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The External Assessment

This chapter examines the tools and concepts needed to conduct an external strategic manage-

ment audit (sometimes called environmental scanning or industry analysis). An external audit

focuses on identifying and evaluating trends and events beyond the control of a single firm, such

as increased foreign competition, population shifts to the Sunbelt, an aging society, consumer

fear of traveling, and stock market volatility. An external audit reveals key opportunities and

threats confronting an organization so that managers can formulate strategies to take advantage

of the opportunities and avoid or reduce the impact of threats. This chapter presents a practical

framework for gathering, assimilating, and analyzing external information. The Industrial

Organization (I/O) view of strategic management is introduced.

The Chapter 3 boxed insert company pursuing strategies based on an excellent external stra-

tegic analysis is Wells Fargo, the fourth-largest lender by assets in the United States.

The Nature of an External Audit

The purpose of an external audit is to develop a finite list of opportunities that could benefit

a firm and threats that should be avoided. As the term finite suggests, the external audit is not

aimed at developing an exhaustive list of every possible factor that could influence the business;

rather, it is aimed at identifying key variables that offer actionable responses. Firms should be able to respond either offensively or defensively to the factors by formulating strategies that take

advantage of external opportunities or that minimize the impact of potential threats. Figure 3-1

illustrates how the external audit fits into the strategic-management process.

Key External Forces

External forces can be divided into five broad categories: (1) economic forces; (2) social,

cultural, demographic, and natural environment forces; (3) political, governmental, and legal

forces; (4) technological forces; and (5) competitive forces. Relationships among these forces

and an organization are depicted in Figure 3-2. External trends and events, such as rising food

prices and people in African countries coming online, significantly affect products, services,

markets, and organizations worldwide. The U.S. unemployment rate is about 10 percent—the

most since 1945 when the country downsized from the war effort. All sectors witness high

unemployment rates, except for education, health-care services, and government employment.

Many Americans still resort to minimum wage jobs to make ends meet.

Changes in external forces translate into changes in consumer demand for both industrial

and consumer products and services. External forces affect the types of products developed,

the nature of positioning and market segmentation strategies, the type of services offered, and

the choice of businesses to acquire or sell. External forces directly affect both suppliers and

distributors. Identifying and evaluating external opportunities and threats enables organizations

to develop a clear mission, to design strategies to achieve long-term objectives, and to develop

policies to achieve annual objectives.

The increasing complexity of business today is evidenced by more countries developing the

capacity and will to compete aggressively in world markets. Foreign businesses and countries

are willing to learn, adapt, innovate, and invent to compete successfully in the marketplace.

There are more competitive new technologies in Europe and Asia today than ever before

The Process of Performing an External Audit

The process of performing an external audit must involve as many managers and employees as

possible. As emphasized in earlier chapters, involvement in the strategic-management process

can lead to understanding and commitment from organizational members. Individuals appreci-

ate having the opportunity to contribute ideas and to gain a better understanding of their firm’s

industry, competitors, and markets.

To perform an external audit, a company first must gather competitive intelligence and

information about economic, social, cultural, demographic, environmental, political, govern-

mental, legal, and technological trends. Individuals can be asked to monitor various sources

of information, such as key magazines, trade journals, and newspapers. These persons can

submit periodic scanning reports to a committee of managers charged with performing the

external audit. This approach provides a continuous stream of timely strategic information

and involves many individuals in the external-audit process. The Internet provides another

source for gathering strategic information, as do corporate, university, and public libraries.

Suppliers, distributors, salespersons, customers, and competitors represent other sources of

vital information.

Once information is gathered, it should be assimilated and evaluated. A meeting or series

of meetings of managers is needed to collectively identify the most important opportunities and

threats facing the firm. These key external factors should be listed on flip charts or a chalkboard.

A prioritized list of these factors could be obtained by requesting that all managers rank the factors

identified, from 1 for the most important opportunity/threat to 20 for the least important opportunity/

threat. These key external factors can vary over time and by industry. Relationships with suppliers or

distributors are often a critical success factor. Other variables commonly used include market share

breadth of competing products, world economies, foreign affiliates, proprietary and key account

advantages, price competitiveness, technological advancements, population shifts, interest rates, and

pollution abatement.

Freund emphasized that these key external factors should be (1) important to achieving

long-term and annual objectives, (2) measurable, (3) applicable to all competing firms, and

(4) hierarchical in the sense that some will pertain to the overall company and others will be

more narrowly focused on functional or divisional areas.1 A final list of the most important

key external factors should be communicated and distributed widely in the organization. Both

opportunities and threats can be key external factors.

The Industrial Organization (I/O) View

The Industrial Organization (I/O) approach to competitive advantage advocates that external

(industry) factors are more important than internal factors in a firm for achieving competitive

advantage. Proponents of the I/O view, such as Michael Porter, contend that organizational

performance will be primarily determined by industry forces. Porter’s Five-Forces Model,

presented later in this chapter, is an example of the I/O perspective, which focuses on analyz-

ing external forces and industry variables as a basis for getting and keeping competitive ad-

vantage. Competitive advantage is determined largely by competitive positioning within an

industry, according to I/O advocates. Managing strategically from the I/O perspective entails

firms striving to compete in attractive industries, avoiding weak or faltering industries, and

gaining a full understanding of key external factor relationships within that attractive industry.

I/O research provides important contributions to our understanding of how to gain competitive

advantage.

I/O theorists contend that external factors and the industry in which a firm competes

has a stronger influence on the firm’s performance than do the internal functional issues in

marketing, finance, and the like. Firm performance, they contend, is based more on industry

properties such as economies of scale, barriers to market entry, product differentiation, the

economy, and level of competitiveness than on internal resources, capabilities, structure,

and operations. The recent global economic recession’s negative impact on both strong

and weak firms added credence to the notion that external forces are more important than

internal.

The I/O view has enhanced our understanding of strategic management. However, it is not

a question of whether external or internal factors are more important in gaining and maintain-

ing competitive advantage. Effective integration and understanding of both external and inter-

nal factors is the key to securing and keeping a competitive advantage. In fact, as discussed in

Chapter 6, matching key external opportunities/threats with key internal strengths/weaknesses

provides the basis for successful strategy formulation.

Economic Forces

The Dow Jones Industrial Average is over 10,500, corporate profits are high, dividend increases

are up sharply, and emerging markets are growing in double digits. Yet, job growth is still sty-

mied, home prices remain low, and millions of people work for minimum wages or are either

unemployed or underemployed. Strong exports of energy and grains have farm suppliers and

railroads hiring, but commodity prices are up sharply, especially food, which is contributing to

rising inflation fears. Many firms are switching to the extent possible to part-time rather than

full-time employees to avoid having to pay health benefits. Consumer spending rebounded

nicely in 2011 from 2010.

Economic factors have a direct impact on the potential attractiveness of various strategies.

For example, when interest rates rise, funds needed for capital expansion become more costly

or unavailable. Also, as interest rates rise, discretionary income declines, and the demand for

discretionary goods falls. When stock prices increase, the desirability of equity as a source of

capital for market development increases. Also, when the market rises, consumer and business

wealth expands. A summary of economic variables that often represent opportunities and threats

for organizations is provided in Table 3-1

To take advantage of Canada’s robust economy and eager-to-spend people, many firms

are aggressively expanding operations into Canada, including TJX opening many Marshalls

stores, Target opening 220 stores, Wal-Mart opening 40 supercenters, and Tanger Outlet Factory

Centers opening five new stores in 2011. “Canada is one of the most economically prosperous

countries in the world,” said Howard Davidowitz, chairman of Davidowitz & Associates, a retail

consultancy and investment-banking firm. “It has a stable currency, it did not have a banking

crisis and it did not spend itself into insanity.”

Trends in the dollar’s value have significant and unequal effects on companies in different

industries and in different locations. For example, the pharmaceutical, tourism, entertainment,

motor vehicle, aerospace, and forest products industries benefit greatly when the dollar falls

against the yen and euro. Agricultural and petroleum industries are hurt by the dollar’s rise

against the currencies of Mexico, Brazil, Venezuela, and Australia. Generally, a strong or high

dollar makes U.S. goods more expensive in overseas markets. This worsens the U.S. trade defi-

cit. When the value of the dollar falls, tourism-oriented firms benefit because Americans do not

travel abroad as much when the value of the dollar is low; rather, foreigners visit and vacation

more in the United States.

A low value of the dollar means lower imports and higher exports; it helps U.S. companies’

competitiveness in world markets. The dollar has fallen to five-year lows against the euro and

yen, which makes U.S. goods cheaper to foreign consumers and combats deflation by push-

ing up prices of imports. However, European firms such as Volkswagen AG, Nokia Corp., and

Michelin complain that the strong euro hurts their financial performance. The low value of the

dollar benefits the U.S. economy in many ways. First, it helps stave off the risks of deflation in

the United States and also reduces the U.S. trade deficit. In addition, the low value of the dol-

lar raises the foreign sales and profits of domestic firms, thanks to dollar-induced gains, and

encourages foreign countries to lower interest rates and loosen fiscal policy, which stimulates

worldwide economic expansion. Some sectors, such as consumer staples, energy, materials,

technology, and health care, especially benefit from a low value of the dollar. Manufacturers

in many domestic industries in fact benefit because of a weak dollar, which forces foreign

rivals to raise prices and extinguish discounts. Domestic firms with big overseas sales, such as

McDonald’s, greatly benefit from a weak dollar. Table 3-2 lists some advantages and disadvan-

tages of a weak U.S. dollar for American firms.

