Strategic Management

Dr. Tantri Yanuar R Syah, SE, MSM

Implementing Strategies: Marketing, Finance/Accounting, R&D, and MIS Issues
A note from David

Strategies have no chance of being implemented successfully in organizations that do not market goods an d services well, in firms that cannot raise needed working capital, in firms that produce technologically inferior products, or in firms that have a weak information system. This chapter examines marketing, finance/accounting, R&D, and management information systems (MIS) issues that are central to effective strategy implementation. Special topics include market segmentation, market positioning, evaluating the worth of a business, determining to what extent debt and/or stock should be used as a source of capital, developing projected financial statements, contracting R&D outside the firm, and creating an information support system. Manager and employee involvement and participation are essential for success in marketing, finance/accounting, R&D, and MIS activities.
The Nature of Strategy Implementation The quarterback can call the best play possible in the huddle, but that does not mean the play will go for a touchdown. The team may even lose yardage unless the play is executed (implemented) well. Less than 10 percent of strategies formulated are successfully implemented! There are many reasons for this low success rate, including failing to appropriately segment markets, paying too much for a new acquisition, and falling behind competitors in R&D. Johnson & Johnson implements strategies well. Strategy implementation directly affects the lives of plant managers, division managers, department managers, sales managers, product managers, project managers, personnel managers, staff managers, supervisors, and all employees. In some situations, individuals may not have participated in the strategy-formulation process at all and may not appreciate, understand, or even accept the work and thought that went into strategy formulation. There may even be foot dragging or resistance on their part. Managers and employees who do not understand the business and are not committed to the business may attempt to sabotage strategy-implementation efforts in hopes that the organization will return to its old ways. The strategy-implementation stage of the strategic-management process is highlighted in Figure 8-1.

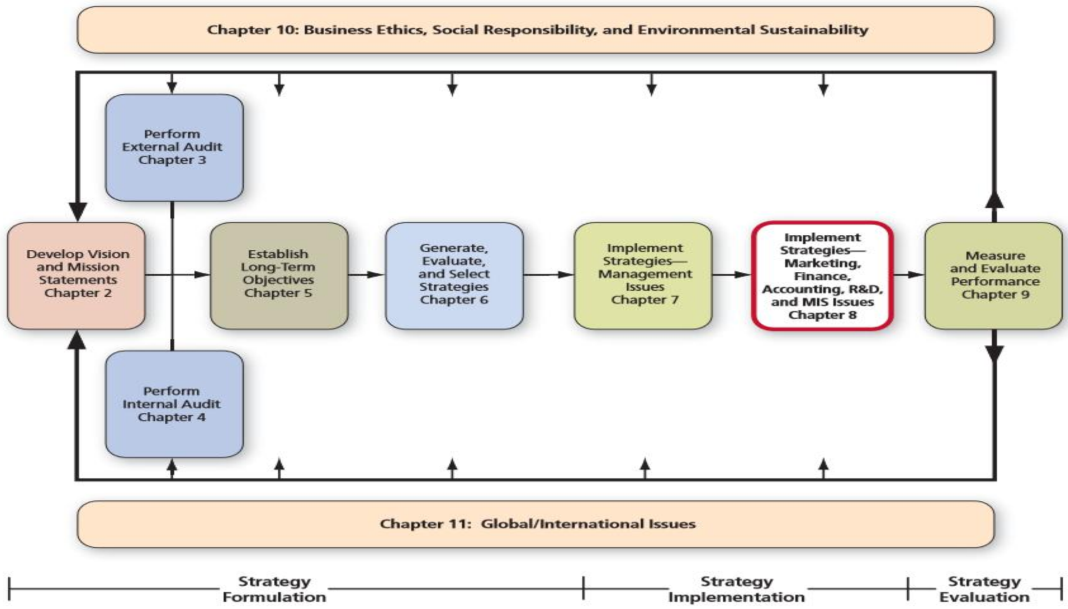
Current Marketing Issues
Countless marketing variables affect the success or failure of strategy implementation, and the scope of this text does not allow us to address all those issues. Some examples of marketing decisions that may require policies are as follows:
1. To use exclusive dealerships or multiple channels of distribution
2. To use heavy, light, or no TV advertising
3. To limit (or not) the share of business done with a single customer
4. To be a price leader or a price follower
5. To offer a complete or limited warranty
6. To reward salespeople based on straight salary, straight commission, or a combination salary/commission
7. To advertise online or not

A marketing issue of increasing concern to consumers today is the extent to which companies can track individuals' movements on the Internet—and even be able to identify an individual by name and e-mail address. Individuals' wanderings on the Internet are no longer anonymous, as many persons still believe. Marketing companies such as DoubleClick, Flycast, AdKnowledge, AdForce, and Real Media have sophisticated methods to identify who you are and your particular interests.1 If you are especially concerned about being tracked, visit the www.networkadvertising.org Web site, which gives details about how marketers today are identifying you and your buying habits.

Marketing of late has become more about building a two-way relationship with consumers than just informing consumers about a product or service. Marketers today must get their customers involved in their company Web site and solicit suggestions from customers in terms of product development, customer service, and ideas. The online community is much quicker, cheaper, and effective than traditional focus groups and surveys. Companies and organizations should encourage their employees to create wikis—Web sites that allows users to add, delete, and edit content regarding frequently asked questions and information across the firm's whole value chain of activities. The most common wiki is Wikipedia, but think of wikis as user-generated content. Know that anyone can change the content in a wiki but the group and other editors can change the content or changes that you submit.

FIGURE 8-1

A Comprehensive Strategic-Management Model



Source: Fred R. David, "How Companies Define Their Mission," *Long Range Planning* 22, no. 3 (June 1988): 40.

Firms should provide incentives to consumers to share their thoughts, opinions, and experiences on the company Web site. Encourage consumers to network among themselves on topics of their choosing on the company Web site. So the company Web site must not be all about the company—it must be all about the customer too. Perhaps offer points or discounts for customers who provide ideas and suggestions. This practice will not only encourage participation but will allow both the company and other customers to interact with "experts."

New Principles of Marketing

Today a business or organization's Web site must provide clear and simple instructions for customers to set up a blog and/or contribute to a wiki. Customers trust each others' opinions more than a company's marketing pitch, and the more they talk freely, the more the firm can learn how to improve its product, service, and marketing. Marketers today monitor blogs daily to determine, evaluate, and influence opinions being formed by customers. Customers must not feel like they are a captive audience for advertising at a firm's Web site. Table 8-1 provides new principles of marketing according to Parise, Guinan, and Weinberg.2

Wells Fargo and Bank of America in 2009 began to tweet customers, meaning they posted messages of 140 characters or less on Twitter.com to describe features of bank products. Some banks are placing marketing videos on YouTube. Discover Financial, American Express, and Citigroup all now have Facebook or My Space pages. UMB Financial of Kansas City, Missouri, tweets about everything from the bank's financial stability to the industry's prospects. Steve Furman, Discover's director of e-commerce, says the appeal of social networking is that it provides "pure, instant" communication with customers.3

When the big three U.S. automakers were asking lawmakers for bailout funding, all three firms launched extensive Internet marketing campaigns to garner support for their requests and plans for the future. Ford's online marketing campaign was anchored by the Web site www.TheFordStory.com. In addition to a new Web site of its own, Chrysler launched a new marketing YouTube Channel named Grab Democracy and also posted ad information to its blog. GM employed similar marketing tactics to drive visitors to its main Web site. Once any controversial topic arises in a company or industry, millions of people are out there googling, yahooing, aoling, youtubing, facebooking, and myspacing to find out more information in order to form their own opinions and preferences.4
Although the exponential increase in social networking and business online has created huge opportunities for marketers, it also has produced some severe threats. Perhaps the greatest threat is that any king of negative publicity travels fast online. For example, Dr Pepper recently suffered immensely when an attorney for the rock band Guns N' Roses accused the company of not following through on giving every American a soft drink if they released their album Chinese Democracy. Other examples abound, such as Motrin ads that lightheartedly talked about Mom's back pain from holding babies in slings, and Burger King's Whopper Virgin campaign, which featured a taste test of a Whopper versus a McDonald's Big Mac in remote areas of the world. Even Taco Bell suffered from its ads that featured asking 50 Cent (aka Curtis Jackson) if he would change his name to 79 Cent or 89 Cent for a day in exchange for a $10,000 donation to charity. Seemingly minor ethical and questionable actions can catapult these days into huge public relations problems for companies as a result of the monumental online social and business communications. For example, Domino's, the nation's largest pizza delivery chain, spent a month in 2009 trying to dispel the video on YouTube and Facebook showing two of its employees doing gross things to a Domino's sub sandwich, including passing gas on salami.5

In increasing numbers, people living in underdeveloped and poor nations around the world have cell phones but no computers, so the Internet is rapidly moving to cell phone platforms. This is opening up even larger markets to online marketing. People in remote parts of Indonesia, Egypt, and Russia represent the fastest growing customer base for Opera Software ASA, a Norwegian maker of Internet browsers for mobile devices. Actually, persons who cannot afford computers live everywhere in every country, and many of these persons will soon be on the Internet on their cell phones. Cell phones are rapidly becoming used for data transfer, not just for phone calls. Companies such as Nokia, AT&T, Purple Labs SA of France, Japan's Access, Vodafone Group PLC, Siemens AG, Research in Motion, and Apple are spurring this transition by developing new and improved Web-capable mobile products every day.6

TABLE 8-1 The New Principles of Marketing

1. Don't just talk at consumers—work with them throughout the marketing process.
2. Give consumers a reason to participate.
3. Listen to—and join—the conversation outside your company's Web site.
4. Resist the temptation to sell, sell, sell. Instead attract, attract, attract.
5. Don't control online conversations; let it flow freely.
6. Find a "marketing technologist," a person who has three excellent skill sets (marketing, technology, and social interaction).
7. Embrace instant messaging and chatting.

