# Chapter Five

# The Internal Assessment

## 5.1 The nature of an internal audit

Analysis of the firm's internal environment finds evaluators thinking of their firm as a *bundle* of heterogeneous resources and capabilities that can be used to create an exclusive market position This perspective suggests that individual firms possess at least some resources and capabilities that other companies do not—at least not in the same combination. Resources are the source of capabilities, some of which lead to the development of a firm's core competencies or its competitive advantages.

Understanding how to l*everage* the firm's unique bundle of resources and capabilities is a key outcome decision makers seek when analyzing the internal environment. Figure 5.1 illustrates the relationships among resources, capabilities, and core competencies and shows how firms use them to create strategic competitiveness. Before examining these topics in depth, we describe value and how firms use their resources, capabilities, and core competencies to create it.

**Creating Value**

By exploiting their core competencies or competitive advantages to at least meet if not exceed the demanding standards of global competition, firms create value for customers. **Value** is measured by a product's performance characteristics and by its attributes for which customers are willing to pay. Evidence suggests that increasingly, customers perceive higher value in global rather than domestic-only brands. Firms create value by innovatively bundling and leveraging their resources and capabilities. Firms unable to creatively bundle and leverage their resources and capabilities in ways that create value for customers suffer performance declines

During the last several decades, the strategic management process was concerned largely with understanding the characteristics of the industry in which the firm competed and, in light of those characteristics, determining how the firm should position itself relative to competitors. This emphasis on industry characteristics and competitive strategy may have underestimated the role of the firm's resources and capabilities in developing competitive advantage. In fact, core competencies, in combination with product-market positions, are the firm's most important sources of competitive advantage. The core competencies of a firm, in addition to its analysis of its general, industry, and competitor environments, should drive its selection of strategies. As Clayton Christensen noted, "Successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that under bind each advantage. Only thus will they be able to see when old advantages are poised to disappear and how new advantages can be built in their stead." By emphasizing core competencies when formulating strategies, companies learn to compete primarily on the basis of fir m-specific differences, but they must be very aware of how things are changing in the external environment as well.

## 5.2 Resources, Capabilities, and Core Competencies

Resources, capabilities, and core competencies are the characteristics that make up the foundation of competitive advantage. Resources are the source of a firm's capabilities. Capabilities in turn are the source of a firm's core competencies, which are the basis of competitive advantages. As shown in Figure 5.1, combinations of resources and capabilities are managed to create core competencies.

**Resources**

Broad in scope, resources cover a spectrum of individual, social, and organizational phenomena. Typically, resources alone do not yield a competitive advantage. In fact, a competitive advantage is created through the *unique bundling of several resources* For example; Amazon.com has combined service and distribution resources to develop its competitive advantages. The firm started as an online bookseller, directly shipping orders to customers. It quickly grew large and established a distribution network through which it could ship "millions of different items to millions of different customers." Compared to Amazon's use of combined resources, traditional bricks-and mortar companies, such as Toys 'R' Us and Borders, found it hard to establish an effective online presence. These difficulties led them to develop partnerships with Amazon Through these arrangements, Amazon now handles the online presence and the shipping of goods for several firms, including Toys 'R' Us and Borders—which now can focus on sales in their stores. Arrangements such as these are useful to the bricks-and mortar companies because they are not accustomed to shipping so much diverse merchandise directly to individuals

Some of a firm's resources are tangible while others are intangible **Tangible resources** are assets that can be seen and quantified. Production equipment, manufacturing plants, and formal reporting structures are examples of tangible resources. **Intangible resources** include assets that typically are rooted deeply in the firm's history and have accumulated over time. Because they are embedded in unique patterns of routines, intangible resources are relatively difficult for competitors to analyze and imitate. Knowledge, trust between managers and employees, ideas the capacity for innovation, managerial capabilities, organizational routines (the unique ways people work together), scientific capabilities, and the firm's reputation for its goods or services and how it interacts with people (such as employees, customers, and suppliers) are all examples of intangible resources. The four types of tangible resources are financial, organizational, physical, and technological and the three types of intangible resources are human, innovation and reputational.