The improving but weak economy worldwide and depressed home prices has dramati-

cally slowed the migration of people from country to country and from the city to the suburbs.

Because people are not moving nearly as much as in years past, there is lower and lower demand

for new or used houses. Thus the housing market is expected to remain sluggish well into 2012

and 2013.

Social, Cultural, Demographic, and Natural

Environment Forces

Social, cultural, demographic, and environmental changes have a major impact on virtually all

products, services, markets, and customers. Small, large, for-profit, and nonprofit organizations

in all industries are being staggered and challenged by the opportunities and threats arising

from changes in social, cultural, demographic, and environmental variables. In every way,

the United States is much different today than it was yesterday, and tomorrow promises even

greater changes.

The United States is getting older and less white. The oldest members of America’s

76 million baby boomers plan to retire soon, and this has lawmakers and younger taxpay-

ers deeply concerned about who will pay their Social Security, Medicare, and Medicaid.

Individuals age 65 and older in the United States as a percentage of the population will rise

to 18.5 percent by 2025.

By 2075, the United States will have no racial or ethnic majority. This forecast is aggra-

vating tensions over issues such as immigration and affirmative action. Hawaii, California,

and New Mexico already have no majority race or ethnic group. For the first time ever, the

number of Hispanic people surpassed the number of whites in New Mexico in the recent 2010

census data. New Mexico’s population grew 13.2 percent to 2.06 million from 2000 to 2010.

Also, people from the West Coast are seeking more affordable living in the Rocky Mountain

states. For example, Idaho’s population increased 21.1 percent from 2000 to 2010 with 1.7

million people now calling Idaho home. There is a “migration for cheaper life” across the

United States.

The population of the world surpassed 7.0 billion in 2011; the United States has just over 310

million people. That leaves billions of people outside the United States who may be interested

in the products and services produced through domestic firms. Remaining solely domestic is an

increasingly risky strategy, especially as the world population continues to grow to an estimated 8

billion in 2028 and 9 billion in 2054.

Social, cultural, demographic, and environmental trends are shaping the way Americans

live, work, produce, and consume. New trends are creating a different type of consumer and,

consequently, a need for different products, different services, and different strategies. There are

now more American households with people living alone or with unrelated people than there are

households consisting of married couples with children. American households are making more

and more purchases online. Page 67

The trend toward an older America is good news for restaurants, hotels, airlines, cruise lines,

tours, resorts, theme parks, luxury products and services, recreational vehicles, home builders,

furniture producers, computer manufacturers, travel services, pharmaceutical firms, automakers,

and funeral homes. Older Americans are especially interested in health care, financial services,

travel, crime prevention, and leisure. The world’s longest-living people are the Japanese, with

Japanese women living to 86.3 years and men living to 80.1 years on average. By 2050, the

Census Bureau projects that the number of Americans age 100 and older will increase to over

834,000 from just under 100,000 centenarians in the United States in 2000. Americans age 65

and over will increase from 12.6 percent of the U.S. population in 2000 to 20.0 percent by the

year 2050.

The aging American population affects the strategic orientation of nearly all organi-

zations. Apartment complexes for the elderly, with one meal a day, transportation, and

utilities included in the rent, have increased nationwide. Called lifecare facilities, these

complexes now exceed 2 million. Some well-known companies building these facilities

include Avon, Marriott, and Hyatt. Individuals age 65 and older in the United States com-

prise 13 percent of the total population; Japan’s elderly population ratio is 17 percent, and

Germany’s is 19 percent.

Americans were on the move in a population shift to the South and Rocky Mountain states

away from the Northeast and Midwest (Frostbelt), and the expensive West Coast. But the reces-

sion and housing bust nationwide has slowed migration throughout the United States. More

Americans are staying in place rather than moving. New jobs are the primary reason people

move across state lines, so with fewer jobs, there is less need to move. Falling home prices

also have prompted people to avoid moving. The historical trend of people moving from the

Northeast and Midwest to the Sunbelt and West has dramatically slowed. Hard number data

related to this trend can represent key opportunities for many firms and thus can be essential for

successful strategy formulation, including where to locate new plants and distribution centers

and where to focus marketing efforts.

A summary of important social, cultural, demographic, and environmental variables that

represent opportunities or threats for virtually all organizations is given in Table 3-3.

Political, Governmental, and Legal Forces

Federal, state, local, and foreign governments are major regulators, deregulators, subsidizers,

employers, and customers of organizations. Political, governmental, and legal factors, there-

fore, can represent key opportunities or threats for both small and large organizations. Political

unrest in the Middle East threatens to raise oil prices globally, which could cause inflation. The

political overthrow of monarchies in Egypt, Tunisia, and Libya is spreading to Yemen, Jordan,

Syria, and other countries as people in all nations desire liberty and freedom rather than oppres-

sion and suppression.

For industries and firms that depend heavily on government contracts or subsidies, political

forecasts can be the most important part of an external audit. Changes in patent laws, antitrust

legislation, tax rates, and lobbying activities can affect firms significantly. The increasing global

interdependence among economies, markets, governments, and organizations makes it impera-

tive that firms consider the possible impact of political variables on the formulation and imple-

mentation of competitive strategies.

Many countries worldwide are resorting to protectionism to safeguard their own industries.

European Union (EU) nations, for example, have tightened their own trade rules and resumed

subsidies for various of their own industries while barring imports from certain other coun-

tries. The EU recently restricted imports of U.S. chicken and beef. India is increasing tariffs on

foreign steel. Russia perhaps has instituted the most protectionist measures by raising tariffs on

most imports and subsidizing its own exports. Russia even imposed a new toll on trucks from

the EU, Switzerland, and Turkmenistan. Despite these measures taken by other countries, the

United States has largely refrained from “Buy American” policies and protectionist measures,

although there are increased tariffs on French cheese and Italian water. Many economists say the

current rash of trade constraints will make it harder for global economic growth to recover from

the global recession.

A political debate raging in the United States concerns sales taxes on the Internet.

Wal-Mart, Target, and other large retailers are pressuring state governments to collect sales

taxes from Amazon.com. Big brick-and-mortar retailers are backing a coalition called the

Alliance for Main Street Fairness, which is leading political efforts to change sales-tax

laws in more than a dozen states. Wal-Mart’s executive Raul Vazquez says, “The rules to-

day don’t allow brick-and-mortar retailers to compete evenly with online retailers, and that

needs to be addressed.”

American Labor Unions

The extent that a state is unionized can be a significant political factor in strategic planning

decisions as related to manufacturing plant location and other operational matters. The size

of American labor unions has fallen sharply in the last decade due in large part to erosion

of the U.S. manufacturing base. The single best example of this is the decline of the United

Automobile Workers (UAW) as U.S. automakers and car parts suppliers went through hard

times. The number of workers represented by unions in the U.S. fell from 9 percent to 6.9

percent between 2000 and 2010.

Huge declines of late in receipts of federal, state, and municipal governments has contrib-

uted to a sharp decline in the membership of public-sector unions. Organized public-sector labor

issues are being debated in many state legislatures. State governments seek concessions, the

most drastic of which may be the abolition of collective bargaining rights. Wisconsin recently

passed a law eliminating most collective-bargaining rights for the state’s public-employee

unions. That law sets a precedent that many other states may follow to curb union rights as a way

to help state budgets become solvent. Ohio is close to passing a similar bill curbing union rights

for 400,000 public workers.

The Republican majority in many state legislatures and governors’ offices makes the

“declining public unionization” trend likely to continue. Public unions now face the kind

of erosion that private unions did in the last decade. Local governments simply do not have

sufficient tax receipts to support current union payrolls and benefits. Table 3-4 compares the

most unionized states with the least unionized. Note that union membership overall dropped in

most states from 2000 to 2010 due to private sector losses, but public sector union employees,

on the other hand, have held their own.

Governments worldwide are under pressure to protect jobs at home and maintain the

nation’s industrial base. For example, in France, Renault SA’s factory in Sandouville is one of

the most unproductive auto factories in the world. However, Renault has taken $3.9 billion in

low-interest loans from the French government, so the company cannot close any French facto-

ries for the duration of the loan or resort to mass layoffs in France for a year.

Local, state, and federal laws; regulatory agencies; and special-interest groups can have

a major impact on the strategies of small, large, for-profit, and nonprofit organizations. Many

companies have altered or abandoned strategies in the past because of political or govern-

mental actions. In the academic world, as state budgets have dropped in recent years, so too

has state support for colleges and universities. Due to the decline in monies received from the

state, many institutions of higher learning are doing more fund-raising on their own—naming

buildings and classrooms, for example, for donors. A summary of political, governmental, and

legal variables that can represent key opportunities or threats to organizations is provided in

Table 3-5

Technological Forces

Papa John’s International in 2012 expects to receive 50 percent of all its pizza orders through

its website, up from 30 percent in 2011 and far more than the industry average of 10 percent.