Source: Based on Salvatore Parise, Patricia Guinan, and Bruce Weinberg, "The Secrets of Marketing in a Web 2.0 World," *Wall Street Journal* (December 15, 2008): R1.

Advertising Media

Recent research by Forrester Research reveals that people ages 18 to 27 spend more time weekly on the Internet than watching television, listening to the radio, or watching DVDs or VHS tapes. Table 8-2 reveals why companies are rapidly coming to the realization that social networking sites and video sites are better means of reaching their customers than spending so many marketing dollars on traditional yellow pages or television, magazine, radio, or newspaper ads. Note the time that people spend on the Internet. And it is not just the time. Television viewers are passive viewers of ads, whereas Internet users take an active role in choosing what to look at—so customers on the Internet are tougher for marketers to reach.7

TABLE 8-2 Average Amount of Time That 18- to 27-Year-Olds Spend Weekly on Various Media (in hours)

Media	Hours
On the Internet	High-13.0
Watching television	↓
On their cell phone	
Listening to the Radio	Medium-7.0
Watching DVDs or VHSs	↓
Playing video games	
Reading magazines	Low-1.0

Source: Based on Ellen Byron, "A New Odd Couple: Google, P&G Swap Workers to Spur Innovation," *Wall Street Journal* (November 19, 2008): A1.

New companies such as Autonet Mobile based in San Francisco are selling new technology equipment for cars so the front passenger may conduct an iChat video conference while persons in the back each have a laptop and watch a YouTube video or download music or wirelessly transfer pictures from a digital camera. Everyone in the vehicle can be online except, of course, the driver. This technology is now available for installation in nearly all cars and is accelerating the movement from hard media to Webbased media. With this technology also, when the vehicle drives into a new location, you may instantly download information on shows, museums, hotels, and other attractions around you.

Growth of Internet advertising is expected to decline from a 16 percent increase in 2008 to a 5 percent increase in 2009. With this slowdown, companies are changing the restrictions they previously imposed on the categories and formats of advertising. For example, marketers are more and more allowed to create bigger, more intrusive ads that take up more space on the Web page. And Web sites are allowing lengthier ads to run before short video clips play. And blogs are creating more content that doubles also as an ad. Companies are also waiving minimum ad purchases. Companies are redesigning their Web sites to be much more interactive and are building new sponsorship programs and other enticements on their sites. Editorial content and advertising content are increasingly being mixed on blogs.
In 2009–2011, consumers will act rationally. JC Penney CEO Mike Ullman says, "Consumers now shop for what they 'need' and less for what they 'want.' And they don't need much." Essentials, such as food, health-care products, and beauty aids are selling, but even in those industries, consumers are shifting to less costly brands and stores. There is a need for marketers to convince consumers that their brand will make life easier or better. Consumers now often wait until prices are slashed 75 percent or more to buy. Consumers today are very cautious about how they spend their money. Gone are the days when retailers could convince consumers to buy something they do not need.

JC Penney is among many firms that today have revamped their marketing to be more digital related. Penney's is segmenting its e-mail databases according to customers' shopping behaviors and then sending out relevant messages. Penney's corporate director of brand communications recently said, "Tailoring the e-mail insures that our customers are receiving timely, relevant information."

Expectations for total U.S. advertising spending in 2009 may decline anywhere from 6.2 percent to 3 percent to about $160 billion as the fallout from global financial crises continues to cut into ad spending.8 Global ad spending is expected to decline about 0.5 percent. One bright spot, however, is online advertising expenditures that are expected to increase 5 percent in 2009 following a 16 percent increase in 2008. Companies are shifting ad dollars from newspaper, magazine, and radio to online media.

Purpose-Based Marketing

The global marketing chief at Procter & Gamble, Jim Stengel, recently started his own LLC business to try to persuade companies that the best way to sell in a weak economy is to "show customers how they can improve their lives" with your product or service. Stengel calls this "purpose-based marketing," and hundreds of firms have now adopted this approach successfully. He says there is need in an ad to build trust and an emotional connection to the customer in order to differentiate your product or service.9

In a weak economy when consumers are more interested in buying cheaper brands, Stengel acknowledges that ads must promote price, but he says ads must also show the intrinsic value of the product or service to be cost effective. Stengel contends that ads should do both: promote low price and build emotional equity through "purpose-based appeal."

The Coca-Cola Company is leading the way to another new kind of selling in a weak economy. CEO Muhtar Kent at Coke says marketing today must "employ optimism." That is why Coca-Cola launched a new global ad campaign in 2009 appealing to consumers' longing for comfort and optimism. The new campaign features the new slogan "Open Happiness," which replaced Coke's prior popular slogan of three years, "The Coke Side of Life." The Coke CEO says marketers must use feel-good messages to counter the fallout from the economic crisis. Firms must today project to customers that their products or services offer a beacon of comfort and optimism. Coke's cola volume declined 4.0 percent in the United States in 2008. Coke Classic's U.S. volume fell about 16 percent from 1998 through 2007 as customers switched to bottled water, enhanced teas, and other alternative drinks.10

Market Segmentation

Two variables are of central importance to strategy implementation: market segmentation and product positioning. Market segmentation and product positioning rank as marketing's most important contributions to strategic management.

Market segmentation is widely used in implementing strategies, especially for small and specialized firms. Market segmentation can be defined as the subdividing of a market into distinct subsets of customers according to needs and buying habits.

TABLE 8-3 The Marketing Mix Component Variables

Product	Place	Promotion	Price
Quality	Distribution channels	Advertising	Level
Features and options	Distribution coverage	Personal selling	Discounts and allowances
Style	Outlet location	Sales promotion	Payment terms
Brand name	Sales territories	Publicity	
Packaging	Inventory levels and locations		
Product line	Transportation carriers		
Warranty			
Service level			
Other services			

Source: From E. Jerome McCarthy, *Basic Marketing: A Managerial Approach,* 9th ed. (Homewood, IL: Richard D. Irwin, Inc., 1987): 37–44. Used with permission.

Market segmentation is an important variable in strategy implementation for at least three major reasons. First, strategies such as market development, product development, market penetration, and diversification require increased sales through new markets and products. To implement these strategies successfully, new or improved market-segmentation approaches are required. Second, market segmentation allows a firm to operate with limited resources because mass production, mass distribution, and mass advertising are not required. Market segmentation enables a small firm to compete successfully with a large firm by maximizing per-unit profits and per-segment sales. Finally, market segmentation decisions directly affect marketing mix variables: product, place, promotion, and price, as indicated in Table 8-3. For example, SnackWells, a pioneer in reduced-fat snacks, has shifted its advertising emphasis from low-fat to great taste as part of its new market-segmentation strategy.

Perhaps the most dramatic new market-segmentation strategy is the targeting of regional tastes. Firms from McDonald's to General Motors are increasingly modifying their products to meet different regional preferences within the United States. Campbell's has a spicier version of its nacho cheese soup for the Southwest, and Burger King offers breakfast burritos in New Mexico but not in South Carolina. Geographic and demographic bases for segmenting markets are the most commonly employed, as illustrated in Table 8-4.

Evaluating potential market segments requires strategists to determine the characteristics and needs of consumers, to analyze consumer similarities and differences, and to develop consumer group profiles. Segmenting consumer markets is generally much simpler and easier than segmenting industrial markets, because industrial products, such as electronic circuits and forklifts, have multiple applications and appeal to diverse customer groups.

Segmentation is a key to matching supply and demand, which is one of the thorniest problems in customer service. Segmentation often reveals that large, random fluctuations in demand actually consist of several small, predictable, and manageable patterns. Matching supply and demand allows factories to produce desirable levels without extra shifts, overtime, and subcontracting. Matching supply and demand also minimizes the number and severity of stock-outs. The demand for hotel rooms, for example, can be dependent on foreign tourists, businesspersons, and vacationers. Focusing separately on these three market segments, however, can allow hotel firms to more effectively predict overall supply and demand.

Banks now are segmenting markets to increase effectiveness. "You're dead in the water if you aren't segmenting the market," says Anne Moore, president of a bank consulting firm in Atlanta. The Internet makes market segmentation easier today because consumers naturally form "communities" on the Web.

Does the Internet Make Market Segmentation Easier? Yes. The segments of people whom marketers want to reach online are much more precisely defined than the segments of people reached through traditional forms of media, such as television, radio, and magazines. For example, Quepasa.com is widely visited by Hispanics. Marketers aiming to reach college students, who are notoriously difficult to reach via traditional media, focus on sites such as collegeclub.com and studentadvantage.com. The gay and lesbian population, which is estimated to comprise about 5 percent of the U.S. population, has always been difficult to reach via traditional media but now can be focused on at sites such as gay.com. Marketers can reach persons interested in specific topics, such as travel or fishing, by placing banners on related Web sites.

People all over the world are congregating into virtual communities on the Web by becoming members/customers/visitors of Web sites that focus on an endless range of topics. People in essence segment themselves by nature of the Web sites that comprise their "favorite places," and many of these Web sites sell information regarding their "visitors." Businesses and groups of individuals all over the world pool their purchasing power in Web sites to get volume discounts.