| | | |
|---|---|---|
| *TANGIBLE RESOURCES* | Financial resources | •The firm's borrowing capacity |
| | Organizational resources | • The firm's ability to generate internal funds<br>•The firm's formal reporting structure and its formal planning, controlling, and coordinating systems |
| | Physical resources | • Sophistication and location of a firm's plant and equipment<br>• Access to raw materials |
| *INTANGIBLE RESOURCES* | Technological resources | • Stock of technology, such as patents, trade-marks, copyrights, and trade secrets |
| | Human resources | • Knowledge<br>• Trust<br>• Managerial capabilities<br>• Organizational routines |
| | Innovation resources | • Ideas<br>• Scientific capabilities<br>• Capacity to innovate |
| | Reputational resources | • Reputation with customers<br>• Brand name<br>• Perceptions of product quality, durability, and reliability<br>• Reputation with suppliers<br>• For efficient, effective, supportive, and mutually beneficial interactions and relationships |

**Capabilities**

Capabilities are the firm's capacity to deploy resources that have been purposely integrated to achieve a desired end state. The glue binding an organization together, capabilities emerge over time through complex interactions among tangible and intangible resources. Critical to the forming of competitive advantages, capabilities are often based on developing, carrying, and exchanging information and knowledge through the firm's human capital. Because a knowledge base is grounded in organizational actions that may not be explicitly understood by all employees, repetition and practice increase the value of a firm's capabilities. The foundation of many capabilities lies in the unique skills and knowledge of a firm's employees and, often, their functional expertise. Hence, the value of human capital in developing and using capabilities and, ultimately, core competencies cannot be overstated. Capabilities often developed in specific functional areas (such as manufacturing, R&D, and marketing) or in a part of a functional area (for example, advertising).

| **Functional Areas** | **Capabilities** | **Example** |
|---|---|---|
| Distribution | Effective use of logistics management techniques | *Wal-Mart* |
| Management Information System | point-of-purchase data collection methods | *Wal-Mart* |
| Human resources | Motivating, empowering, and retaining employees | *Microsoft Corp.* |
| Marketing | Effective promotion of brand-name products | *Gillette* |
| Management | Effective organizational structure | *PepsiCo* |
| Manufacturing | Design and production skills yielding reliable | *Komatsu* |

**Core Competencies**

Core competencies are resources and capabilities that serve as a source of a firm's competitive advantage over rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities. Some resources or capabilities may stifle or prevent the development of a core competence. Firms with the tangible resource of financial capital, such as Microsoft, which has a large amount of cash on hand, may be able to purchase facilities or hire the skilled workers required to manufacture products that yield customer value.

**Core Competences for Competitive Advantage**

Core competences which confer competitive advantage to a firm have four attributes:

- ✓ **Value**--the resource allows the firm to conceive of and implement strategies that effectively deal with opportunities and threats
- ✓ **Rarity**--the resource is generally unavailable to large numbers of current or potential competitors.
- ✓ **Not imitable**--the resource cannot be easily obtained by competitors

- ✓ **Non-substitutability** there are no strategically equivalent valuable resources available to competitors. Resources are substitutes when they can each individually be used to implement the same strategies.

## 5.3 VALUE CHAIN ANALYSIS

Value Chain Analysis describes the activities that take place in a business and relates them to an analysis of the competitive strength of the business. In order to better understand the activities leading to a competitive advantage, one can begin with the generic value chain and then identify the relevant firm-specific activities A linkage exists if the performance or cost of one activity affects that of another. Competitive advantage may be obtained by optimizing and coordinating linked activities. The value chain also is useful in outsourcing decisions. Influential work by Michael Porter suggested that the activities of a business could be grouped under two headings

(1) **Primary Activities**- those that are directly concerned with creating and delivering a product (e.g. component assembly); and

(2) **Support Activities** which whilst they are not directly involved in production, may increase effectiveness or efficiency (e.g. human resource management). It is rare for a business to undertake all primary and support activities.

Value Chain Analysis is one way of identifying which activities are best undertaken by a business and which are best provided by others ("out sourced"). The value chain shows how a product moves from the raw-material stage to the final customer. For individual firms, the essential idea of the value chain is to create additional value without incurring significant costs while doing so and to capture the value that has been created. In a globally competitive economy, the most valuable links on the chain tend to belong to people who have knowledge about customers. This locus of value-creating possibilities applies just as strongly to retail and service firms as to manufacturers.