Technology is a key to Papa John’s success as it strives to compete with Domino’s Pizza and

Pizza Hut. Papa John’s new website is interactive, where customers can see a picture of their

pizza as they decide upon toppings. Papa John’s new loyalty program, called Papa Points, is

promoted heavily through its new website.

Lagging behind Netflix and Redbox in technology has been disastrous for Blockbuster,

which recently filed for Chapter 11 bankruptcy protection and then barely escaped liquidation

before being acquired by Dish Network Corp. for $320 million. Internet streaming giant Netflix

and $1 DVD movies offered by Redbox essentially forced Blockbuster to close more than 1,000

of its 3,000 stores while at the same time desperately trying to shift to digital distribution. In

virtually every industry, the more technologically astute firms gain overwhelming competitive

advantage over less competent rivals.

The Internet has changed the very nature of opportunities and threats by altering the life

cycles of products, increasing the speed of distribution, creating new products and services, eras-

ing limitations of traditional geographic markets, and changing the historical trade-off between

production standardization and flexibility. The Internet is altering economies of scale, changing

entry barriers, and redefining the relationship between industries and various suppliers, credi-

tors, customers, and competitors.

Total Internet retail sales the last two months of 2010 jumped 15.4 percent compared to

2009. Purchases online of apparel at specialty stores increased 25 percent, even though people

prefer to touch and try on garments.2 Retail sales over the Internet now account for about 10

percent of all retail sales, excluding purchases of automobiles and gas.

To effectively capitalize on e-commerce, a number of organizations are establishing two new

positions in their firms: chief information officer (CIO) and chief technology officer (CTO). This

trend reflects the growing importance of information technology (IT) in strategic management.

A CIO and CTO work together to ensure that information needed to formulate, implement, and

evaluate strategies is available where and when it is needed. These individuals are responsible

for developing, maintaining, and updating a company’s information database. The CIO is more

a manager, managing the firm’s relationship with stakeholders; the CTO is more a technician,

focusing on technical issues such as data acquisition, data processing, decision-support systems,

and software and hardware acquisition.

Technological forces represent major opportunities and threats that must be considered

in formulating strategies. Technological advancements can dramatically affect organizations’

products, services, markets, suppliers, distributors, competitors, customers, manufacturing

processes, marketing practices, and competitive position. Technological advancements can

create new markets, result in a proliferation of new and improved products, change the rela-

tive competitive cost positions in an industry, and render existing products and services obso-

lete. Technological changes can reduce or eliminate cost barriers between businesses, create

shorter production runs, create shortages in technical skills, and result in changing values

and expectations of employees, managers, and customers. Technological advancements can

create new competitive advantages that are more powerful than existing advantages. No com-

pany or industry today is insulated against emerging technological developments. In high-

tech industries, identification and evaluation of key technological opportunities and threats

can be the most important part of the external strategic-management audit.

Organizations that traditionally have limited technology expenditures to what they can

fund after meeting marketing and financial requirements urgently need a reversal in thinking.

The pace of technological change is increasing and literally wiping out businesses every day.

An emerging consensus holds that technology management is one of the key responsibilities of

strategists. Firms should pursue strategies that take advantage of technological opportunities to

achieve sustainable, competitive advantages in the marketplace.

In practice, critical decisions about technology too often are delegated to lower organi-

zational levels or are made without an understanding of their strategic implications. Many

strategists spend countless hours determining market share, positioning products in terms

of features and price, forecasting sales and market size, and monitoring distributors; yet too

often, technology does not receive the same respect.

Not all sectors of the economy are affected equally by technological developments. The

communications, electronics, aeronautics, and pharmaceutical industries are much more volatile

than the textile, forestry, and metals industries.

Competitive Forces

An important part of an external audit is identifying rival firms and determining their strengths,

weaknesses, capabilities, opportunities, threats, objectives, and strategies.

For example, Tupperware Brands Corp. (TBC) produces and sells household products

and beauty items. TBC competes intensely with Avon Products and Newell Rubbermaid.

Tupperware parties became synonymous with American suburban life in the 1950s, when

independent salespeople organized gatherings to sell their plastic containers. TBC today

deploys a sales force of about 2.6 million people in about 100 countries and obtains more

than 80 percent of their annual $2.3 billion revenue from outside the United States. Table 3-6

compares Tupperware with its two largest competitors. Note that TBC outperforms Avon and

Rubbermaid on most criteria.

Collecting and evaluating information on competitors is essential for successful strat-

egy formulation. Identifying major competitors is not always easy because many firms have

divisions that compete in different industries. Many multidivisional firms do not provide

sales and profit information on a divisional basis for competitive reasons. Also, privately-

held firms do not publish any financial or marketing information. Addressing questions

about competitors such as those presented in Table 3-7 is important in performing an

external audit.

Competition in virtually all industries can be described as intense—and sometimes as cutthroat.

For example, Walgreens and CVS pharmacies are located generally across the street from each other

and battle each other every day on price and customer service. Most automobile dealerships also are

located close to each other. Dollar General, based in Goodlettsville, Tennessee, and Family Dollar,

based in Matthews, North Carolina, compete intensely on price to attract customers away from each

other and away from Wal-Mart. Best Buy dropped prices wherever possible to finally put Circuit

City totally out of business.

Seven characteristics describe the most competitive companies:

1. Market share matters; the 90th share point isn’t as important as the 91st, and nothing is

more dangerous than falling to 89.

2. Understand and remember precisely what business you are in.

3. Whether it’s broke or not, fix it—make it better; not just products, but the whole company,

if necessary.

Competitive Intelligence Programs

What is competitive intelligence? Competitive intelligence (CI), as formally defined by the

Society of Competitive Intelligence Professionals (SCIP), is a systematic and ethical process

for gathering and analyzing information about the competition’s activities and general business

trends to further a business’s own goals (SCIP website).

Good competitive intelligence in business, as in the military, is one of the keys to suc-

cess. The more information and knowledge a firm can obtain about its competitors, the more

likely it is that it can formulate and implement effective strategies. Major competitors’ weak-

nesses can represent external opportunities; major competitors’ strengths may represent key

threats.

Starwood Hotels & Resorts Worldwide recently sued Hilton Hotels Corp. for allegedly

stealing more than 100,000 confidential electronic and paper documents containing “Starwood’s

most competitively sensitive information.” The complaint alleges that two Starwood executives,

Ross Klein and Amar Lalvani, resigned from Starwood to join Hilton and took this informa-

tion with them. The legal complaint says, “This is the clearest imaginable case of corporate

espionage, theft of trade secrets, unfair competition and computer fraud.” In addition to mone-

tary awards, Starwood is seeking to force Hilton to cancel the rollout of the Denizen hotel chain.

Hilton is owned by Blackstone Group.

Hiring top executives from rival firms is also a way companies obtain competitive intel-

ligence. Just two days after Facebook’s COO, Owen Van Natta, left the company, he accepted

the CEO job at Myspace, replacing then CEO and cofounder Chris DeWolfe. Van Natta had

previously also been Facebook’s COO, chief revenue officer, and vice president of operations.

Google Inc. is losing top staff to Facebook, Twitter, and LinkedIn, which are all private com-

panies that can lure top engineers and executives with pre-IPO stock. For example, Facebook’s

COO, Sheryl Sandberg, was previously Google’s vice president of online sales and operations,

and Facebook’s VP of advertising and global operations, David Fischer, previously held that

same position at Google. In 2010 alone, Facebook went from 1,000 employees to 2,000, Twitter

went from 100 to 300, and LinkedIn went from 450 to 900.

Many U.S. executives grew up in times when U.S. firms dominated foreign competitors so

much that gathering competitive intelligence did not seem worth the effort. Too many of these

executives still cling to these attitudes—to the detriment of their organizations today. Even most

MBA programs do not offer a course in competitive and business intelligence, thus reinforcing

this attitude. As a consequence, three strong misperceptions about business intelligence prevail

among U.S. executives today:

1. Running an intelligence program requires lots of people, computers, and other resources.

2. Collecting intelligence about competitors violates antitrust laws; business intelligence

equals espionage.

3. Intelligence gathering is an unethical business practice.4

Any discussions with a competitor about price, market, or geography intentions could

violate antitrust statutes. However, this fact must not lure a firm into underestimating the need

for and benefits of systematically collecting information about competitors for strategic plan-

ning purposes. The Internet is an excellent medium for gathering competitive intelligence.

Information gathering from employees, managers, suppliers, distributors, customers, creditors,

and consultants also can make the difference between having superior or just average intelli-

gence and overall competitiveness.