TABLE 8-4 Alternative Bases for Market Segmentation

Variable	Typical Breakdowns
	Geographic
Region	Pacific, Mountain, West North Central, West South Central, East North Central, East South Central, South Atlantic, Middle Atlantic, New England
County Size	A, B, C, D
City Size	Under 5,000; 5,000–20,000; 20,001–50,000; 50,001–100,000; 100,001–250,000; 250,001–500,000; 500,001–1,000,000; 1,000,001–4,000,000; 4,000,001 or over
Density	Urban, suburban, rural
Climate	Northern, southern
	Demographic
Age	Under 6, 6–11, 12–19, 20–34, 35–49, 50–64, 65+
Gender	Male, female
Family Size	1–2, 3–4, 5+
Family Life Cycle	Young, single; young, married, no children; young, married, youngest child under 6; young, married, youngest child 6 or over; older, married, with children; older, married, no children under 18; older, single; other
Income	Under $10,000; $10,001–$15,000; $15,001–$20,000; $20,001–$30,000; $30,001–$50,000; $50,001–$70,000; $70,001–$100,000; over $100,000
Occupation	Professional and technical; managers, officials, and proprietors; clerical and sales; craftspeople; foremen; operatives; farmers; retirees; students; housewives; unemployed
Education	Grade school or less; some high school; high school graduate; some college; college graduate
Religion	Catholic, Protestant, Jewish, Islamic, other
Race	White, Asian, Hispanic, African American
Nationality	American, British, French, German, Scandinavian, Italian, Latin American, Middle Eastern, Japanese
	Psychographic
Social Class	Lower lowers, upper lowers, lower middles, upper middles, lower uppers, upper uppers
Personality	Compulsive, gregarious, authoritarian, ambitious
	Behavioral
Use Occasion	Regular occasion, special occasion
Benefits Sought	Quality, service, economy
User Status	Nonuser, ex-user, potential user, first-time user, regular user
Usage Rate	Light user, medium user, heavy user
Loyalty Status	None, medium, strong, absolute
Readiness Stage	Unaware, aware, informed, interested, desirous, intending to buy
Attitude Toward Product	Enthusiastic, positive, indifferent, negative, hostile

Source: Adapted from Philip Kotler, *Marketing Management: Analysis, Planning and Control*, © 1984: 256. Adapted by permission of Prentice-Hall, Inc., Upper Saddle River, New Jersey.

Product Positioning

After markets have been segmented so that the firm can target particular customer groups, the next step is to find out what customers want and expect. This takes analysis and research. A severe mistake is to assume the firm knows what customers want and expect. Countless research studies reveal large differences between how customers define service and rank the importance of different service activities and how producers view services. Many firms have become successful by filling the gap between what customers and producers see as good service. What the customer believes is good service is paramount, not what the producer believes service should be.

Identifying target customers to focus marketing efforts on sets the stage for deciding how to meet the needs and wants of particular consumer groups. Product positioning is widely used for this purpose. Positioning entails developing schematic representations that reflect how your products or services compare to competitors' on dimensions most important to success in the industry. The following steps are required in product positioning:

1. Select key criteria that effectively differentiate products or services in the industry.
2. Diagram a two-dimensional product-positioning map with specified criteria on each axis.
3. Plot major competitors' products or services in the resultant four-quadrant matrix.
4. Identify areas in the positioning map where the company's products or services could be most competitive in the given target market. Look for vacant areas (niches).
5. Develop a marketing plan to position the company's products or services appropriately.

Because just two criteria can be examined on a single product-positioning map, multiple maps are often developed to assess various approaches to strategy implementation. Multidimensional scalingcould be used to examine three or more criteria simultaneously, but this technique requires computer assistance and is beyond the scope of this text. Some examples of product-positioning maps are illustrated in Figure 8-2.

Some rules for using product positioning as a strategy-implementation tool are the following:

1. Look for the hole or vacant niche. The best strategic opportunity might be an unserved segment.
2. Don't serve two segments with the same strategy. Usually, a strategy successful with one segment cannot be directly transferred to another segment.
3. Don't position yourself in the middle of the map. The middle usually means a strategy that is not clearly perceived to have any distinguishing characteristics. This rule can vary with the number of competitors. For example, when there are only two competitors, as in U.S. presidential elections, the middle becomes the preferred strategic position.11

An effective product-positioning strategy meets two criteria: (1) it uniquely distinguishes a company from the competition, and (2) it leads customers to expect slightly less service than a company can deliver. Firms should not create expectations that exceed the service the firm can or will deliver. Network Equipment Technology is an example of a company that keeps customer expectations slightly below perceived performance. This is a constant challenge for marketers. Firms need to inform customers about what to expect and then exceed the promise. Underpromise and then overdeliver is the key!

Finance/Accounting

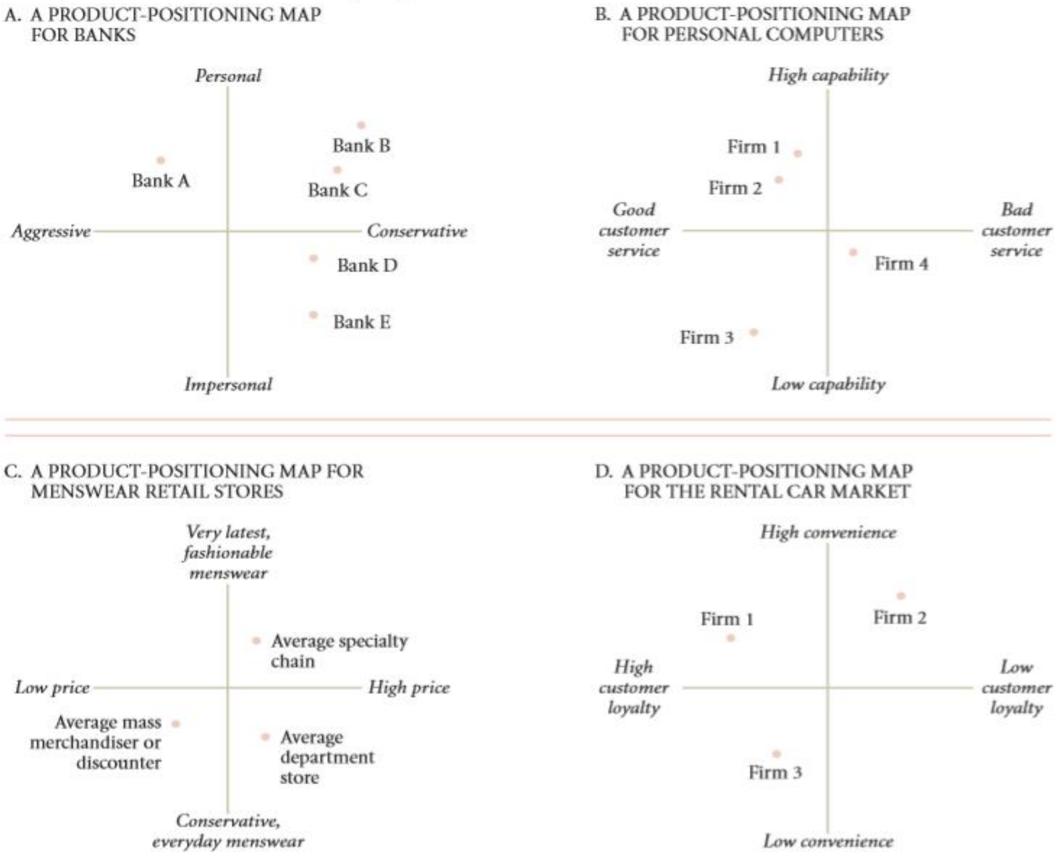
Issues In this section, we examine several finance/accounting concepts considered to be central to strategy implementation: acquiring needed capital, developing projected financial statements, preparing financial budgets, and evaluating the worth of a business. Some examples of decisions that may require finance/accounting policies are these:

1. To raise capital with short-term debt, long-term debt, preferred stock, or common stock
2. To lease or buy fixed assets
3. To determine an appropriate dividend payout ratio
4. To use LIFO (Last-in, First-out), FIFO (First-in, First-out), or a market-value accounting approach
5. To extend the time of accounts receivable

6. To establish a certain percentage discount on accounts within a specified period of time
7. To determine the amount of cash that should be kept on hand

FIGURE 8-2

Examples of Product-Positioning Maps



Acquiring Capital to Implement Strategies

Successful strategy implementation often requires additional capital. Besides net profit from operations and the sale of assets, two basic sources of capital for an organization are debt and equity. Determining an appropriate mix of debt and equity in a firm's capital structure can be vital to successful strategy implementation. An Earnings Per Share/Earnings Before Interest and Taxes (EPS/EBIT) analysis is the most widely used technique for determining whether debt, stock, or a combination of debt and stock is the best alternative for raising capital to implement strategies. This technique involves an examination of the impact that debt versus stock financing has on earnings per share under various assumptions as to EBIT.

Theoretically, an enterprise should have enough debt in its capital structure to boost its return on investment by applying debt to products and projects earning more than the cost of the debt. In low earning periods, too much debt in the capital structure of an organization can endanger stockholders' returns and jeopardize company survival. Fixed debt obligations generally must be met, regardless of circumstances. This does not mean that stock issuances are always better than debt for raising capital. Some special concerns with stock issuances are dilution of ownership, effect on stock price, and the need to share future earnings with all new shareholders.

Without going into detail on other institutional and legal issues related to the debt versus stock decision, EPS/EBIT may be best explained by working through an example. Let's say the Brown Company needs to raise $1 million to finance implementation of a market-development strategy. The company's common stock currently sells for $50 per share, and 100,000 shares are outstanding. The prime interest rate is 10 percent, and the company's tax rate is 50 percent. The company's earnings before interest and taxes next year are expected to be $2 million if a recession occurs, $4 million if the economy stays as is, and $8 million if the economy significantly improves. EPS/EBIT analysis can be used to determine if all stock, all debt, or some combination of stock and debt is the best capital financing alternative. The EPS/EBIT analysis for this example is provided in Table 8-5.

