# Guidelines for Strategic Financial Analysis

By Mark L. Frigo

"Much of the financial analysis performed today is flawed."

"One metric does not fit all situations, even within the same organization."

"Cash is still king, but how cash is defined is varying more and more."

These are just a few of the comments heard during a recent executive conference at the Kellstadt Graduate School of Business at DePaul University. The conference was co-sponsored by DePaul's Center for Strategy, Execution, and Valuation and Financial Executives International (FEI). I'll share some of the pressing issues that were raised regarding strategic financial analysis today and cover some key guidelines for improving the way financial analysis is done.

## Designing Financial Analysis

Premise: Financial performance measures can be seriously flawed. We know accounting-based financial performance measures can contain many distortions. Problems with net income, earnings per share, and other basic measuring sticks of business performance have generated extensive press coverage. So then how should you design your financial analysis?

This question is often answered by a discussion of performance metrics. Yet this question can't really be answered unless we adequately define the context of the analysis. Is the financial analysis for executive compensation, resource allocation, investor relations, or other purposes? The key is to design the process of financial analysis, not a specific metric, and to enable and empower the decision makers.

We know some performance measures aren't well aligned to business strategy. This has been shown in surveys and case research, including those I have done with the Institute of Management Accountants over several

### METRIC WARS

Many people have battled over how to "replace" GAAP metrics. Here's a summary of some of the benefits and problems with these "metric wars."

Benefits

- Highlighted the problems and distortions in GAAP accounting (net income, EPS)
- Brought focus on cash and "economic reality," the keys to financial performance measurement
- Raised the importance of the cost of capital and investment
- Brought companies to examine their methods for making all their strategic decisions

Problems

- Belief in a "one, true, be-all, end-all" metric
- "Fixing" static calculations with hundreds of adjustments
- Firms heralding the superiority of one metric over another
- Wasted spending and effort on massive, single-metric implementations

years. The balanced scorecard, though, has helped many organizations address this problem, forcing managers to think about the kinds of metrics being used in the organization and the types of behavior desired. A well-designed scorecard will consider the quality of the financial performance measures used in its financial perspective.

Though management embarks on a specific scorecard initiative, companies often retain the same traditional financial analysis methodologies they've always used. While retaining familiarity, the methods also retain the serious limitations and distortions of the measures. To get the most from balanced scorecard initiatives—or any business initiative—you need to take a serious look at the financial metrics used to review, design, and achieve that initiative.

## One Metric Does not Fit All Uses

There isn't one right measure for financial analysis, but there can certainly be wrong ones. For example, earnings per share (EPS), while commonly used, can be the wrong measure in many situations. Too many GAAP conventions applied in different ways by different businesses can destroy comparability. More than simply choices of accounting electives, EPS and net income don't adequately capture the balance sheet activities that drive the creation of income. Put bluntly, net income can be a widely varying representation of business cash flows. In the handling of research and development expenses and pension accounting, GAAP-based measures grossly violate their own dictum of "the matching principle."

So what can replace GAAP-based performance measures? One speaker said openly: "There is not now and never will be a perfect measure for financial analysis." The speaker specifically noted how some CFOs and financial managers can be heard to say, "We're looking to create the right metric for our firm, the right calculation that fits our business." Unfortunately, it doesn't exist. There isn't one true metric, even in the same company, at the same time, in the same business unit.

During the 1990s, the debate around choosing a perfect performance metric was most heated, and the term "metric wars" was brought up (see "Metric Wars," p. 9). This thinking occupied a tremendous amount of management's time and attention. Although the debate revealed many of the limitations of GAAP - financial metrics, the issue of what is the "best" single metric is moot.

## Cash Is Still King!

It's widely accepted that cash is king in economic performance measurement. The July 2003 column ("Strategy and Cash Flow") examined some of the problems with measuring cash flow and with the GAAP statement of cash flows. It also highlighted how performance measures based on cash flows can be incredibly difficult and inherently flawed because of the problems with the GAAP statement of cash flows and suggested that management must take the time to understand how to measure real cash flow and cash flow returns more accurately.

## Replacing the Metric with a Process and a Philosophy

How can you improve financial analysis at your organization? First, accept that your existing financial performance measures may have serious flaws and that there isn't a quick fix. Replacing the metric won't serve the company well. Design your financial analysis by first defining the context of the analysis. Remember that cash flow and cash flow returns are incredibly important to measure, but beware of the limitations of reported GAAP-defined cash flow information. Respect the matching principle. Follow a set of guidelines, not a specific metric. Not only will your financial analysis improve, but, more importantly, so will the strategic decisions and activities the analysis supports. ■

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