Firms need an effective competitive intelligence (CI) program. The three basic objectives

of a CI program are (1) to provide a general understanding of an industry and its competitors,

(2) to identify areas in which competitors are vulnerable and to assess the impact strategic

actions would have on competitors, and (3) to identify potential moves that a competitor might

make that would endanger a firm’s position in the market.5 Competitive information is equally

applicable for strategy formulation, implementation, and evaluation decisions. An effective CI

program allows all areas of a firm to access consistent and verifiable information in making

decisions. All members of an organization—from the chief executive officer to custodians—are

valuable intelligence agents and should feel themselves to be a part of the CI process. Special

Market Commonality and Resource Similarity

By definition, competitors are firms that offer similar products and services in the same

market. Markets can be geographic or product areas or segments. For example, in the insur-

ance industry the markets are broken down into commercial/consumer, health/life, or Europe/

Asia. Researchers use the terms market commonality and resource similarity to study rivalry

among competitors. Market commonality can be defined as the number and significance of

markets that a firm competes in with rivals.6 Resource similarity is the extent to which the

type and amount of a firm’s internal resources are comparable to a rival.7 One way to analyze

competitiveness between two or among several firms is to investigate market commonality and

resource similarity issues while looking for areas of potential competitive advantage along each

firm’s value chain.

Competitive Analysis: Porter’s Five-Forces Model

As illustrated in Figure 3-3, Porter’s Five-Forces Model of competitive analysis is a widely

used approach for developing strategies in many industries. The intensity of competition

among firms varies widely across industries. Table 3-8 reveals the average gross profit mar-

gin and earnings per share for firms in different industries. Note the substantial variation

among industries. For example, note that gross profit margin ranges from 59.28 percent to

24.50 percent, while EPS ranges from $2.45 to $0.18. Note that brick and mortar bookstores

have the lowest EPS, which implies fierce competition in that industry. Intensity of com-

petition is highest in lower-return industries. The collective impact of competitive forces is

so brutal in some industries that the market is clearly “unattractive” from a profit-making

standpoint. Rivalry among existing firms is severe, new rivals can enter the industry with

relative ease, and both suppliers and customers can exercise considerable bargaining lever-

age. According to Porter, the nature of competitiveness in a given industry can be viewed as

a composite of five forces:

1. Rivalry among competing firms

2. Potential entry of new competitors

3. Potential development of substitute products

4. Bargaining power of suppliers

5. Bargaining power of consumers

The intensity of rivalry among competing firms tends to increase as the number of

competitors increases, as competitors become more equal in size and capability, as demand

for the industry’s products declines, and as price cutting becomes common. Rivalry also in-

creases when consumers can switch brands easily; when barriers to leaving the market are

high; when fixed costs are high; when the product is perishable; when consumer demand

is growing slowly or declines such that rivals have excess capacity and/or inventory; when

the products being sold are commodities (not easily differentiated, such as gasoline); when

rival firms are diverse in strategies, origins, and culture; and when mergers and acquisitions

are common in the industry. As rivalry among competing firms intensifies, industry profits

decline, in some cases to the point where an industry becomes inherently unattractive. When

rival firms sense weakness, typically they will intensify both marketing and production

efforts to capitalize on the “opportunity.” Table 3-9 summarizes conditions that cause high

rivalry among competing firms.

Potential Entry of New Competitors

Whenever new firms can easily enter a particular industry, the intensity of competitiveness

among firms increases. Barriers to entry, however, can include the need to gain economies of

scale quickly, the need to gain technology and specialized know-how, the lack of experience,

strong customer loyalty, strong brand preferences, large capital requirements, lack of adequate

distribution channels, government regulatory policies, tariffs, lack of access to raw materials,

possession of patents, undesirable locations, counterattack by entrenched firms, and potential

saturation of the market.

Despite numerous barriers to entry, new firms sometimes enter industries with higher-quality

products, lower prices, and substantial marketing resources. The strategist’s job, therefore, is to

identify potential new firms entering the market, to monitor the new rival firms’ strategies, to

counterattack as needed, and to capitalize on existing strengths and opportunities. When the threat

of new firms entering the market is strong, incumbent firms generally fortify their positions and

take actions to deter new entrants, such as lowering prices, extending warranties, adding features,

or offering financing specials.

Potential Development of Substitute Products

In many industries, firms are in close competition with producers of substitute products in other

industries. Examples are plastic container producers competing with glass, paperboard, and

aluminum can producers, and acetaminophen manufacturers competing with other manufactur-

ers of pain and headache remedies. The presence of substitute products puts a ceiling on the

price that can be charged before consumers will switch to the substitute product. Price ceilings

equate to profit ceilings and more intense competition among rivals. Producers of eyeglasses

and contact lenses, for example, face increasing competitive pressures from laser eye surgery.

Producers of sugar face similar pressures from artificial sweeteners. Newspapers and magazines

face substitute-product competitive pressures from the Internet and 24-hour cable television.

The magnitude of competitive pressure derived from the development of substitute products is

generally evidenced by rivals’ plans for expanding production capacity, as well as by their sales

and profit growth numbers.

Competitive pressures arising from substitute products increase as the relative price of

substitute products declines and as consumers’ costs of switching decrease. The competitive

strength of substitute products is best measured by the inroads into the market share those prod-

ucts obtain, as well as those firms’ plans for increased capacity and market penetration.

For example, circulation of U.S. newspapers continues to drop drastically, with the excep-

tion of the Wall Street Journal and a few other bright spots. The growing popularity of free news

on the web and more timely news online are two key factors negatively impacting traditional

papers such as the New York Times, Los Angeles Times, and others.

Bargaining Power of Suppliers

The bargaining power of suppliers affects the intensity of competition in an industry, especially

when there is a large number of suppliers, when there are only a few good substitute raw materi-

als, or when the cost of switching raw materials is especially high. It is often in the best interest

of both suppliers and producers to assist each other with reasonable prices, improved quality,

development of new services, just-in-time deliveries, and reduced inventory costs, thus enhanc-

ing long-term profitability for all concerned.

Firms may pursue a backward integration strategy to gain control or ownership of suppliers. This

strategy is especially effective when suppliers are unreliable, too costly, or not capable of meeting a

firm’s needs on a consistent basis. Firms generally can negotiate more favorable terms with suppliers

when backward integration is a commonly used strategy among rival firms in an industry.

However, in many industries it is more economical to use outside suppliers of component

parts than to self-manufacture the items. This is true, for example, in the outdoor power equip-

ment industry, where producers of lawn mowers, rotary tillers, leaf blowers, and edgers such

as Murray generally obtain their small engines from outside manufacturers such as Briggs &

Stratton that specialize in such engines and have huge economies of scale.

In more and more industries, sellers are forging strategic partnerships with select suppliers

in efforts to (1) reduce inventory and logistics costs (e.g., through just-in-time deliveries); (2)

speed the availability of next-generation components; (3) enhance the quality of the parts and

components being supplied and reduce defect rates; and (4) squeeze out important cost savings

for both themselves and their suppliers.8

Bargaining Power of Consumers

When customers are concentrated or large in number or buy in volume, their bargaining power

represents a major force affecting the intensity of competition in an industry. Rival firms may

offer extended warranties or special services to gain customer loyalty whenever the bargain-

ing power of consumers is substantial. Bargaining power of consumers also is higher when

the products being purchased are standard or undifferentiated. When this is the case, consum-

ers often can negotiate selling price, warranty coverage, and accessory packages to a greater

extent.

The bargaining power of consumers can be the most important force affecting

competitive advantage. Consumers gain increasing bargaining power under the following

circumstances:

1. If they can inexpensively switch to competing brands or substitutes

2. If they are particularly important to the seller

3. If sellers are struggling in the face of falling consumer demand

4. If they are informed about sellers’ products, prices, and costs

5. If they have discretion in whether and when they purchase the product9

Sources of External Information

A wealth of strategic information is available to organizations from both published and unpub-

lished sources. Unpublished sources include customer surveys, market research, speeches at pro-

fessional and shareholders’ meetings, television programs, interviews, and conversations with

stakeholders. Published sources of strategic information include periodicals, journals, reports,

government documents, abstracts, books, directories, newspapers, and manuals. The Internet has

made it easier for firms to gather, assimilate, and evaluate information.

There are many excellent websites for gathering strategic information, but six that the author

uses routinely are listed here:

1. http://marketwatch.multexinvestor.com

2. http://moneycentral.msn.com

3. http://finance.yahoo.com

4. www.clearstation.com

5. http://us.etrade.com/e/t/invest/markets

6. www.hoovers.com

7. http://globaledge.msu.edu/industries/

An excellent source of industry information is provided by Michigan State University at

http://globaledge.msu.edu/industries/ as indicated above. Industry Profiles provided at that site

are an excellent source for information, news, events, and statistical data for any industry. In

addition to a wealth of indices, risk assessments, and interactive trade information, a wide array

of global resources are provided.