As indicated by the EPS values of 9.5, 19.50, and 39.50 in Table 8-5, debt is the best financing alternative for the Brown Company if a recession, boom, or normal year is expected. An EPS/EBIT chart can be constructed to determine the break-even point, where one financing alternative becomes more attractive than another. Figure 8-3 indicates that issuing common stock is the least attractive financing alternative for the Brown Company. EPS/EBIT analysis is a valuable tool for making the capital financing decisions needed to implement strategies, but several considerations should be made whenever using this technique. First, profit levels may be higher for stock or debt alternatives when EPS levels are lower. For example, looking only at the earnings after taxes (EAT) values in Table 8-5, you can see that the common stock option is the best alternative, regardless of economic conditions. If the Brown Company's mission includes strict profit maximization, as opposed to the maximization of stockholders' wealth or some other criterion, then stock rather than debt is the best choice of financing.

TABLE 8-5 EPS/EBIT Analysis for the Brown Company (in millions)

	Common Stock Financing			Debt Financing			Combination Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	$2.0	$ 4.0	$ 8.0	$2.0	$ 4.0	$ 8.0	$2.0	$ 4.0	$ 8.0
Interest[a]	0	0	0	.10	.10	.10	.05	.05	.05
EBT	2.0	4.0	8.0	1.9	3.9	7.9	1.95	3.95	7.95
Taxes	1.0	2.0	4.0	.95	1.95	3.95	.975	1.975	3.975
EAT	1.0	2.0	4.0	.95	1.95	3.95	.975	1.975	3.975
#Shares[b]	.12	.12	.12	.10	.10	.10	.11	.11	.11
EPS[c]	8.33	16.66	33.33	9.5	19.50	39.50	8.86	17.95	36.14

[a]The annual interest charge on $1 million at 10% is $100,000 and on $0.5 million is $50,000. This row is in $, not %.

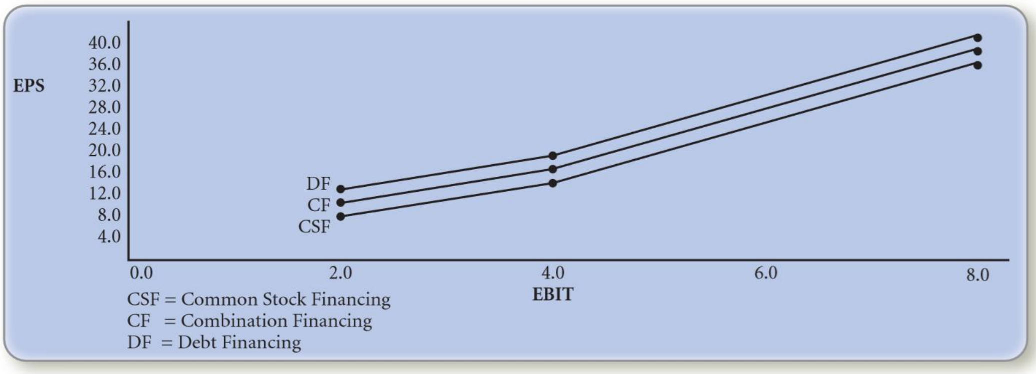
[b]To raise all of the needed $1 million with stock, 20,000 new shares must be issued, raising the total to 120,000 shares outstanding. To raise one-half of the needed $1 million with stock, 10,000 new shares must be issued, raising the total to 110,000 shares outstanding.

[c]EPS = Earnings After Taxes (EAT) divided by shares (number of shares outstanding).

Another consideration when using EPS/EBIT analysis is flexibility. As an organization's capital structure changes, so does its flexibility for considering future capital needs. Using all debt or all stock to raise capital in the present may impose fixed obligations, restrictive covenants, or other constraints that could severely reduce a firm's ability to raise additional capital in the future. Control is also a concern. When additional stock is issued to finance strategy implementation, ownership and control of the enterprise are diluted. This can be a serious concern in today's business environment of hostile takeovers, mergers, and acquisitions.

FIGURE 8-3

An EPS/EBIT Chart for the Brown Company



Dilution of ownership can be an overriding concern in closely held corporations in which stock issuances affect the decision-making power of majority stockholders. For example, the Smucker family owns 30 percent of the stock in Smucker's, a well-known jam and jelly company. When Smucker's acquired Dickson Family, Inc., the company used mostly debt rather than stock in order not to dilute the family ownership.

When using EPS/EBIT analysis, timing in relation to movements of stock prices, interest rates, and bond prices becomes important. In times of depressed stock prices, debt may prove to be the most suitable alternative from both a cost and a demand standpoint. However, when cost of capital (interest rates) is high, stock issuances become more attractive.

Tables 8-6 and 8-7 provide EPS/EBIT analyses for two companies—Gateway and Boeing. Notice in those analyses that the combination stock/debt options vary from 30/70 to 70/30. Any number of combinations could be explored. However, sometimes in preparing the EPS/EBIT graphs, the lines will intersect, thus revealing break-even points at which one financing alternative becomes more or less attractive than another. The slope of these lines will be determined by a combination of factors including stock price, interest rate, number of shares, and amount of capital needed. Also, it should be noted here that the best financing alternatives are indicated by the highest EPS values. In Tables 8-6 and 8-7, note that the tax rates for the companies vary considerably and should be computed from the respective income statements by dividing taxes paid by income before taxes.

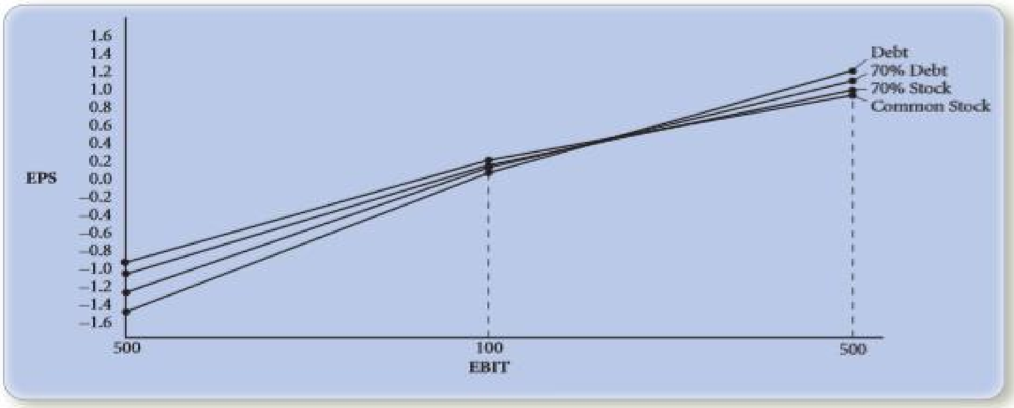
In Table 8-6, the higher EPS values indicate that Gateway should use stock to raise capital in recession or normal economic conditions but should use debt financing under boom conditions. Stock is the best alternative for Gateway under all three conditions if EAT (profit maximization) were the decision criteria, but EPS (maximize shareholders' wealth) is the better ratio to make this decision. Firms can do many things in the short run to maximize profits, so investors and creditors consider maximizing shareholders' wealth to be the better criteria for making financing decisions.

TABLE 8-6 EPS/EBIT Analysis for Gateway (M = In Millions)

Amount Needed: $1,000 M
EBIT Range: − $500 M to + $100 M to + $500 M
Interest Rate: 5%
Tax Rate: 0% (because the firm has been incurring a loss annually)
Stock Price: $6.00
# of Shares Outstanding: 371 M

	Common Stock Financing			Debt Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	(500.00)	100.00	500.00	(500.00)	100.00	500.00
Interest	0.00	0.00	0.00	50.00	50.00	50.00
EBT	(500.00)	100.00	500.00	(550.00)	50.00	450.00
Taxes	0.00	0.00	0.00	0.00	0.00	0.00
EAT	(500.00)	100.00	500.00	(550.00)	50.00	450.00
#Shares	537.67	537.67	537.67	371.00	371.00	371.00
EPS	**(0.93)**	**0.19**	**0.93**	**(1.48)**	**0.13**	**1.21**

	70 Percent Stock—30 Percent Debt			70 Percent Debt—30 Percent Stock		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	(500.00)	100.00	500.00	(500.00)	100.00	500.00
Interest	15.00	15.00	15.00	35.00	35.00	35.00
EBT	(515.00)	85.00	485.00	(535.00)	65.00	465.00
Taxes	0.00	0.00	0.00	0.00	0.00	0.00
EAT	(515.00)	85.00	485.00	(535.00)	65.00	465.00
#Shares	487.67	487.67	487.67	421.00	421.00	421.00
EPS	**(1.06)**	**0.17**	**0.99**	**(1.27)**	**0.15**	**1.10**



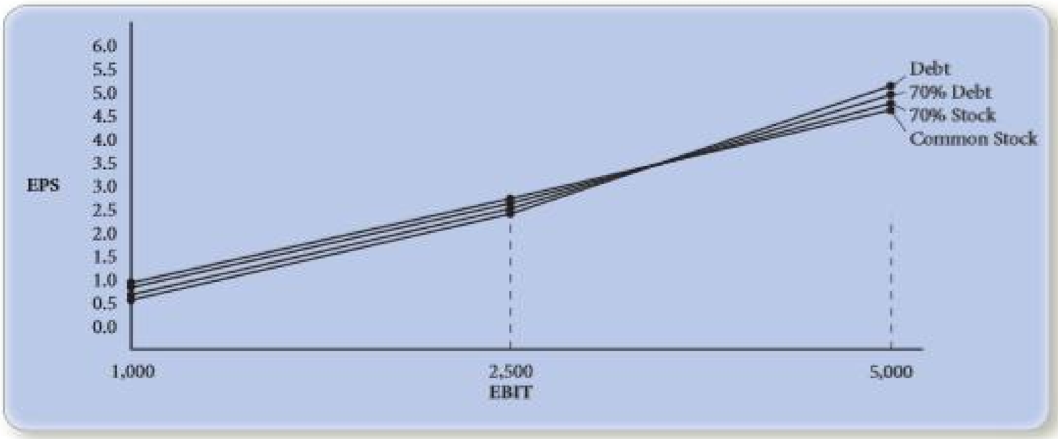
Conclusion: Gateway should use common stock to raise capital in recession or normal economic conditions but should use debt financing under boom conditions. Note that stock is the best alternative under all three conditions according to EAT (profit maximization), but EPS (maximize shareholders' wealth) is the better ratio to make this decision.