**Primary Value Chain Activities**

***Inbound Logistics* > *Operations* > *Outbound Logistics* > *marketing and sales* > *services***

The goal of these activities is to create value that exceeds the cost of providing the product or service, thus generating a profit margin

- ✓ **Inbound logistics** include the receiving, warehousing, and inventory control of input materials

- ✓ **Operations** are the value-creating activities that transform the inputs into the final product
- ✓ **Outbound logistics** are the activities required to get the finished product to the customer, including warehousing, order fulfillment, etc.
- ✓ **Marketing & Sales** are those activities associated with getting buyers to purchase the product, including channel selection, advertising, pricing, etc
- ✓ **Service** activities are those that maintain and enhance the product's value including customer support, repair services, etc

**Support Activities**

The primary value chain activities described above are facilitated by support activities Porter identified four generic categories of support activities, the details of which are industry-specific

- ✓ **Procurement** the function of purchasing the raw materials and other inputs used in the value-creating activities
- ✓ **Technology Development** includes research and development, process automation, and other technology development used to support the value-chain activities
- ✓ **Human Resource Management** the activities associated with recruiting development, and compensation of employees
- ✓ **Firm Infrastructure** includes activities such as finance, legal, quality management, etc

Value chain analysis can be broken down into a three sequential steps:

1) Break down a market/organization into its key activities under each of the major headings in the model;
2) Assess the potential for adding value via cost advantage or differentiation, or identify current activities where a business appears to be at a competitive disadvantage
3) Determine strategies built around focusing on activities where competitive advantage can be sustained

## 5.4 Relationship among the Functional Areas of Business

**Functional relationships** refer to the Number and complexity increases relative to organization size. The process of performing an *internal audit* closely parallels the process of performing an external audit. Representative Managers and employees from throughout the firm need to be involved in determining a firm's strengths and weaknesses. It gathers & assimilates information from:

- Management
- Marketing
- Finance/accounting

- Production/operations
- Research & development
- Management information systems

Involvement in performing an internal strategic-management audit provides vehicle for understanding nature and effect of decisions in other functional business areas of the firm. Internal audit creates an environment of Coordination and understanding among managers from all functional areas.

Strategic management is a highly interactive process that requires effective coordination among management, marketing, finance/accounting, production/operations, R&D, and computer information systems managers. A failure to recognize and understand relationships among the functional areas of business can be detrimental to strategic management, and the number of those relationships that must be managed increases dramatically with a firm's size, diversity, geographic dispersion, and the number of products or services offered. Governmental and nonprofit enterprises traditionally have not placed sufficient emphasis on relationships among the business functions. For example, some state governments, utilities, universities, and hospitals only recently have begun to establish marketing objectives and policies that are consistent with their financial capabilities and limitations. Some firms place too great an emphasis on one function at the expense of others.

**Financial Ratio Analysis**:

*Financial ratio analysis* exemplifies the complexity of relationships among the functional areas of business. A declining return on investment or profit margin ratio could be the result of ineffective marketing, poor management policies, research and development errors, or a weak computer information system. The effectiveness of strategy formulation, implementation, and evaluation activities hinges upon a clear understanding of how major business functions affect one another. For strategies to succeed, a coordinated effort among all the functional areas of business is needed.

**Integrating Strategy and Culture**

Relationships among a firm's functional business activities perhaps can be exemplified best by focusing on organizational culture, an internal phenomenon that permeates all departments and divisions of an organization. Organizational culture can be defined as "a pattern of behavior developed by an organization as it learns to cope with its problem of external adaptation and internal integration that has worked well enough to be considered valid and to be taught to new members as the correct way to perceive, think, and feel." This definition emphasizes the importance of matching external with internal factors in making strategic decisions.

Internal strengths and weaknesses associated with a firm's culture sometimes are overlooked because of the inter-functional nature of this phenomenon. It is important, therefore, for strategists to understand their firm as a socio cultural system. Success is often determined by linkages between a firm's culture and strategies. The challenge of strategic management today is to bring about the changes in organizational culture and individual mind-sets necessary to support the formulation, implementation, and evaluation of strategies.

**Management**

The *functions of management* consist of five basic activities: planning, organizing, motivating, staffing, and controlling.

**Marketing:**

Marketing can be described as the process of defining, anticipating, creating, and fulfilling customers' needs and wants for products and services.