Most college libraries subscribe to Standard & Poor’s (S&P’s) Industry Surveys. These

documents are exceptionally up-to-date and give valuable information about many different

industries. Each report is authored by a Standard & Poor’s industry research analyst and includes

the following sections:

1. Current Environment

2. Industry Trends

3. How the Industry Operates

4. Key Industry Ratios and Statistics

5. How to Analyze a Company

6. Glossary of Industry Terms

7. Additional Industry Information

8. References

9. Comparative Company Financial Analysis

Forecasting Tools and Techniques

Boeing announced in early 2011 that it forecasts China to need 4,330 new commercial air-

planes valued at $480 billion over the next 20 years, making China the world’s second-largest

airplane market after the United States. Boeing projects that China’s airplane market will grow

at nearly twice the rate of the rest of the industry globally. Based on these forecasts, Boeing

plans to grow its 52 percent airplane market share in China by producing more single-isle jet

planes.

Forecasts are educated assumptions about future trends and events. Forecasting is a complex

activity because of factors such as technological innovation, cultural changes, new products,

improved services, stronger competitors, shifts in government priorities, changing social values,

unstable economic conditions, and unforeseen events. Managers often must rely on published

forecasts to effectively identify key external opportunities and threats.

A sense of the future permeates all action and underlies every decision a person makes.

People eat expecting to be satisfied and nourished in the future. People sleep assuming that

in the future they will feel rested. They invest energy, money, and time because they believe

their efforts will be rewarded in the future. They build highways assuming that automobiles

and trucks will need them in the future. Parents educate children on the basis of forecasts that

they will need certain skills, attitudes, and knowledge when they grow up. The truth is we a

make implicit forecasts throughout our daily lives. The question, therefore, is not whether we

should forecast but rather how we can best forecast to enable us to move beyond our ordinarily

unarticulated assumptions about the future. Can we obtain information and then make educated

assumptions (forecasts) to better guide our current decisions to achieve a more desirable future

state of affairs? We should go into the future with our eyes and our minds open, rather than

stumble into the future with our eyes closed.10

Sometimes organizations must develop their own projections. Most organizations forecast

(project) their own revenues and profits annually. Organizations sometimes forecast market

share or customer loyalty in local areas. Because forecasting is so important in strategic manage-

ment and because the ability to forecast (in contrast to the ability to use a forecast) is essential,

selected forecasting tools are examined further here.

Forecasting tools can be broadly categorized into two groups: quantitative techniques and

qualitative techniques. Quantitative forecasts are most appropriate when historical data are

available and when the relationships among key variables are expected to remain the same in

the future. Linear regression, for example, is based on the assumption that the future will be

just like the past—which, of course, it never is. As historical relationships become less stable,

quantitative forecasts become less accurate.

No forecast is perfect, and some forecasts are even wildly inaccurate. This fact accents the

need for strategists to devote sufficient time and effort to study the underlying bases for published

forecasts and to develop internal forecasts of their own. Key external opportunities and threats

can be effectively identified only through good forecasts. Accurate forecasts can provide major

competitive advantages for organizations. Forecasts are vital to the strategic-management process

and to the success of organizations.

Making Assumptions

Planning would be impossible without assumptions. McConkey defines assumptions as the “best

present estimates of the impact of major external factors, over which the manager has little if

any control, but which may exert a significant impact on performance or the ability to achieve

desired results.”11 Strategists are faced with countless variables and imponderables that can be

neither controlled nor predicted with 100 percent accuracy. Wild guesses should never be made

in formulating strategies, but reasonable assumptions based on available information must

always be made.

By identifying future occurrences that could have a major effect on the firm and by mak-

ing reasonable assumptions about those factors, strategists can carry the strategic-management

process forward. Assumptions are needed only for future trends and events that are most likely

to have a significant effect on the company’s business. Based on the best information at the time,

assumptions serve as checkpoints on the validity of strategies. If future occurrences deviate

significantly from assumptions, strategists know that corrective actions may be needed. Without

reasonable assumptions, the strategy-formulation process could not proceed effectively. Firms

that have the best information generally make the most accurate assumptions, which can lead to

major competitive advantages.

Industry Analysis: The External Factor

Evaluation (EFE) Matrix

An External Factor Evaluation (EFE) Matrix allows strategists to summarize and evaluate eco-

nomic, social, cultural, demographic, environmental, political, governmental, legal, technologi-

cal, and competitive information. Illustrated in Table 3-10, the EFE Matrix can be developed in

five steps:

1. List key external factors as identified in the external-audit process. Include a total of 15 to 20

factors, including both opportunities and threats, that affect the firm and its industry. List the

opportunities first and then the threats. Be as specific as possible, using percentages, ratios,

and comparative numbers whenever possible. Recall that Edward Deming said, “In God we

trust. Everyone else bring data.”

2. Assign to each factor a weight that ranges from 0.0 (not important) to 1.0 (very impor-

tant). The weight indicates the relative importance of that factor to being successful in

the firm’s industry. Opportunities often receive higher weights than threats, but threats

can receive high weights if they are especially severe or threatening. Appropriate weights

can be determined by comparing successful with unsuccessful competitors or by discuss-

ing the factor and reaching a group consensus. The sum of all weights assigned to the

factors must equal 1.0.

3. Assign a rating between 1 and 4 to each key external factor to indicate how effectively the

firm’s current strategies respond to the factor, where 4 = the response is superior, 3 = the

response is above average, 2 = the response is average, and 1 = the response is poor. Ratings

are based on effectiveness of the firm’s strategies. Ratings are thus company-based, whereas

the weights in Step 2 are industry-based. It is important to note that both threats and opportu-

nities can receive a 1, 2, 3, or 4.

4. Multiply each factor’s weight by its rating to determine a weighted score.

5. Sum the weighted scores for each variable to determine the total weighted score for the

organization.

Regardless of the number of key opportunities and threats included in an EFE Matrix, the

highest possible total weighted score for an organization is 4.0 and the lowest possible total

weighted score is 1.0. The average total weighted score is 2.5. A total weighted score of 4.0

indicates that an organization is responding in an outstanding way to existing opportunities and

threats in its industry. In other words, the firm’s strategies effectively take advantage of exist-

ing opportunities and minimize the potential adverse effects of external threats. A total score of

1.0 indicates that the firm’s strategies are not capitalizing on opportunities or avoiding external

threats.

An example of an EFE Matrix is provided in Table 3-10 for a local 10-theater cinema com-

plex. Note that the most important factor to being successful in this business is “Trend toward

healthy eating eroding concession sales” as indicated by the 0.12 weight. Also note that the lo-

cal cinema is doing excellent in regard to handling two factors, “TDB University is expanding

6 percent annually” and “Trend toward healthy eating eroding concession sales.” Perhaps the

cinema is placing flyers on campus and also adding yogurt and healthy drinks to its concession

menu. Note that you may have a 1, 2, 3, or 4 anywhere down the Rating column. Note also

that the factors are stated in quantitative terms to the extent possible, rather than being stated in

vague terms. Quantify the factors as much as possible in constructing an EFE Matrix. Finally,

note that the total weighted score of 2.58 is above the average (midpoint) of 2.5, so this cinema

business is doing pretty well, taking advantage of the external opportunities and avoiding the

threats facing the firm. There is definitely room for improvement, though, because the highest

total weighted score would be 4.0. As indicated by ratings of 1, this business needs to capital-

ize more on the “two new neighborhoods nearby” opportunity and the “movies rented from

Time Warner” threat. Note also that there are many percentage-based factors among the group.

Be quantitative to the extent possible! Note also that the ratings range from 1 to 4 on both the

opportunities and threats.

An External Factor Evaluation (EFE) Matrix for UPS, Inc. is provided in Table 3-11. Note

that “customers outsourcing their supply chain” and “foreign currency obligations” were con-

sidered by this researcher to be the most important factors in this industry, as indicated by the

0.10 weight values. UPS does best however on opportunity #1 and #4. Overall, UPS does better

internally than externally since the total score of 2.59 is a bit less than the upcoming analogous

IFE Matrix in the next chapter.

The Competitive Profile Matrix (CPM)

The Competitive Profile Matrix (CPM) identifies a firm’s major competitors and its particular

strengths and weaknesses in relation to a sample firm’s strategic position. The weights and

total weighted scores in both a CPM and an EFE have the same meaning. However, criti-

cal success factors in a CPM include both internal and external issues; therefore, the ratings

refer to strengths and weaknesses, where 4 = major strength, 3 = minor strength, 2 = minor

weakness, and 1 = major weakness. The critical success factors in a CPM are not grouped

into opportunities and threats as they are in an EFE. In a CPM, the ratings and total weighted

scores for rival firms can be compared to the sample firm. This comparative analysis provides

important internal strategic information. Avoid assigning the same rating to firms included in

your CPM analysis.

A sample Competitive Profile Matrix is provided in Table 3-12. In this example, the two

most important factors to being successful in the industry are “advertising” and “global expan-

sion,” as indicated by weights of 0.20. If there were no weight column in this analysis, note that

each factor then would be equally important. Thus, having a weight column makes for a more

robust analysis, because it enables the analyst to assign higher and lower numbers to capture

perceived or actual levels of importance. Note in Table 3-12 that Company 1 is strongest on

“product quality,” as indicated by a rating of 4, whereas Company 2 is strongest on “advertis-

ing.” Overall, Company 1 is strongest, as indicated by the total weighted score of 3.15 and

Company 3 is weakest.