TABLE 8-7 EPS/EBIT Analysis for Boeing (M = In Millions)

Amount Needed: $10,000 M
Interest Rate: 5%
Tax Rate: 7%
Stock Price: $53.00
# of Shares Outstanding: 826 M

	Common Stock Financing			Debt Financing		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	1,000.00	2,500.00	5,000.00	1,000.00	2,500.00	5,000.00
Interest	0.00	0.00	0.00	500.00	500.00	500.00
EBT	1,000.00	2,500.00	5,000.00	500.00	2,000.00	4,500.00
Taxes	70.00	175.00	350.00	35.00	140.00	315.00
EAT	930.00	2,325.00	4,650.00	465.00	1,860.00	4,185.00
# Shares	1,014.68	1,014.68	1,014.68	826.00	826.00	826.00
EPS	**0.92**	**2.29**	**4.58**	**0.56**	**2.25**	**5.07**

	70% Stock—30% Debt			70% Debt—30% Stock		
	Recession	*Normal*	*Boom*	*Recession*	*Normal*	*Boom*
EBIT	1,000.00	2,500.00	5,000.00	1,000.00	2,500.00	5,000.00
Interest	150.00	150.00	150.00	350.00	350.00	350.00
EBT	850.00	2,350.00	4,850.00	650.00	2,150.00	4,650.00
Taxes	59.50	164.50	339.50	45.50	150.50	325.50
EAT	790.50	2,185.50	4,510.50	604.50	1,999.50	4,324.50
# Shares	958.08	958.08	958.08	882.60	882.60	882.60
EPS	**0.83**	**2.28**	**4.71**	**0.68**	**2.27**	**4.90**



Conclusion: Boeing should use common stock to raise capital in recession (see 0.92) or normal (see 2.29) economic conditions but should use debt financing under boom conditions (see 5.07). Note that a dividends row is absent from this analysis. The more shares outstanding, the more dividends to be paid (if the firm pays dividends), which would lower the common stock EPS values.

In Table 8-7, note that Boeing should use stock to raise capital in recession (see 0.92) or normal (see 2.29) economic conditions but should use debt financing under boom conditions (see 5.07). Let's calculate here the number of shares figure of 1014.68 given under Boeing's stock alternative. Divide $10,000 M funds needed by the stock price of $53 = 188.68 M new shares to be issued + the 826 M shares outstanding already = 1014.68 M shares under the stock scenario. Along the final row, EPS is the number of shares outstanding divided by EAT in all columns.

Note in Table 8-6 and Table 8-7 that a dividends row is absent from both the Gateway and Boeing analyses. The more shares outstanding, the more dividends to be paid (if the firm indeed pays dividends). Paying dividends lowers EAT, which lowers the stock EPS values whenever this aspect is included. To consider dividends in an EPS/EBIT analysis, simply insert another row for "Dividends" right below the "EAT" row and then insert an "Earnings After Taxes and Dividends" row. Considering dividends would make the analysis more robust.

Note in both the Gateway and Boeing graphs, there is a break-even point between the normal and boom range of EBIT where the debt option overtakes the 70% Debt/30% Stock option as the best financing alternative. A break-even point is where two lines cross each other. A break-even point is the EBIT level where various financing alternative represented by lines crossing are equally attractive in terms of EPS. Both the Gateway and Boeing graphs indicate that EPS values are highest for the 100 percent debt option at high EBIT levels. The two graphs also reveal that the EPS values for 100 percent debt increase faster than the other financing options as EBIT levels increase beyond the break-even point. At low levels of EBIT however, both the Gateway and Boeing graphs indicate that 100 percent stock is the best financing alternative because the EPS values are highest.

New Source of Funding

Credit unions were not involved in the subprime-loan market, so many of them are flush with cash and are making loans, especially to small businesses. Deposits to credit unions were also up when many investors abandoned the stock market. Roughly 27 percent of the 8,147 U.S. credit unions offer business loans.12 The amount of businesses loans was up 18 percent in 2008 to $33 billion, and the average loan size was $215,000.

Many credit unions want to give more business loans, but the 1998 federal law (Credit Union Membership Access Act) caps the amount of business loans credit unions can have at 12.25 percent of their assets. Credit unions are trying to get this law changed, but of course banks are lobbying hard to have the law remain in place. Credit unions are chartered as nonprofit cooperative institutions owned by their members. Thus credit unions are taxexempt organizations. Bankers argue that allowing credit unions to give more business loans would give them an unfair competitive advantage over traditional banks.

Projected Financial Statements

Projected financial statement analysisis a central strategy-implementation technique because it allows an organization to examine the expected results of various actions and approaches. This type of analysis can be used to forecast the impact of various implementation decisions (for example, to increase promotion expenditures by 50 percent to support a market-development strategy, to increase salaries by 25 percent to support a market-penetration strategy, to increase research and development expenditures by 70 percent to support product development, or to sell $1 million of common stock to raise capital for diversification). Nearly all financial institutions require at least three years of projected financial statements whenever a business seeks capital. Aprojected income statement and balance sheet allow an organization to compute projected financial ratios under various strategy-implementation scenarios.

When compared to prior years and to industry averages, financial ratios provide valuable insights into the feasibility of various strategy-implementation approaches.

Primarily as a result of the Enron collapse and accounting scandal and the ensuing Sarbanes-Oxley Act, companies today are being much more diligent in preparing projected financial statements to "reasonably rather than too optimistically" project future expenses and earnings. There is much more care not to mislead shareholders and other constituencies.13

A 2011 projected income statement and a balance sheet for the Litten Company are provided in Table 8-8. The projected statements for Litten are based on five assumptions: (1) The company needs to raise $45 million to finance expansion into foreign markets; (2) $30 million of this total will be raised through increased debt and $15 million through common stock; (3) sales are expected to increase 50 percent; (4) three new facilities, costing a total of $30 million, will be constructed in foreign markets; and (5) land for the new facilities is already owned by the company. Note in Table 8-8 that Litten's

TABLE 8-8 A Projected Income Statement and Balance Sheet for the Litten Company (in millions)

	Prior Year 2010	Projected Year 2011	Remarks
PROJECTED INCOME STATEMENT			
Sales	$100	$150.00	50% increase
Cost of Goods Sold	70	105.00	70% of sales
Gross Margin	30	45.00	
Selling Expense	10	15.00	10% of sales
Administrative Expense	5	7.50	5% of sales
Earnings Before Interest and Taxes	15	22.50	
Interest	3	3.00	
Earnings Before Taxes	12	19.50	
Taxes	6	9.75	50% rate
Net Income	**6**	**9.75**	
Dividends	2	5.00	
Retained Earnings	4	4.75	
PROJECTED BALANCE SHEET			
Assets			
Cash	5	7.75	Plug figure
Accounts Receivable	2	4.00	100% increase
Inventory	20	45.00	
Total Current Assets	27	56.75	
Land	15	15.00	
Plant and Equipment	50	80.00	Add three new plants at $10 million each
Less Depreciation	10	20.00	
Net Plant and Equipment	40	60.00	
Total Fixed Assets	55	75.00	
Total Assets	**82**	**131.75**	
Liabilities			
Accounts Payable	10	10.00	
Notes Payable	10	10.00	
Total Current Liabilities	20	20.00	
Long-term Debt	40	70.00	Borrowed $30 million
Additional Paid-in-Capital	20	35.00	Issued 100,000 shares at $150 each
Retained Earnings	2	6.75	$2 + $4.75
Total Liabilities and Net Worth	**82**	**131.75**	

strategies and their implementation are expected to result in a sales increase from $100 million to $150 million and in a net increase in income from $6 million to $9.75 million in the forecasted year.

There are six steps in performing projected financial analysis:

1. Prepare the projected income statement before the balance sheet. Start by forecasting sales as accurately as possible. Be careful not to blindly push historical percentages into the future with regard to revenue (sales) increases. Be

mindful of what the firm did to achieve those past sales increases, which may not be appropriate for the future unless the firm takes similar or analogous actions (such as opening a similar number of stores, for example). If dealing with a manufacturing firm, also be mindful that if the firm is operating at 100 percent capacity running three eighthour shifts per day, then probably new manufacturing facilities (land, plant, and equipment) will be needed to increase sales further.

