitive intelligence is defined as **all of** the information flow that enables the organization to make decisions and take actions so as to seize opportunities or reduce threats, in order to keep or improve its competitive advantage. In both literature and practice, competitive intelligence is a polysemous word. Depending on the sector and the practice, its form and understanding vary greatly: foresight, data mining, strategic analysis, benchmarking, financial analysis, strategic early warning systems, monitoring tools, information management, knowledge management, etc.

We will call competitive intelligence the way companies organize themselves to get—ethically and legally— information which is closely related to all their stakeholders (clients, shareholders, competitors, suppliers, etc.).

Since we are focusing on the company's strategic dimension, the competitive intelligence field is restricted to strategic management. This is why we have decided to replace the expression economic intelligence by competitive intelligence or strategic intelligence from here on.

The ACI matrix

Keeping watch on your environment

Keeping watch on your environment means applying all environment analysis tools that exist in the strategic management field and that we have reviewed in the first part. This need corresponds to the company's most favorable situation, for the company is in a leadership position, with a very strong strategic capability and a rare and inimitable competitive advantage.

The company being a leader on its market, it must endeavor to keep that advantage by keeping watch on its environment. This entails keeping up with technological evolutions, or even imposing new critical success factors; ensuring the highest level of customer satisfaction by responding accurately to shifts in demand; keeping the sophistication level at the best value for money by making an effort to raise the barriers to entry and finally, following political and legal changes in its sector and linked sectors.

Influencing the environment

In which cases do we need to influence the environment? As we have discussed above with the Blue Ocean Strategy, influencing the environment is important when there is a strong competitive intensity on the market. It is therefore necessary to create new critical success factors in order to lead competitors to a yet untapped path. This can also be an opportunity to restrict the market with new standards or regulations through lobbying actions.

This situation occurs when the company has a high rarity level and yet a moderate or high level of imitability. This means that either the sector realizes its full potential and that the access to technologies and/or to the market becomes imitable and substitutable; or the competitive advantage and rarity are easily imitable as they can be quickly accessed by competitors or new entrants.

Protecting the assets

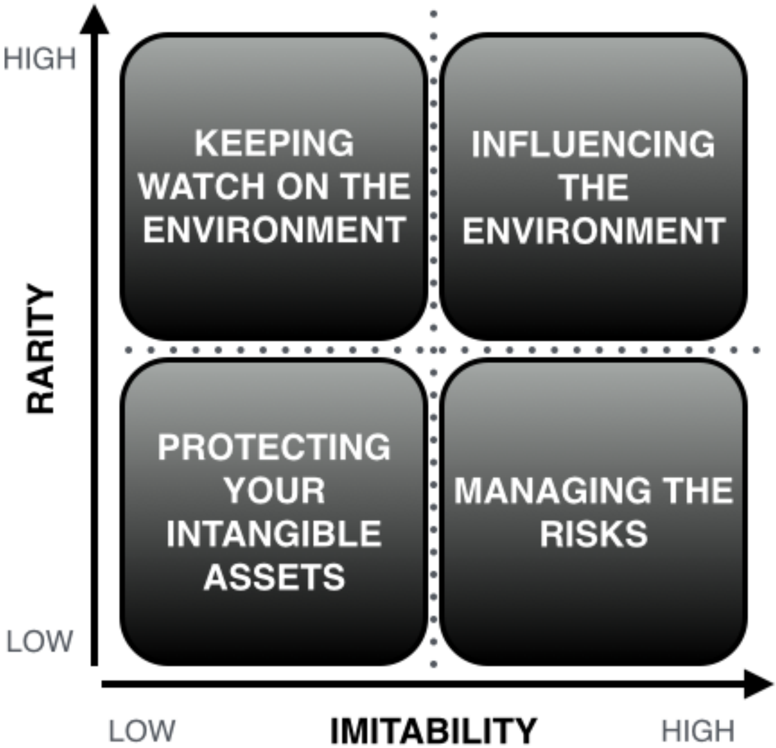
Protecting the assets of a company means protecting your associates, your tangible and intangible assets and your skills. It means protecting your key associates, but also the ones who represent a risk factor considering their access to the company's inside information or their exposure to risk areas. Protecting your tangible assets means controlling the access to sensitive areas. Sensitivity can be explained by the fragility or the degree of danger of the material that is used; by the cost and rarity of the technologies that are used; but also by the skills that constitute a competitive advantage. However, it also means protecting your intangible assets with trademarks and patents application in order to lock the market for the duration of the exploitation of the technology and thus helping research and development find new and more innovative technologies.