Other than the critical success factors listed in the example CPM, factors often included in

this analysis include breadth of product line, effectiveness of sales distribution, proprietary or

patent advantages, location of facilities, production capacity and efficiency, experience, union

relations, technological advantages, and e-commerce expertise.

A word on interpretation: Just because one firm receives a 3.20 rating and another

receives a 2.80 rating in a Competitive Profile Matrix, it does not follow that the first firm

is 20 percent better than the second. Numbers reveal the relative strengths of firms, but their

implied precision is an illusion. Numbers are not magic. The aim is not to arrive at a single

number, but rather to assimilate and evaluate information in a meaningful way that aids in

decision making.

Another Competitive Profile Matrix is provided in Table 3-13. Note that Company 2 has

the best product quality and management experience; Company 3 has the best market share and

inventory system; and Company 1 has the best price as indicated by the ratings. Again, avoid

assigning duplicate ratings on any row in a CPM instead of robotically going through the weights and ratings (which by the way are critically im-

portant), highlight various factors in light of where you are leading the firm. Make it abundantly

clear in your discussion how your firm, with your suggestions, can subdue rival firms or at least

profitably compete with them. Showcase during this section of your project the key underlying

reasons how and why your firm can prosper among rivals. Remember to be prescriptive, rather

than descriptive, in the manner that you present your entire project. If presenting your project

orally, be self confident and passionate rather than timid and uninterested. Definitely “bring the

data” throughout your project because “vagueness” is the most common downfall of students in

case analyses.

Conclusion

Increasing turbulence in markets and industries around the world means the external audit

has become an explicit and vital part of the strategic-management process. This chapter pro-

vides a framework for collecting and evaluating economic, social, cultural, demographic,

environmental, political, governmental, legal, technological, and competitive information.

Firms that do not mobilize and empower their managers and employees to identify, monitor,

forecast, and evaluate key external forces may fail to anticipate emerging opportunities and

threats and, consequently, may pursue ineffective strategies, miss opportunities, and invite

organizational demise. Firms not taking advantage of e-commerce and social media networks

are technologically falling behind.

A major responsibility of strategists is to ensure development of an effective external-audit

system. This includes using information technology to devise a competitive intelligence system

that works. The external-audit approach described in this chapter can be used effectively by any

size or type of organization. Typically, the external-audit process is more informal in small firms,

but the need to understand key trends and events is no less important for these firms. The EFE

Matrix and Porter’s Five-Forces Model can help strategists evaluate the market and industry,

but these tools must be accompanied by good intuitive judgment. Multinational firms especially

need a systematic and effective external-audit system because external forces among foreign

countries vary so greatly. Page 85

Chapter 4

“NOTABLE QUOTES”

This chapter focuses on identifying and evaluating a firm’s strengths and weaknesses in the

functional areas of business, including management, marketing, finance/accounting, production/

operations, research and development, and management information systems. Relationships

among these areas of business are examined. Strategic implications of important functional area

concepts are examined. The process of performing an internal audit is described. The Resource-

Based View (RBV) of strategic management is introduced as is the Value Chain Analysis (VCA)

concept. Pearson PLC, publisher of this textbook, does an excellent job using its strengths to

capitalize upon external opportunities. Pearson is showcased in the opening chapter boxed insert.

The Nature of an Internal Audit

All organizations have strengths and weaknesses in the functional areas of business. No enter-

prise is equally strong or weak in all areas. Maytag, for example, is known for excellent produc-

tion and product design, whereas Procter & Gamble is known for superb marketing. Internal

strengths/weaknesses, coupled with external opportunities/threats and a clear statement of

mission, provide the basis for establishing objectives and strategies. Objectives and strategies

are established with the intention of capitalizing upon internal strengths and overcoming weak-

nesses. The internal-audit part of the strategic-management process is illustrated in Figure 4-1.

Key Internal Forces

It is not possible in a strategic-management text to review in depth all the material presented

in courses such as marketing, finance, accounting, management, management information

systems, and production/operations; there are many subareas within these functions, such as

customer service, warranties, advertising, packaging, and pricing under marketing.

For different types of organizations, such as hospitals, universities, and government agen-

cies, the functional business areas, of course, differ. In a hospital, for example, functional areas

may include cardiology, hematology, nursing, maintenance, physician support, and receivables.

Functional areas of a university can include athletic programs, placement services, housing,

fund-raising, academic research, counseling, and intramural programs. Within large organiza-

tions, each division has certain strengths and weaknesses.

A firm’s strengths that cannot be easily matched or imitated by competitors are called

distinctive competencies. Building competitive advantages involves taking advantage of distinctive

competencies. For example, the firm Research in Motion (RIM) exploits its distinctive compe-

tence in research and development by producing a wide range of innovative products. Strategies

are designed in part to improve on a firm’s weaknesses, turning them into strengths—and maybe

even into distinctive competencies.

The Process of Performing an Internal Audit

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. The internal audit requires gather-

ing and assimilating information about the firm’s management, marketing, finance/accounting,

production/operations, research and development (R&D), and management information systems

operations. Key factors should be prioritized as described in Chapter 3 so that the firm’s most

important strengths and weaknesses can be determined collectively.

Compared to the external audit, the process of performing an internal audit provides more

opportunity for participants to understand how their jobs, departments, and divisions fit into the

whole organization. This is a great benefit because managers and employees perform better when

they understand how their work affects other areas and activities of the firm. For example, when

marketing and manufacturing managers jointly discuss issues related to internal strengths and

weaknesses, they gain a better appreciation of the issues, problems, concerns, and needs of all the

functional areas. In organizations that do not use strategic management, marketing, finance, and

manufacturing managers often do not interact with each other in significant ways. Performing an

internal audit thus is an excellent vehicle or forum for improving the process of communication in

the organization. Communication may be the most important word in management.

Performing an internal audit requires gathering, assimilating, and evaluating information

about the firm’s operations. Critical success factors, consisting of both strengths and weak-

nesses, can be identified and prioritized in the manner discussed in Chapter 3. According to

William King, a task force of managers from different units of the organization, supported by

staff, should be charged with determining the 10 to 20 most important strengths and weaknesses

that should influence the future of the organization. He says:

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 that

has been developed by an organization as it learns to cope with its problem of external adapta-

tion and internal integration, and 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.”6 This definition empha-

sizes the importance of matching external with internal factors in making strategic decisions.

Organizational culture captures the subtle, elusive, and largely unconscious forces that

shape a workplace. Remarkably resistant to change, culture can represent a major strength or

weakness for the firm. It can be an underlying reason for strengths or weaknesses in any of the

major business functions.

Defined in Table 4-1, cultural products include values, beliefs, rites, rituals, ceremonies,

myths, stories, legends, sagas, language, metaphors, symbols, heroes, and heroines. These prod-

ucts or dimensions are levers that strategists can use to influence and direct strategy formulation,

implementation, and evaluation activities. An organization’s culture compares to an individual’s

personality in the sense that no two organizations have the same culture and no two individuals

have the same personality. Both culture and personality are enduring and can be warm, aggres-

sive, friendly, open, innovative, conservative, liberal, harsh, or likable.

At Google, the culture is very informal. Employees are encouraged to wander the halls

on employee-sponsored scooters and brainstorm on public whiteboards provided everywhere.

In contrast, the culture at Procter & Gamble (P&G) is so rigid that employees jokingly call

themselves “Proctoids.” Despite this difference, the two companies are swapping employees

and participating in each other’s staff training sessions. Why? Because P&G spends more

money on advertising than any other company and Google desires more of P&G’s $8.7 bil-

lion in annual advertising expenses; P&G has come to realize that the next generation of

laundry-detergent, toilet-paper, and skin-cream customers now spend more time online than

watching TV.

Dimensions of organizational culture permeate all the functional areas of business. It is

something of an art to uncover the basic values and beliefs that are deeply buried in an organiza-

tion’s rich collection of stories, language, heroes, and rituals, but cultural products can represent

both important strengths and weaknesses. Culture is an aspect of an organization that can no lon-

ger be taken for granted in performing an internal strategic-management audit because culture

and strategy must work together.

Table 4-2 provides some example (possible) aspects of an organization’s culture. Note you

could ask employees/managers to rate the degree that the dimension characterizes the firm.

When one firm acquires another firm, integrating the two cultures can be important. For ex-

ample, in Table 4-2, one firm may score mostly 1’s (low) and the other firm may score mostly

5’s (high), which would present a challenging strategic problem.

The strategic-management process takes place largely within a particular organization’s

culture. Lorsch found that executives in successful companies are emotionally committed to

the firm’s culture, but he concluded that culture can inhibit strategic management in two basic

ways. First, managers frequently miss the significance of changing external conditions because

they are blinded by strongly held beliefs. Second, when a particular culture has been effective

in the past, the natural response is to stick with it in the future, even during times of major

strategic change.7 An organization’s culture must support the collective commitment of its

people to a common purpose. It must foster competence and enthusiasm among managers and

employees.