2. Use the percentage-of-sales method to project cost of goods sold (CGS) and the expense items in the income statement. For example, if CGS is 70 percent of sales in the prior year (as it is in Table 8-8), then use that same percentage to calculate CGS in the future year—unless there is a reason to use a different percentage. Items such as interest, dividends, and taxes must be treated independently and cannot be forecasted using the percentage-of-sales method.
3. Calculate the projected net income.
4. Subtract from the net income any dividends to be paid for that year. This remaining net income is retained earnings (RE). Bring this retained earnings amount for that year (NI - DIV = RE) over to the balance sheet by adding it to the prior year's RE shown on the balance sheet. In other words, every year a firm adds its RE for that particular year (from the income statement) to its historical RE total on the balance sheet. Therefore, the RE amount on the balance sheet is a cumulative number rather than money available for strategy implementation! Note that RE is the first projected balance sheet item to be entered. Due to this accounting procedure in developing projected financial statements, the RE amount on the balance sheet is usually a large number. However, it also can be a low or even negative number if the firm has been incurring losses. The only way for RE to decrease from one year to the next on the balance sheet is (1) if the firm incurred an earnings loss that year or (2) the firm had positive net income for the year but paid out dividends more than the net income. Be mindful that RE is the key link between a projected income statement and balance sheet, so be careful to make this calculation correctly.
5. Project the balance sheet items, beginning with retained earnings and then forecasting stockholders' equity, long-term liabilities, current liabilities, total liabilities, total assets, fixed assets, and current assets (in that order). Use the cash account as the plug figure—that is, use the cash account to make the assets total the liabilities and net worth. Then make appropriate adjustments. For example, if the cash needed to balance the statements is too small (or too large), make appropriate changes to borrow more (or less) money than planned.
6. List comments (remarks) on the projected statements. Any time a significant change is made in an item from a prior year to the projected year, an explanation (remark) should be provided. Remarks are essential because otherwise pro formas are meaningless.

Projected Financial Statement Analysis for Mattel,Inc.

Because so many strategic management students have limited experience developing projected financial statements, let's apply the steps outlined on the previous pages to Mattel, the huge toy company headquartered in El Segundo, California. Mattel designs, manufactures, and markets toy products from fashion dolls to children's books. The company Web site is www.mattel.com. Mattel's recent income statements and balance sheets are provided in Table 8-9 and Table 8-10 respectively.

TABLE 8-9 Mattel's Actual Income Statements (in thousands)

	2006	2005	2004
Total Revenue	$5,650,156	5,179,016	5,102,786
Cost of Revenue	3,038,363	2,806,148	2,692,061
Gross Profit	2,611,793	2,372,868	2,410,725
Operating Expenses			
Research Development	-	-	-
Selling General and Administrative	1,882,975	1,708,339	1,679,908
Non-Recurring	-	-	-
Others	-	-	-
Total Operating Expenses	-	-	-
Operating Income or Loss	728,818	664,529	730,817
Income from Continuing Operations			
Total Other Income/Expenses Net	34,791	64,010	43,201
Earnings Before Interest and Taxes	763,609	728,539	774,018
Interest Expense	79,853	76,490	77,764
Income Before Tax	683,756	652,049	696,254
Income Tax Expense	90,829	235,030	123,531
Minority Interest	-	-	-
Net Income from Continuing Ops	592,927	417,019	572,723
Non-Recurring Events			
Discontinued Operations	-	-	-
Extraordinary Items	-	-	-
Effect of Accounting Changes	-	-	-
Other Items	-	-	-
Net Income	592,927	417,019	572,723
Preferred Stock and Other Adjustments	-	-	-
Net Income Applicable to Common Shares	$592,927	$417,019	$572,723

In Tables 8-11 and 8-12, Mattel's projected income statements and balance sheets respectively for 2007, 2008, and 2009 are provided based on the firm pursuing the following strategies:

1. The company desires to build 20 Mattel stores annually at a cost of $1 million each.
2. The company plans to develop new toy products at an annual cost of $10 million.
3. The company plans to increase its advertising/promotion expenditures 30 percent over three years, at a cost of $30 million ($10 million per year).
4. The company plans to buy back $100 million of its own stock (called Treasury stock) annually for the next three years.
5. The company expects revenues to increase 10 percent annually with the above strategies. Mattel can handle this increase with existing production facilities.
6. Dividend payout will be increased from 57 percent of net income to 60 percent.
7. To finance the $380 million total cost for the above strategies, Mattel plans to use long-term debt for $150 million ($50 million per year for three years) and $230 million by issuing stock ($77 million per year for three years).

The Mattel projected financial statements were prepared using the six steps outlined on prior pages and the above seven strategy statements. Note the cash account is used as the plug figure, and it is too high, so Mattel could reduce this number and concurrently reduce a liability and/or equity account the same amount to keep the statement in balance. Rarely is the cash account perfect on the first pass through, so adjustments are needed and made. However, these adjustments are not made on the projected statements given in

TABLE 8-10 Mattel's Actual Balance Sheets (in thousands)

	2006	2005	2004
Assets			
Current Assets			
Cash and Cash Equivalents	$1,205,552	997,734	1,156,835
Short-Term Investments	–	–	–
Net Receivables	943,813	760,643	759,033
Inventory	383,149	376,897	418,633
Other Current Assets	317,624	277,226	302,649
Total Current Assets	2,850,138	2,412,500	2,637,150
Long-Term Investments	–	–	–
Property, Plant, and Equipment	536,749	547,104	586,526
Goodwill	845,324	718,069	735,680
Intangible Assets	70,593	20,422	22,926
Accumulated Amortization	–	–	–
Other Assets	149,912	178,304	201,836
Deferred Long-Term Asset Charges	503,168	495,914	572,374
Total Assets	$4,955,884	4,372,313	4,756,492
Liabilities			
Current Liabilities			
Accounts Payable	$1,518,234	1,245,191	1,303,822
Short/Current Long-Term Debt	64,286	217,994	423,349
Other Current Liabilities	–	–	–
Total Current Liabilities	1,582,520	1,463,185	1,727,171
Long-Term Debt	635,714	525,000	400,000
Other Liabilities	304,676	282,395	243,509
Deferred Long-Term Liability Charges	–	–	–
Minority Interest	–	–	–
Negative Goodwill	–	–	–
Total Liabilities	2,522,910	2,270,580	2,370,680
Stockholders' Equity			
Misc. Stocks, Options, Warrants	–	–	–
Redeemable Preferred Stock	–	–	–
Preferred Stock	–	–	–
Common Stock	441,369	441,369	441,369
Retained Earnings	1,652,140	1,314,068	1,093,288
Treasury Stock	(996,981)	(935,711)	(473,349)
Capital Surplus	1,613,307	1,589,281	1,594,332
Other Stockholders' Equity	(276,861)	(307,274)	(269,828)
Total Stockholders' Equity	2,432,974	2,101,733	2,385,812
Total Liabilities and SE	$4,955,884	4,372,313	4,756,492

Tables 8-11 and 8-12, so that the seven strategy statements above can be more readily seen on respective rows. Note the author's comments on Tables 8-11 and 8-12 that help explain changes in the numbers. The U.S. Securities and Exchange Commission (SEC) conducts fraud investigations if projected numbers are misleading or if they omit information that's important to investors. Projected statements must conform with generally accepted accounting principles (GAAP) and must not be designed to hide poor expected results. The Sarbanes-Oxley Act requires CEOs and CFOs of corporations to personally sign their firms' financial statements attesting to their accuracy. These executives could thus be held personally liable for misleading or inaccurate statements. The collapse of the Arthur Andersen accounting firm, along with its client Enron, fostered a "zero tolerance" policy among auditors and shareholders with regard to a firm's financial statements. But plenty of firms still "inflate" their financial projections and call them "pro formas," so investors, shareholders, and other stakeholders must still be wary of different companies' financial projections.14

TABLE 8-11 Mattel's Projected Income Statements (in thousands)

	2009	2008	2007	Author Comment
Total Revenue	$7,520,357	6,836,688	6,215,171	up 10% annually
Cost of Revenue	4,060,992	3,691,811	3,356,192	remains 54%
Gross Profit	3,459,365	3,144,877	2,858,979	subtraction
Operating Expenses				
Research Development	10,000	10,000	10,000	total $30M new
Selling General and Administrative	2,491,717	2,256,107	2,051,006	remains 33% + $10 M annually
Non-Recurring	-	-	-	
Others	-	-	-	
Total Operating Expenses	-	-	-	
Operating Income or Loss	957,648	878,770	797,973	subtraction
Income from Continuing Operations				
Total Other Income/Expenses Net	34,791	34,791	34,791	keep it the same
Earnings Before Interest and Taxes	992,439	913,561	832,764	addition
Interest Expense	97,823	91,423	85,442	up 7%; LTD up 7%
Income Before Tax	894,616	822,138	737,322	
Income Tax Expense	90,829	90,829	90,829	keep it the same
Minority Interest	-	-	-	
Net Income from Continuing Ops	803,787	731,309	646,493	subtraction
Discontinued Operations	-	-	-	
Extraordinary Items	-	-	-	
Effect of Accounting Changes	-	-	-	
Other Items	-	-	-	
Net Income	803,787	731,309	646,493	
Preferred Stock and Other Adjustments	-	-	-	
Net Income Applicable to Common Shares	$803,787	731,309	646,493	

On financial statements, different companies use different terms for various items, such as revenues or sales used for the same item by different companies. For net income, many firms use the term earnings, and many others use the term profits.

