competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

5. *What strategic issues and problems merit front-burner managerial attention?* This analytical step zeros in on the strategic issues and problems that stand in the way of the company's success. It involves using the results of both industry and competitive analysis and company situation analysis to identify a "worry list" of issues to be resolved for the company to be financially and competitively successful in the years ahead. Actually deciding upon a strategy and what specific actions to take comes after the list of strategic issues and problems that merit front-burner management attention has been developed.

Good company situation analysis, like good industry and competitive analysis, is a valuable precondition for good strategy making.

ASSURANCE OF LEARNING EXERCISES

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1. Using the financial ratios provided in the Appendix and the financial statement information for Macy's, Inc., below, calculate the following ratios for Macy's for both 2011 and 2012.
   a. Gross profit margin.
   b. Operating profit margin.
   c. Net profit margin.
   d. Times interest earned coverage.
   e. Return on shareholders' equity.
   f. Return on assets.
   g. Debt-to-equity ratio.
   h. Days of inventory.
   i. Inventory turnover ratio.
   j. Average collection period.

   Based on these ratios, did Macy's financial performance improve, weaken, or remain about the same from 2011 to 2012?

Consolidated Statements of Income for Macy's, Inc., 2011–2012 (in millions, except per share data)

	2012	2011
Net sales	$ 27,686	$ 26,405
Cost of sales	(16,538)	(15,738)
Gross margin	11,148	10,667
Selling, general, and administrative expenses	(8,482)	(8,281)
Impairments, store closing costs and gain on sale of leases	(5)	25
Operating income	2,661	2,411

(continued)

Consolidated Statements of Income for Macy's, Inc., 2011–2012 (in millions, except per share data)

	2012	2011
Interest expense	(425)	(447)
Premium on early retirement of debt	(137)	—
Interest income	3	4
Income before income taxes	2,102	1,968
Federal, state, and local income tax expense	(767)	(712)
Net income	$ 1,335	$ 1,256
Basic earnings per share	$ 3.29	$ 2.96
Diluted earnings per share	$ 3.24	$ 2.92

Consolidated Balance Sheets for Macy's, Inc., 2011–2012 (in millions, except per share data)

ASSETS	FEBRUARY 2, 2013	JANUARY 28, 2012
Current Assets:		
Cash and cash equivalents	$ 1,836	$ 2,827
Receivables	371	368
Merchandise inventories	5,308	5,117
Prepaid expenses and other current assets	361	465
Total Current Assets	7,876	8,777
Property and Equipment – net	8,196	8,420
Goodwill	3,743	3,743
Other Intangible Assets – net	561	598
Other Assets	615	557
Total Assets	$ 20,991	$ 22,095
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Short-term debt	$ 124	$ 1,103
Merchandise accounts payable	1,579	1,593
Accounts payable and accrued liabilities	2,610	2,788
Income taxes	355	371
Deferred income taxes	407	408
Total Current Liabilities	5,075	6,263
Long-Term Debt	6,806	6,655
Deferred Income Taxes	1,238	1,141
Other Liabilities	1,821	2,103
Shareholders' Equity:		
Common stock (387.7 and 414.2 shares outstanding)	4	5
Additional paid-in capital	3,872	5,408
Accumulated equity	5,108	4,015
Treasury stock	(2,002)	(2,434)
Accumulated other comprehensive loss	(931)	(1,061)
Total Shareholders' Equity	6,051	5,933
Total Liabilities and Shareholders' Equity	$ 20,991	$ 22,095

Source: Macy's, Inc., 2012 10-K.