Organizational culture significantly affects business decisions and thus must be evaluated

during an internal strategic-management audit. If strategies can capitalize on cultural strengths,

such as a strong work ethic or highly ethical beliefs, then management often can swiftly and eas-

ily implement changes. However, if the firm’s culture is not supportive, strategic changes may

be ineffective or even counterproductive. A firm’s culture can become antagonistic to new strate-

gies, with the result being confusion and disorientation.

Management

The functions of management consist of five basic activities: planning, organizing, motivating,

staffing, and controlling. An overview of these activities is provided in Table 4-3. These ac-

tivities are important to assess in strategic planning because an organization should continually

capitalize on its management strengths and improve on its management weak areas.

Planning

The only thing certain about the future of any organization is change, and planning is the essen-

tial bridge between the present and the future that increases the likelihood of achieving desired

results. Planning is the process by which one determines whether to attempt a task, works out

the most effective way of reaching desired objectives, and prepares to overcome unexpected

difficulties with adequate resources. Planning is the start of the process by which an individual

or business may turn empty dreams into achievements. Planning enables one to avoid the trap of

working extremely hard but achieving little.

Planning is an up-front investment in success. Planning helps a firm achieve maximum effect

from a given effort. Planning enables a firm to take into account relevant factors and focus on the

critical ones. Planning helps ensure that the firm can be prepared for all reasonable eventualities

and for all changes that will be needed. Planning enables a firm to gather the resources needed and

carry out tasks in the most efficient way possible. Planning enables a firm to conserve its own re-

sources, avoid wasting ecological resources, make a fair profit, and be seen as an effective, useful

firm. Planning enables a firm to identify precisely what is to be achieved and to detail precisely the

who, what, when, where, why, and how needed to achieve desired objectives. Planning enables a

firm to assess whether the effort, costs, and implications associated with achieving desired objec-

tives are warranted.9 Planning is the cornerstone of effective strategy formulation. But even though

it is considered the foundation of management, it is commonly the task that managers neglect

most. Planning is essential for successful strategy implementation and strategy evaluation, largely

because organizing, motivating, staffing, and controlling activities depend upon good planning.

The process of planning must involve managers and employees throughout an organiza-

tion. The time horizon for planning decreases from two to five years for top-level to less than

six months for lower-level managers. The important point is that all managers do planning and

should involve subordinates in the process to facilitate employee understanding and commitment.

Planning can have a positive impact on organizational and individual performance. Planning

allows an organization to identify and take advantage of external opportunities as well as mini-

mize the impact of external threats. Planning is more than extrapolating from the past and present

into the future (long range planning). It also includes developing a mission, forecasting future

events and trends, establishing objectives, and choosing strategies to pursue (strategic planning).

An organization can develop synergy through planning. Synergy exists when everyone

pulls together as a team that knows what it wants to achieve; synergy is the 2 + 2 = 5 effect. By

establishing and communicating clear objectives, employees and managers can work together

toward desired results. Synergy can result in powerful competitive advantages. The strategic-

management process itself is aimed at creating synergy in an organization.

Planning allows a firm to adapt to changing markets and thus to shape its own destiny.

Strategic management can be viewed as a formal planning process that allows an organization to

pursue proactive rather than reactive strategies. Successful organizations strive to control their

own futures rather than merely react to external forces and events as they occur. Historically,

organisms and organizations that have not adapted to changing conditions have become extinct.

Swift adaptation is needed today more than ever because changes in markets, economies, and

competitors worldwide are accelerating. Many firms did not adapt to the global recession of late

and went out of business.

Organizing

The purpose of organizing is to achieve coordinated effort by defining task and authority rela-

tionships. Organizing means determining who does what and who reports to whom. There are

countless examples in history of well-organized enterprises successfully competing against—

and in some cases defeating—much stronger but less-organized firms. A well-organized firm

generally has motivated managers and employees who are committed to seeing the organization

succeed. Resources are allocated more effectively and used more efficiently in a well-organized

firm than in a disorganized firm.

The organizing function of management can be viewed as consisting of three sequential

activities: breaking down tasks into jobs (work specialization), combining jobs to form depart-

ments (departmentalization), and delegating authority. Breaking down tasks into jobs requires

the development of job descriptions and job specifications. These tools clarify for both managers

and employees what particular jobs entail. In The Wealth of Nations, published i

Motivating

Motivating can be defined as the process of influencing people to accomplish specific objec-

tives.11 Motivation explains why some people work hard and others do not. Objectives, strate-

gies, and policies have little chance of succeeding if employees and managers are not motivated

to implement strategies once they are formulated. The motivating function of management

includes at least four major components: leadership, group dynamics, communication, and orga-

nizational change.

When managers and employees of a firm strive to achieve high levels of productivity, this

indicates that the firm’s strategists are good leaders. Good leaders establish rapport with subor-

dinates, empathize with their needs and concerns, set a good example, and are trustworthy and

fair. Leadership includes developing a vision of the firm’s future and inspiring people to work

hard to achieve that vision. Kirkpatrick and Locke reported that certain traits also characterize

effective leaders: knowledge of the business, cognitive ability, self-confidence, honesty, integ-

rity, and drive.12

Staffing

The management function of staffing, also called personnel management or human resource

management, includes activities such as recruiting, interviewing, testing, selecting, orienting,

training, developing, caring for, evaluating, rewarding, disciplining, promoting, transferring,

demoting, and dismissing employees, as well as managing union relations.

Staffing activities play a major role in strategy-implementation efforts, and for this reason,

human resource managers are becoming more actively involved in the strategic-management

process. It is important to identify strengths and weaknesses in the staffing area.

The complexity and importance of human resource activities have increased to such a

degree that all but the smallest organizations now need a full-time human resource manager.

Numerous court cases that directly affect staffing activities are decided each day. Organizations

and individuals can be penalized severely for not following federal, state, and local laws and

guidelines related to staffing. Line managers simply cannot stay abreast of all the legal devel-

opments and requirements regarding staffing. The human resources department coordinates

staffing decisions in the firm so that an organization as a whole meets legal requirements. This

department also provides needed consistency in administering company rules, wages, policies,

and employee benefits as well as collective bargaining with unions.

Human resource management is particularly challenging for international companies. For

example, the inability of spouses and children to adapt to new surroundings can be a staffing

problem in overseas transfers. The problems include premature returns, job performance slumps,

resignations, discharges, low morale, marital discord, and general discontent. Firms such as Ford

Motor and ExxonMobil screen and interview spouses and children before assigning persons to

overseas positions. 3M Corporation introduces children to peers in the target country and offers

spouses educational benefits.

Controlling

The controlling function of management includes all of those activities undertaken to ensure

that actual operations conform to planned operations. All managers in an organization have

controlling responsibilities, such as conducting performance evaluations and taking necessary

action to minimize inefficiencies. The controlling function of management is particularly impor-

tant for effective strategy evaluation. Controlling consists of four basic steps:

1. Establishing performance standards

2. Measuring individual and organizational performance

3. Comparing actual performance to planned performance standards

4. Taking corrective actions

Measuring individual performance is often conducted ineffectively or not at all in organi-

zations. Some reasons for this shortcoming are that evaluations can create confrontations that

most managers prefer to avoid, can take more time than most managers are willing to give, and

can require skills that many managers lack. No single approach to measuring individual perfor-

mance is without limitations. For this reason, an organization should examine various methods,

such as the graphic rating scale, the behaviorally anchored rating scale, and the critical incident

method, and then develop or select a performance-appraisal approach that best suits the firm’s

needs. Increasingly, firms are striving to link organizational performance with managers’ and

employees’ pay. This topic is discussed further in Chapter 7.

Marketing

Marketing can be described as the process of defining, anticipating, creating, and fulfill-

ing 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.15

Understanding these functions helps strategists identify and evaluate marketing strengths and

weaknesses.

Customer Analysis

Customer analysis—the examination and evaluation of consumer needs, desires, and wants—

involves administering customer surveys, analyzing consumer information, evaluating market

positioning strategies, developing customer profiles, and determining optimal market segmenta-

tion strategies. The information generated by customer analysis can be essential in developing

an effective mission statement. Customer profiles can reveal the demographic characteristics of

an organization’s customers. Buyers, sellers, distributors, salespeople, managers, wholesalers,

retailers, suppliers, and creditors can all participate in gathering information to successfully

identify customers’ needs and wants. Successful organizations continually monitor present and

potential customers’ buying patterns.

Selling Products/Services

Successful strategy implementation generally rests upon the ability of an organization to sell

some product or service. Selling includes many marketing activities, such as advertising, sales

promotion, publicity, personal selling, sales force management, customer relations, and dealer

relations. These activities are especially critical when a firm pursues a market penetration

strategy. The effectiveness of various selling tools for consumer and industrial products varies.

Personal selling is most important for industrial goods companies, whereas advertising is most

important for consumer goods companies.

Internet advertising revenues received from firms such as Google, Amazon, Yahoo, and

Facebook reached a record $12.1 billion in the first half of 2010, up more than 11 percent from

the first half of the prior year, according to the Interactive Advertising Bureau. In contrast,

newspaper advertising in 2010 totaled $7.3 billion, down 4.7 percent from the prior year and the

lowest total since 1985.