Financial Budgets

A financial budget is a document that details how funds will be obtained and spent for a specified period of time. Annual budgets are most common, although the period of time for a budget can range from one day to more than 10 years. Fundamentally, financial budget ing is a method for specifying what must be done to complete strategy implementation successfully. Financial budgeting should not be thought of as a tool for limiting expenditures but rather as a method for obtaining the most productive and profitable use of an organization's resources. Financial budgets can be viewed as the planned allocation of a firm's resources based on forecasts of the future. There are almost as many different types of financial budgets as there are types of organizations. Some common types of budgets include cash budgets, operating budgets, sales budgets, profit budgets, factory budgets, capital budgets, expense budgets, divisional

TABLE 8-12 Mattel's Projected Balance Sheets (in thousands)

	2009	2008	2007	Author Comment
Assets				
Current Assets				
Cash and Cash Equivalents	$3,232,406	2,972,664	2,570,635	too high, could reduce this and pay off some LTD to keep balance
Short-Term Investments	-	-	-	
Net Receivables	943,813	760,643	759,033	
Inventory	509,969	463,609	421,463	up 10% annually
Other Current Assets	317,624	317,624	317,624	keep it the same
Total Current Assets				
Long-Term Investments	-	-	-	
Property, Plant, and Equipment	596,749	576,749	556,749	up $20M annually
Goodwill	845,324	845,324	845,324	keep it the same
Intangible Assets	70,593	70,593	70,593	keep it the same
Accumulated Amortization	-	-	-	
Other Assets	149,912	149,912	149,912	keep it the same
Deferred Long-Term Asset Charges	503,168	503,168	503,168	keep it the same
Total Assets	7,169,558	6,660,286	6,194,501	
Liabilities				
Current Liabilities				
Accounts Payable	1,518,234	1,518,234	1,518,234	keep it the same
Short/Current Long-Term Debt	64,286	64,286	64,286	keep it the same
Other Current Liabilities	-	-	-	
Total Current Liabilities	1,582,520	1,582,520	1,582,520	
Long-Term Debt	785,714	735,714	685,714	up $50M annually
Other Liabilities	304,676	304,676	304,676	keep it the same
Deferred Long-Term Liability Charges	-	-	-	
Minority Interest	-	-	-	
Negative Goodwill	-	-	-	
Total Liabilities	2,672,910	2,622,910	2,572,910	
Stockholders' Equity				
Misc. Stocks, Options, Warrants	-	-	-	
Redeemable Preferred Stock	-	-	-	
Preferred Stock	-	-	-	
Common Stock	441,369	441,369	441,369	keep it the same
Retained Earnings	2,961,092	2,478,820	2,040,035	60% of NI = div
Treasury Stock	(1,296,981)	(1,196,981)	(1,096,981)	up $100M annually
Capital Surplus	2,114,307	2,037,307	1,960,307	up $77M annually
Other Stockholders' Equity	(276,861)	(276,861)	(276,861)	keep it the same
Total Stockholders' Equity	4,496,648	4,037,376	3,621,591	addition
Total Liabilities and SE	$7,169,558	6,660,286	6,194,501	addition

budgets, variable budgets, flexible budgets, and fixed budgets. When an organization is experiencing financial difficulties, budgets are especially important in guiding strategy implementation.

Perhaps the most common type of financial budget is the *cash budget*. The Financial Accounting Standards Board (FASB) has mandated that every publicly held company in the United States must issue an annual cash-flow statement in addition to the usual financial reports. The statement includes all receipts and disbursements of cash in operations, investments, and financing. It supplements the Statement on Changes in Financial Position formerly included in the annual reports of all publicly held companies. A cash budget for the year 2011 for the Toddler Toy Company is provided in Table 8-13. Note that Toddler is not expecting to have surplus cash until November 2011.

Financial budgets have some limitations. First, budgetary programs can become so detailed that they are cumbersome and overly expensive. Overbudgeting or underbudgeting can cause problems. Second, financial budgets can become a substitute for objectives. A budget is a tool and not an end in itself. Third, budgets can hide inefficiencies if based solely on precedent rather than on periodic evaluation of circumstances and standards. Finally, budgets are sometimes used as instruments of tyranny that result in frustration, resentment, absenteeism, and high turnover. To minimize the effect of this last concern, managers should increase the participation of subordinates in preparing budgets.

Evaluating the Worth of a Business

Evaluating the worth of a business is central to strategy implementation because integrative, intensive, and diversification strategies are often implemented by acquiring other firms. Other strategies, such as retrenchment and divestiture, may result in the sale of a division of an organization or of the firm itself. Thousands of transactions occur each year in which businesses are bought or sold in the United States. In all these cases, it is necessary to establish the financial worth or cash value of a business to successfully implement strategies.

All the various methods for determining a business's worth can be grouped into three main approaches: what a firm owns, what a firm earns, or what a firm will bring in the market. But it is important to realize that valuation is not an exact science. The valuation of a firm's worth is based on financial facts, but common sense and intuitive judgment must enter into the process. It is difficult to assign a monetary value to some factors—such as a loyal customer base, a history of growth, legal suits pending, dedicated employees, a favorable lease, a bad credit rating, or good patents—that may

TABLE 8-13 Six-Month Cash Budget for the Toddler Toy Company in 2011

Cash Budget (in thousands)	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.
Receipts							
Collections	$12,000	$21,000	$31,000	$35,000	$22,000	$18,000	$11,000
Payments							
Purchases	14,000	21,000	28,000	14,000	14,000	7,000	
Wages and Salaries	1,500	2,000	2,500	1,500	1,500	1,000	
Rent	500	500	500	500	500	500	
Other Expenses	200	300	400	200	—	100	
Taxes	—	8,000	—	—	—	—	
Payment on Machine	—	—	10,000	—	—	—	
Total Payments	$16,200	$31,800	$41,400	$16,200	$16,000	$8,600	
Net Cash Gain (Loss) During Month	−4,200	−10,800	−10,400	18,800	6,000	9,400	
Cash at Start of Month if No Borrowing Is Done	6,000	1,800	−9,000	−19,400	−600	5,400	
Cumulative Cash (Cash at start plus gains or minus losses)	1,800	−9,000	−19,400	−600	5,400	14,800	
Less Desired Level of Cash	−5,000	−5,000	−5,000	−5,000	−5,000	−5,000	
Total Loans Outstanding to Maintain $5,000 Cash Balance	$3,200	$14,000	$24,400	$5,600	—	—	
Surplus Cash	—	—	—	—	400	9,800	

not be reflected in a firm's financial statements. Also, different valuation methods will yield different totals for a firm's worth, and no prescribed approach is best for a certain situation. Evaluating the worth of a business truly requires both qualitative and quantitative skills.

TABLE 8-14 Company Worth Analysis for Mattel, Nordstrom, and Pfizer (year-end 2008, in $millions, except stock price and EPS)

Input Data	Mattel	Nordstrom	Pfizer
Shareholders' Equity	$2,117	$1,210	$57,556
Net Income (NI)	379	401	8,104
Stock Price	15	10	15
EPS	1.03	1.83	1.19
# of Shares Outstanding	358	215	6,750
Goodwill + Intangibles	815	53	21,464
Total Assets	235	0	17,721
Company Worth Analyses			
1. Shareholders' Equity + Goodwill + Intangibles	$3,167	$1,263	$ 96,741
2. Net Income × 5	1,895	2,005	40,520
3. (Stock Price/EPS) × NI	5,519	2,191	102,151
4. # of Shares Out × Stock Price	5,340	2,150	101,250
5. Four Method Average	3,988	1,902	76,049
$Goodwill/$Total Assets	17.4%	0.94%	19.3%

The first approach in evaluating the worth of a business is determining its net worth or stockholders' equity. Net worth represents the sum of common stock, additional paid-in capital, and retained earnings. After calculating net worth, add or subtract an appropriate amount for goodwill, overvalued or undervalued assets, and intangibles. Whereas intangibles include copyrights, patents, and trademarks, goodwill arises only if a firm acquires another firm and pays more than the book value for that firm.

It should be noted that Financial Accounting Standards Board (FASB) Rule 142 requires companies to admit once a year if the premiums they paid for acquisitions, called goodwill, were a waste of money. Goodwill is not a good thing to have on a balance sheet. Note in Table 8-14 that Mattel's goodwill of $815 million as a percent of its total assets ($4,675 million) is 17.4 percent, which is extremely high compared to Nordstrom's goodwill of $53 million as a percentage of its total assets ($5,661 million), 0.94 percent. Pfizer's goodwill to total assets percentage also is high at 19.3 percent.

At year-end 2008, Mattel, Nordstrom, and Pfizer had $815 million, $53 million, and $21,464 billion in goodwill, respectively, on their balance sheets. Most creditors and investors feel that goodwill indeed should be added to the stockholders' equity in calculating worth of a business, but some feel it should be subtracted, and still others feel it should not be included at all. Perhaps whether you are buying or selling the business may determine whether you negotiate to add or subtract goodwill in the analysis. Goodwill is sometimes listed as intangibles on the balance sheet, but technically intangibles refers to patents, trademarks, and copyrights, rather than the value a firm paid over book value for an acquisition, which is goodwill. If a firm paid less than book value for an acquisition, that could be called negative goodwill—which is a line item on Mattel's balance sheets.

The second approach to measuring the value of a firm grows out of the belief that the worth of any business should be based largely on the future benefits its owners may derive through net profits. A conservative rule of thumb is to establish a business's worth as five times the firm's current annual profit. A five-year average profit level could also be used.

When using the approach, remember that firms normally suppress earnings in their financial statements to minimize taxes.

The third approach is called the price-earnings ratio method. To use this method, divide the market price of the firm's common stock by the annual earnings per share and multiply this number by the firm's average net income for the past five years.

The fourth method can be called the outstanding shares method. To use this method, simply multiply the number of shares outstanding by the market price per share and add a premium. The premium is simply a per-share dollar amount that a person or firm is willing to pay to control (acquire) the other company. A pharmaceutical company based in Tokyo, Astellas Pharma Inc., recently launched an unsolicited takeover of biotechnology company CV Therapeutics Inc., based in Palo Alto, California. Astellas offered $16 a share, or nearly $1 billion, which represented a 41 percent premium over CV's closing stock price of $11.35 on the Nasdaq stock market. The CEO of Astellas said, "We are disappointed that CV's board of directors has rejected outright what we believe is a very compelling all-cash proposal that would deliver stockholders significant immediate value that we believe far exceeds what CV can achieve as a stand-alone company."