APPENDIX

Key Financial Ratios: How to Calculate Them and What They Mean

Ratio	How Calculated	What It Shows
Profitability Ratios		
1. Gross profit margin	$\frac{\text{Sales revenues} - \text{Cost of goods sold}}{\text{Sales revenues}}$	Shows the percentage of revenues available to cover operating expenses and yield a profit. Higher is better and the trend should be upward.
2. Operating profit margin (or return on sales)	$\frac{\text{Sales revenues} - \text{Operating expenses}}{\text{Sales revenues}}$ or $\frac{\text{Operating income}}{\text{Sales revenues}}$	Shows the profitability of current operations without regard to interest charges and income taxes. Higher is better and the trend should be upward.
3. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales revenues}}$	Shows after-tax profits per dollar of sales. Higher is better and the trend should be upward.
4. Total return on assets	$\frac{\text{Profits after taxes} + \text{Interest}}{\text{Total assets}}$	A measure of the return on total monetary investment in the enterprise. Interest is added to after-tax profits to form the numerator since total assets are financed by creditors as well as by stockholders. Higher is better and the trend should be upward.
5. Net return on total assets (ROA)	$\frac{\text{Profits after taxes}}{\text{Total assets}}$	A measure of the return earned by stockholders on the firm's total assets. Higher is better, and the trend should be upward.
6. Return on stockholder's equity	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	Shows the return stockholders are earning on their capital investment in the enterprise. A return in the 12–15% range is "average," and the trend should be upward.
7. Return on invested capital (ROIC) – sometimes referred to as return on capital (ROCE)	$\frac{\text{Profits after taxes}}{\text{Long term debt} + \text{Total stockholders' equity}}$	A measure of the return shareholders are earning on the long-term monetary capital invested in the enterprise. Higher is better and the trend should be upward.
8. Earnings per share (EPS)	$\frac{\text{Profits after taxes}}{\text{Number of shares of common stock outstanding}}$	Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.
Liquidity Ratios		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Shows a firm's ability to pay current liabilities using assets that can be converted to cash in the near term. Ratio should definitely be higher than 1.0; ratios of 2 or higher are better still.
2. Working capital	Current assets – Current liabilities	Bigger amounts are better because the company has more internal funds available to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.
Leverage Ratios		
1. Total debt-to-assets ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the extent to which borrowed funds (both short-term loans and long-term debt) have been used to finance the firm's operations. A low fraction or ratio is better—a high fraction indicates overuse of debt and greater risk of bankruptcy.

Ratio	How Calculated	What It Shows
2. Long-term debt-to-capital ratio	$\frac{\text{Long-term debt}}{\text{Long-term debt + Total stockholders' equity}}$	An important measure of creditworthiness and balance sheet strength. It indicates the percentage of capital investment in the enterprise that has been financed by both long-term lenders and stockholders. A ratio below 0.25 is usually preferable since monies invested by stockholders account for 75% or more of the company's total capital. The lower the ratio, the greater the capacity to borrow additional funds. Debt-to-capital ratios above 0.50 and certainly above 0.75 indicate a heavy and perhaps excessive reliance on long-term borrowing, lower creditworthiness, and weak balance sheet strength.
3. Debt-to-equity ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	Shows the balance between debt (funds borrowed both short-term and long-term) and the amount that stockholders have invested in the enterprise. The further the ratio is below 1.0, the greater the firm's ability to borrow additional funds. Ratios above 1.0 and definitely above 2.0 put creditors at greater risk, signal weaker balance sheet strength, and often result in lower credit ratings.
4. Long-term debt-to-equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	Shows the balance between long-term debt and stockholders' equity in the firm's *long-term* capital structure. Low ratios indicate greater capacity to borrow additional funds if needed.
5. Times-interest-earned (or coverage) ratio	$\frac{\text{Operating income}}{\text{Interest expenses}}$	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios progressively above 3.0 signal progressively better creditworthiness.
Activity Ratios		
1. Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Measures inventory management efficiency. Fewer days of inventory are usually better.
2. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales} \div 365}$ or $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.
Other Important Measures of Financial Performance		
1. Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of the return that shareholders receive in the form of dividends. A "typical" dividend yield is 2–3%. The dividend yield for fast-growth companies is often below 1% (maybe even 0); the dividend yield for slow-growth companies can run 4–5%.
2. Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	P-e ratios above 20 indicate strong investor confidence in a firm's outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.
3. Dividend payout ratio	$\frac{\text{Annual dividends per share}}{\text{Earnings per share}}$	Indicates the percentage of after-tax profits paid out as dividends.
4. Internal cash flow	After tax profits + Depreciation	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.
5. Free cash flow	After tax profits + Depreciation – Capital expenditures – Dividends	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, taxes, dividends, and desirable reinvestments in the business. The larger a company's free cash flow, the greater is its ability to internally fund new strategic initiatives, repay debt, make new acquisitions, repurchase shares of stock, or increase dividend payments.