whether a firm's accounting policies and estimates are consistent with its stated strategy. For example, a firm's choice of functional currency in accounting for its international operations should be consistent with the level of integration between domestic and international operations that the business strategy calls for. Similarly, a firm that mainly sells housing to high-risk customers should have higher-than-average bad debts expenses and a higher-than-average allowance for loan losses.

Strategy analysis is also useful in guiding financial analysis. For example, in a cross-sectional analysis, the analyst should expect firms with cost leadership strategy to have lower gross margins and higher asset turnover than firms that follow differentiated strategies. In a time series analysis, the analyst should closely monitor any increases in expense ratios and asset turnover ratios for low-cost firms, and any decreases in investments critical to differentiation for firms that follow differentiation strategy.

Business strategy analysis also helps in prospective analysis and valuation. First, it allows the analyst to assess whether, and for how long, differences between the firm's performance and its industry's (or industries') performance are likely to persist. Second, strategy analysis facilitates forecasting investment outlays the firm has to make to maintain its competitive advantage.

DISCUSSION QUESTIONS

1. Judith, an accounting major, states, "Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can't we just get straight to the accounting issues?" Explain to Judith why she might be wrong.
2. What are the critical drivers of industry profitability?
3. One of the fastest growing industries in the last 20 years is the memory chip industry, which supplies chips for personal computers and other electronic devices. Yet the average profitability for this industry has been very low. Using the industry analysis framework, list all the potential factors that might explain this apparent contradiction.
4. Rate the pharmaceutical and lumber industries as high, medium, or low on the following dimensions of industry structure:

	Pharmaceutical Industry	Lumber Industry
Rivalry		
Threat of new entrants		
Threat of substitute products		
Bargaining power of buyers		
Bargaining power of suppliers		
Given your ratings, which industry would you expect to earn the highest returns?		

5. Joe Smith argues, "Your analysis of the five forces that affect industry profitability is incomplete. For example, in the banking industry, I can think of at least three other factors that are also important; namely, government regulation, demographic trends, and cultural factors." His classmate Jane Brown disagrees and says, "These three factors are important only to the extent that they influence one of the five forces." Explain how, if at all, the three factors discussed by Joe affect the five forces in the banking industry.
6. Coca-Cola and Pepsi are both very profitable soft drinks. Inputs for these products include corn syrup, bottles/cans, and soft drink syrup. Coca-Cola and Pepsi produce

the syrup themselves and purchase the other inputs. They then enter into exclusive contracts with independent bottlers to produce their products. Use the five forces framework and your knowledge of the soft drink industry to explain how Coca-Cola and Pepsi are able to retain most of the profits in this industry.

7. All major airlines offer frequent flier programs. Originally seen as a way to differentiate their providers in response to excess capacity in the industry, these programs have long since become ubiquitous. Many industry analysts believe that these programs have met with only mixed success in accomplishing their goal. Use the competitive advantage concepts to explain why.
8. What are the ways that a firm can create barriers to entry to deter competition in its business? What factors determine whether these barriers are likely to be enduring?
9. Explain why you agree or disagree with each of the following statements:
   a. It is better to be a differentiator than a cost leader, since you can then charge premium prices.
   b. It is more profitable to be in a high technology industry than a low technology one.
   c. The reason industries with large investments have high barriers to entry is that it is costly to raise capital.
10. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?
11. Many consultants are advising diversified companies in emerging markets such as India, South Korea, Mexico, and Turkey to adopt corporate strategies proven to be of value in advanced economies such as the United States and the United Kingdom. What are the pros and cons of this advice?

NOTES

1. The discussion presented here is intended to provide a basic background in strategy analysis. For a more complete discussion of the strategy concepts, see, for example, *Contemporary Strategy Analysis* by Robert M. Grant (Cambridge, MA: Blackwell Publishers, 1991); *Economics of Strategy* by David Besanko, David Dranove, and Mark Shanley (New York: John Wiley & Sons, 1996); *Strategy and the Business Landscape* by Pankaj Ghemawat (Reading, MA: Addison Wesley Longman, 1999); and *Corporate Strategy: Resources and the Scope of the Firm* by David J. Collis and Cynthia Montgomery (Burr Ridge, IL: Irwin/McGraw-Hill, 1997).
2. Standard & Poor's Compustat data via Research Insight, accessed November 2010. The analysis here owes its logic to that presented in A. M. McGahan, "Do Competitors Perform Better When They Pursue Different Strategies?" working paper, Harvard Business School, May 12, 1999).
3. For a summary of this research, see F. M. Scherer, *Industrial Market Structure and Economic Performance*, second edition (Chicago: Rand McNally College Publishing, 1980).
4. See M. E. Porter, *Competitive Strategy* (New York: The Free Press, 1980).
5. The U.S. Department of Justice and the Federal Trade Commission use the Herfindahl-Hirschman Index (HHI) to measure concentration when evaluating horizontal mergers. The HHI is calculated by summing the squares of the individual market shares of all the participants. The Department of Justice considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000 to 1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. The four-firm concentration ratio is