Business evaluations are becoming routine in many situations. Businesses have many strategy-implementation reasons for determining their worth in addition to preparing to be sold or to buy other companies. Employee plans, taxes, retirement packages, mergers, acquisitions, expansion plans, banking relationships, death of a principal, divorce, partnership agreements, and IRS audits are other reasons for a periodic valuation. It is just good business to have a reasonable understanding of what your firm is worth. This knowledge protects the interests of all parties involved.

Table 8-14 provides the cash value analyses for three companies—Mattel, Nordstrom, and Pfizer—for year-end 2008. Notice that there is significant variation among the four methods used to determine cash value. For example, the worth of the toy company Mattel ranged from $1,895 billion to $5,519 billion. Obviously, if you were selling your company, you would seek the larger values, while if purchasing a company you would seek the lower values. In practice, substantial negotiation takes place in reaching a final compromise (or averaged) amount. Also recognize that if a firm's net income is negative, theoretically the approaches involving that figure would result in a negative number, implying that the firm would pay you to acquire them. Of course, you obtain all of the firm's debt and liabilities in an acquisition, so theoretically this would be possible.

Deciding Whether to Go Public

Going public means selling off a percentage of your company to others in order to raise capital; consequently, it dilutes the owners' control of the firm. Going public is not recommended for companies with less than $10 million in sales because the initial costs can be too high for the firm to generate sufficient cash flow to make going public worthwhile. One dollar in four is the average total cost paid to lawyers, accountants, and underwriters when an initial stock issuance is under $1 million; 1 dollar in 20 will go to cover these costs for issuances over $20 million.

In addition to initial costs involved with a stock offering, there are costs and obligations associated with reporting and management in a publicly held firm. For firms with more than $10 million in sales, going public can provide major advantages: It can allow the firm to raise capital to develop new products, build plants, expand, grow, and market products and services more effectively.

Research and Development (R&D) Issues

Research and development (R&D) personnel can play an integral part in strategy implementation. These individuals are generally charged with developing new products and improving old products in a way that will allow effective strategy implementation. R&D employees and managers perform tasks that include transferring complex technology, adjusting processes to local raw materials, adapting processes to local markets, and altering products to particular tastes and specifications. Strategies such as product development, market penetration, and related diversification require that new products be successfully developed and that old products be significantly improved. But the level of management support for R&D is often constrained by resource availability.

Technological improvements that affect consumer and industrial products and services shorten product life cycles. Companies in virtually every industry are relying on the development of new products and services to fuel profitability and growth.15 Surveys suggest that the most successful organizations use an R&D strategy that ties external opportunities to internal strengths and is linked with objectives. Well-formulated R&D policies match market opportunities with internal capabilities. R&D policies can enhance strategy implementation efforts to:

1. Emphasize product or process improvements.
2. Stress basic or applied research.
3. Be leaders or followers in R&D.
4. Develop robotics or manual-type processes.
5. Spend a high, average, or low amount of money on R&D.
6. Perform R&D within the firm or to contract R&D to outside firms.
7. Use university researchers or private-sector researchers.

Pfizer Inc. has only a few new drugs in its pipeline to show for its $7.5 billion R&D budget, so the firm is laying off 5,000 to 8,000 of its researchers and scientists in labs around the world. Cash-strapped consumers are filling fewer prescriptions and are turning more and more to generic drugs. Pfizer is bracing for the 2011 expiration of its patent on cholesterol fighter Lipitor, the world's top-selling drug that alone accounts for a quarter of Pfizer's roughly $48 billion in annual revenue. Pfizer's $7.5 billion R&D budget is the largest of any drug maker. The firm recently scrapped two drugs nearly ready to go to market—insulin spray Exubera and a Lipitor successor drug—after spending billions to develop them. Research areas that Pfizer is exiting include anemia, bone health, gastrointestinal disorders, obesity, liver disease, osteoarthritis, and peripheral artery disease.

There must be effective interactions between R&D departments and other functional departments in implementing different types of generic business strategies. Conflicts between marketing, finance/accounting, R&D, and information systems departments can be minimized with clear policies and objectives. Table 8-15 gives some examples of R&D activities that could be required for successful implementation of various strategies. Many U.S. utility, energy, and automotive companies are employing their research and development departments to determine how the firm can effectively reduce its gas emissions.

TABLE 8-15 Research and Development Involvement in Selected Strategy-Implementation Situations

Type of Organization	Strategy Being Implemented	R&D Activity
Pharmaceutical company	Product development	Test the effects of a new drug on different subgroups.
Boat manufacturer	Related diversification	Test the performance of various keel designs under various conditions.
Plastic container manufacturer	Market penetration	Develop a biodegradable container.
Electronics company	Market development	Develop a telecommunications system in a foreign country.

Many firms wrestle with the decision to acquire R&D expertise from external firms or to develop R&D expertise internally. The following guidelines can be used to help make this decision:

1. If the rate of technical progress is slow, the rate of market growth is moderate, and there are significant barriers to possible new entrants, then in-house R&D is the preferred solution. The reason is that R&D, if successful, will result in a temporary product or process monopoly that the company can exploit.
2. If technology is changing rapidly and the market is growing slowly, then a major effort in R&D may be very risky, because it may lead to the development of an ultimately obsolete technology or one for which there is no market.
3. If technology is changing slowly but the market is growing quickly, there generally is not enough time for in-house development. The prescribed approach is to obtain R&D expertise on an exclusive or nonexclusive basis from an outside firm.
4. If both technical progress and market growth are fast, R&D expertise should be obtained through acquisition of a well-established firm in the industry.16

There are at least three major R&D approaches for implementing strategies. The first strategy is to be the first firm to market new technological products. This is a glamorous and exciting strategy but also a dangerous one. Firms such as 3M and General Electric have been successful with this approach, but many other pioneering firms have fallen, with rival firms seizing the initiative.

A second R&D approach is to be an innovative imitator of successful products, thus minimizing the risks and costs of start-up. This approach entails allowing a pioneer firm to develop the first version of the new product and to demonstrate that a market exists. Then, laggard firms develop a similar product. This strategy requires excellent R&D personnel and an excellent marketing department.

A third R&D strategy is to be a low-cost producer by mass-producing products similar to but less expensive than products recently introduced. As a new product is accepted by customers, price becomes increasingly important in the buying decision. Also, mass marketing replaces personal selling as the dominant selling strategy. This R&D strategy, requires substantial investment in plant and equipment but fewer expenditures in R&D than the two approaches described previously.

R&D activities among U.S. firms need to be more closely aligned to business objectives. There needs to be expanded communication between R&D managers and strategists. Corporations are experimenting with various methods to achieve this improved communication climate, including different roles and reporting arrangements for managers and new methods to reduce the time it takes research ideas to become reality.

Perhaps the most current trend in R&D management has been lifting the veil of secrecy whereby firms, even major competitors, are joining forces to develop new products. Collaboration is on the rise due to new competitive pressures, rising research costs, increasing regulatory issues, and accelerated product development schedules. Companies not only are working more closely with each other on R&D, but they are also turning to consortia at universities for their R&D needs. More than 600 research consortia are now in operation in the United States. Lifting of R&D secrecy among many firms through collaboration has allowed the marketing of new technologies and products even before they are available for sale. For example, some firms are collaborating on the efficient design of solar panels to power homes and businesses.

Management Information Systems (MIS)

Issues Firms that gather, assimilate, and evaluate external and internal information most effectively are gaining competitive advantages over other firms. Having an effective management information system (MIS) may be the most important factor in differentiating successful from unsuccessful firms. The process of strategic management is facilitated immensely in firms that have an effective information system.

Information collection, retrieval, and storage can be used to create competitive advantages in ways such as cross-selling to customers, monitoring suppliers, keeping managers and employees informed, coordinating activities among divisions, and managing funds. Like inventory and human resources, information is now recognized as a valuable organizational asset that can be controlled and managed. Firms that implement strategies using the best information will reap competitive advantages in the twenty-first century.

A good information system can allow a firm to reduce costs. For example, online orders from salespersons to production facilities can shorten materials ordering time and reduce inventory costs. Direct communications between suppliers, manufacturers, marketers, and customers can link together elements of the value chain as though they were one organization. Improved quality and service often result from an improved information system.

Firms must increasingly be concerned about computer hackers and take specific measures to secure and safeguard corporate communications, files, orders, and business conducted over the Internet. Thousands of companies today are plagued by computer hackers who include disgruntled employees, competitors, bored teens, sociopaths, thieves, spies, and hired agents. Computer vulnerability is a giant, expensive headache.

Dun & Bradstreet is an example company that has an excellent information system. Every D&B customer and client in the world has a separate nine-digit number. The database of information associated with each number has become so widely used that it is like a business Social Security number. D&B reaps great competitive advantages from its information system.

In many firms, information technology is doing away with the workplace and allowing employees to work at home or anywhere, anytime. The mobile concept of work allows employees to work the traditional 9-to-5 workday across any of the 24 time zones around the globe. Affordable desktop videoconferencing software allows employees to “beam in” whenever needed. Any manager or employee who travels a lot away from the office is a good candidate for working at home rather than in an office provided by the firm. Salespersons or consultants are good examples, but any person whose job largely involves talking to others or handling information could easily operate at home with the proper computer system and software.

Many people see the officeless office trend as leading to a resurgence of family togetherness in U.S. society. Even the design of homes may change from having large open areas to having more private small areas conducive to getting work done.17