There are seven basic functions of marketing:

(1) Customer analysis,

(2) Selling products/services,

(3) Product and service planning,

(4) Pricing,

(5) Distribution,

(6) Marketing research, and

(7) Opportunity analysis.

Understanding these functions helps strategists identify and evaluate marketing strengths and weaknesses.

**Finance/Accounting Functions**

- Determining financial strengths and weaknesses key to strategy formulation
- Investment decision (Capital budgeting)
- Financing decision
- Dividend decision

According to James Van Horne, the *functions of finance/accounting* comprise three decisions: the investment decision, the financing decision, and the dividend decision.

Financial ratio analysis is the most widely used method for determining an organization's strengths and weaknesses in the investment, financing, and dividend areas. Because, the functional areas of business are so closely related, financial ratios can signal strengths or weaknesses in management, marketing, production, research and development, and computer information systems activities.

Financial ratios are computed from an organization's income statement and balance sheet. Computing financial ratios is like taking a picture because the results reflect a situation at just one point in time. Comparing ratios over time and to industry averages is more likely to result in meaningful statistics that can be used to identify and evaluate strengths and weaknesses. Trend analysis is a useful technique that incorporates both the time and industry average dimensions of financial ratios. However, all the ratios are not significant for all industries and companies. For example, accounts receivable turnover and average collection period are not very meaningful to a company that does primarily cash receipts business. Key financial ratios can be classified into the following five types:

**Liquidity ratios** measure a firm's ability to meet maturing short-term obligations. It includes:

- Current ratio
- Quick (or acid-test) ratio

**Leverage ratios** measure the extent to which a firm has been financed by debt.

- Debt-to-total-assets ratio
- Debt-to-equity ratio
- Long-term debt-to-equity ratio
- Times-interest-earned (or coverage) ratio

**Activity ratios** measure how effectively a firm is using its resources.

- Inventory-turnover
- Fixed assets turnover
- Total assets turnover
- Accounts receivable turnover
- Average collection period

**Profitability ratios** measure management's overall effectiveness as shown by the returns generated on sales and investment.

- Gross profit margin
- Operating profit margin
- Net profit margin
- Return on total assets (ROA)
- Return on stockholders' equity (ROE)
- Earnings per share
- Price-earnings ratio

**Growth ratios** measure the firm's ability to maintain its economic position in the growth of the economy and industry.

- Sales
- Net income
- Earnings per share
- Dividends per share

**Production/Operations**

The *production/operations function* of a business consists of all those activities that transform inputs into goods and services. Production/operations management deals with inputs, transformations, and outputs that vary across industries and markets. A manufacturing operation transforms or converts inputs such as raw materials, labor, capital, machines, and facilities into finished goods and services. Production/operations management comprises five functions or decision areas: process, capacity, inventory, workforce, and quality.

**Research and Development**

The fifth major area of internal operations that should be examined for specific strengths and weaknesses is research and development (R&D). Many firms today conduct no R&D, and yet many other companies depend on successful R&D activities for survival. Firms pursuing a product development strategy especially need to have a strong R&D orientation.

The purpose of research and development are as follows:

- ✓ Development of new products before competition

Improving product quality

- ✓ Improving manufacturing processes to reduce costs

Internal and External R&D

Cost distributions among R&D activities vary by company and industry, but total R&D costs generally do not exceed manufacturing and marketing start-up costs. Four approaches to determining R&D budget allocations commonly are used:

(1) Financing as many project proposals as possible,

(2) Using a percentage-of-sales method,

(3) Budgeting about the same amount that competitors spend for R&D, or

(4) Deciding how many successful new products are needed and working backward to estimate the required R&D investment.

R&D in organizations can take two basic forms:

(1) Internal R&D, in which an organization operates its own R&D department, and/or

(2) Contract R&D, in which a firm hires independent researchers or independent agencies to develop specific products.

**Management information systems:**

MIS is a general name for the academic discipline covering the application of information technology to business problems. As an area of study it is also referred to as information technology management. The study of information systems is usually a commerce and business administration discipline, and frequently involves software engineering, but also distinguishes itself by concentrating on the integration of computer systems with the aims of the organization. The area of study should not be confused with computer science which is more theoretical in nature and deals mainly with software creation, or computer engineering, which focuses more on the design of computer hardware. IT service management is a practitioner-focused discipline centering on the same general domain.

In business, information systems support business processes and operations, decision-making, and competitive strategies.