The need for protection can present itself on two occasions. Upon starting up if you know beforehand that the technology or skills will rapidly be imitable. Or, when the sector has reached its full potential, to limit temporarily the access to the market to new entrants or substitute products.

Managing the risks

Finally, the management of risks is done in a situation when rarity and imitability are at their most dangerous level for the company. The competitive intensity is high, the resources and skills are not rare and fully imitable. In that case, the company must manage its risks, especially its technological and commercial risks.

As the development of the key points mentioned above is not the subject of this part, we have chosen to remain concise about their contents, their applications and their solutions. However, they are to be found on the following matrix.



The Actions in Competitive Intelligence framework (ACI matrix)

The aim of this matrix is to position the level of competitiveness in accordance with the two variables we have pointed out: rarity and imitability. Depending on its position in the matrix, this model will help the organization work out what action must be implemented first in terms of strategic intelligence.

This model can be adapted to different business sectors and can meet the needs of small and medium-sized enterprises.

PART III: FINANCE

Financial analysis

In this third section, it is necessary to give more details on the company and to undertake a diagnosis of its accounting and financial situation. Even though accounting and financial approaches are intimately related, they do not entirely correspond to the same logic.
Accounting is the measure of the activity and property of an economic entity (company, local government, association, State, public administration, etc.). It is a financial information tool both for the entity itself and the outside. Finance is more understood as the funds management science. The aim of finance is to optimize, through accounting information, the company's activity and assets: investments, financing, financial balance, financial structure, etc.
The aim of the analysis is therefore to make an aggregate of all the accounting and financial information. Most often, the tool will be essentially accounting (use of balance sheet items, financial statements, use of ratios, etc.) but will get to a conclusion whose approach is more financial (financial balance, investment policies, financial structure, etc.).
In this regard, our financial analysis will be structured as follows:

- Analysis of the accounting policies and the quality of the accounting records provided.
- Analysis of the major elements of the financial statements.
- Analysis of profitability.
- Analysis of financial structure and financial balance.
- Analysis of solvency and liquidity.
- An overview: the credit scoring method.

Accounting analysis of the records

The first step entails checking the quality of the provided accounting reports through annual reports, annexes, annual auditor's report, and the auditor's notes for companies required by law to provide audited financials.

In this respect, Messod D. Beneish proposed in 1994 a mathematical model that helps identifying which companies are “manipulative”. This model uses financial ratios, as well as eight variables to determine if one company is likely to manipulate its earnings. The variables are built from the financial statements of the company and results in the M-score that corresponds to the degree of accounting manipulation.
Once the quality of the accounting reports has been checked, the accounting policy choices of the company are to be brought out. The combination of different accounting methods can vary according to the organization, legal form, sector specificities, size, characteristics of the activities and economic situation. The chosen combination determines the accounting policies of the company. Thus, these policies gather the methods, practices, rules and the adopted procedures in the company, in the accounting management and in the establishment of reports, and have an impact on the financial statements of the company.
Consequently, we will focus on considering the following elements[11]: accounting standards, consolidate methods if needed, depreciation policy, regulated provisions[12], inclusion in the cost of sales of certain types of expenses, lease policy, etc. The importance and the impact

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[11] Straight-line depreciation: assumes that the value loss of an asset is proportional to its use, or to its acquisition period. The asset is therefore straight-line depreciated over the duration of its estimated useful life.
Declining balance depreciation: assumes that the value loss through use declines with time. This method is closer to economic reality, and creates a cash-flow advantage: the depreciation expense recorded the first years exceeds those using straight-line depreciation, and proportionally reduces the taxable income. (Applicable for a depreciation of at least three years).
[12] The regulated provisions are provisions 'that do not correspond to the normal object of a provision and are accounted under statutory provisions'; they are not intended to overcome losses or expenses. These are tax benefits aiming at increasing the company’s financing resources (ex: provisions for price increases).