Total advertising expenditures in the United States in 2011 is expected to be $155.2 bil-

lion, up 2.5 percent from the prior year. Global ad spending, however, is forecast to increase 4.2

percent to $470.8 billion. ZenithOptimedia expects the largest ad spending increases in the U.S.

in 2011 to flow to the Internet, which is projected to increase 13 percent. One aspect of ads in a

recession is that they generally take more direct aim at competitors, and this marketing practice

is holding true in our bad economic times. Nick Brien at Mediabrands says, “Ads have to get

combative in bad times. It’s a dog fight, and it’s about getting leaner and meaner.” Ads are less

lavish and glamorous today and are also more interactive. Table 4-4 lists specific characteristics

of ads forthcoming in 2012 in response to the economic hard times many people nationwide and

worldwide are facing.

Marketers spent between $2.8 and $3 million per 30-second advertising spot during the

2011 Super Bowl between the Pittsburg Steelers and Green Bay Packers. Advertising can be

very expensive, and that is why marketing is a major business function to be studied carefully.

Without marketing, even the best products and services have little chance of being successful.

A private company and the world’s largest social network, Facebook, may epitomize where

the advertising industry is going. Facebook subtly injects the advertiser’s brand into the user’s

consciousness in order to provoke a purchase down the line by getting you to “like” the brand.

Companies such as Ford, 7-Eleven, and McDonald’s have recently unveiled new products on

their Facebook pages. Starbucks offers coupons and free pastries to its 14 million Facebook

fans. BP used its Facebook page to release statements and photos during the Gulf Oil Crisis.

Anton Vincent, marketing vice president for General Mills’ baking products division, says that

Facebook allows a company to “leverage the loyalty” of its best customers. If you have recently

gotten engaged and updated your Facebook status, you may start seeing ads from local jewelers

who have used Facebook’s automated ad system to target you. Facebook enables any firm today

to very effectively target their exact audience with perfect advertising.16 In performing a strate-

gic planning analysis, in addition to comparing rival firms’ websites, it is important to compare

rival firms’ Facebook page.

One of the last off-limit advertising outlets has historically been books, but with the prolif-

eration of e-books, marketers are experimenting more and more with advertising to consumers

as they read e-books. New ads are being targeted based on the book’s content and the demo-

graphic profile of the reader. Digital e-book companies such as Wowio and Amazon are trying to

insert ads between chapters and along borders of digital pages. Random House says its e-books

will soon include ads, but only with author approval. Global advertising expenditures are ex-

pected to grow 4.6 percent in 2011 and a bit more in 2012.

Determining organizational strengths and weaknesses in the selling function of marketing is

an important part of performing an internal strategic-management audit. With regard to advertis-

ing products and services on the Internet, a new trend is to base advertising rates exclusively on

sales rates. This new accountability contrasts sharply with traditional broadcast and print adver-

tising, which bases rates on the number of persons expected to see a given advertisement. The

new cost-per-sale online advertising rates are possible because any website can monitor which

user clicks on which advertisement and then can record whether that consumer actually buys the

product. If there are no sales, then the advertisement is free.

Product and Service Planning

Product and service planning includes activities such as test marketing; product and brand

positioning; devising warranties; packaging; determining product options, features, style, and

quality; deleting old products; and providing for customer service. Product and service planning

is particularly important when a company is pursuing product development or diversification.

One of the most effective product and service planning techniques is test marketing. Test

markets allow an organization to test alternative marketing plans and to forecast future sales of

new products. In conducting a test market project, an organization must decide how many cities

to include, which cities to include, how long to run the test, what information to collect during

the test, and what action to take after the test has been completed. Test marketing is used more

frequently by consumer goods companies than by industrial goods companies. Test marketing

can allow an organization to avoid substantial losses by revealing weak products and ineffective

marketing approaches before large-scale production begins. Starbucks is currently test market-

ing selling beer and wine in its stores to boost its “after 5 pm” sales. Page 106

Pricing

Five major stakeholders affect pricing decisions: consumers, governments, suppliers, distribu-

tors, and competitors. Sometimes an organization will pursue a forward integration strategy

primarily to gain better control over prices charged to consumers. Governments can impose

constraints on price fixing, price discrimination, minimum prices, unit pricing, price advertis-

ing, and price controls. For example, the Robinson-Patman Act prohibits manufacturers and

wholesalers from discriminating in price among channel member purchasers (suppliers and

distributors) if competition is injured.

Competing organizations must be careful not to coordinate discounts, credit terms, or con-

dition of sale; not to discuss prices, markups, and costs at trade association meetings; and not to

arrange to issue new price lists on the same date, to rotate low bids on contracts, or to uniformly

restrict production to maintain high prices. Strategists should view price from both a short-run

and a long-run perspective, because competitors can copy price changes with relative ease.

Often a dominant firm will aggressively match all price cuts by competitors.

With regard to pricing, as the value of the dollar increases, U.S. multinational companies

have a choice. They can raise prices in the local currency of a foreign country or risk losing sales

and market share. Alternatively, multinational firms can keep prices steady and face reduced

profit when their export revenue is reported in the United States in dollars.

Intense price competition, coupled with Internet price-comparative shopping, has reduced

profit margins to bare minimum levels for most companies. For example, airline tickets, rental

car prices, hotel room rates, and computer prices are lower today than they have been in many

years.

PepsiCo. Inc. recently raised prices for its Tropicana juice line by up to 8 percent after the

2011 harsh winter crushed Florida’s citrus crop in many places. Also due to especially cold

winters hurting citrus crops, Coca-Cola Co. recently raised prices of their Minute Maid and

Simply Juice brands. Fruit and vegetable prices are rising dramatically all over the world as a

result not only of harsh winters, but also rising gas prices, which significantly increases the cost

of transporting perishable products. The rapid rise in food commodity prices is attributed as

one reason why regimes in Tunisia, Egypt, Yemen, and Libya toppled. Global populations are

growing, becoming more prosperous and informed, and draining stockpiles of grain and meat.

Corn inventories are used in food, feed, and fuel, and that reserve fell to just 50 days recently,

a 37-year low. Soybean stockpiles worldwide are the lowest in two decades. Consumers world-

wide are seeing high food prices at supermarkets.

Distribution

Distribution includes warehousing, distribution channels, distribution coverage, retail site loca-

tions, sales territories, inventory levels and location, transportation carriers, wholesaling, and

retailing. Most producers today do not sell their goods directly to consumers. Various marketing

entities act as intermediaries; they bear a variety of names such as wholesalers, retailers, brokers,

facilitators, agents, vendors—or simply distributors.

Distribution becomes especially important when a firm is striving to implement a market

development or forward integration strategy. Some of the most complex and challenging deci-

sions facing a firm concern product distribution. Intermediaries flourish in our economy be-

cause many producers lack the financial resources and expertise to carry out direct marketing.

Manufacturers who could afford to sell directly to the public often can gain greater returns by

expanding and improving their manufacturing operations.

Successful organizations identify and evaluate alternative ways to reach their ultimate mar-

ket. Possible approaches vary from direct selling to using just one or many wholesalers and re-

tailers. Strengths and weaknesses of each channel alternative should be determined according to

economic, control, and adaptive criteria. Organizations should consider the costs and benefits of

various wholesaling and retailing options. They must consider the need to motivate and control

channel members and the need to adapt to changes in the future. Once a marketing channel is

chosen, an organization usually must adhere to it for an extended period of time.

Marketing Research

Marketing research is the systematic gathering, recording, and analyzing of data about prob-

lems relating to the marketing of goods and services. Marketing research can uncover critical

strengths and weaknesses, and marketing researchers employ numerous scales, instruments,

procedures, concepts, and techniques to gather information. Marketing research activities sup-

port all of the major business functions of an organization. Organizations that possess excellent

marketing research skills have a definite strength in pursuing generic strategies. The president of

PepsiCo said,

Cost/Benefit Analysis

The seventh function of marketing is cost/benefit analysis, which involves assessing the costs,

benefits, and risks associated with marketing decisions. Three steps are required to perform a

cost/benefit analysis: (1) compute the total costs associated with a decision, (2) estimate the total

benefits from the decision, and (3) compare the total costs with the total benefits. When expected

benefits exceed total costs, an opportunity becomes more attractive. Sometimes the variables

included in a cost/benefit analysis cannot be quantified or even measured, but usually reasonable

estimates can be made to allow the analysis to be performed. One key factor to be considered is

risk. Cost/benefit analysis should also be performed when a company is evaluating alternative

ways to be socially responsible.

The practice of cost/benefit analysis differs among countries and industries. Some of the

main differences include the types of impacts that are included as costs and benefits within ap-

praisals, the extent to which impacts are expressed in monetary terms, and differences in the

discount rate. Government agencies across the world rely on a basic set of key cost/benefit

indicators, including the following:

1. NPV (net present value)

2. PVB (present value of benefits)

3. PVC (present value of costs)

4. BCR (benefit cost ratio = PVB / PVC)

5. Net benefit (= PVB – PVC)

6. NPV/k (where k is the level of funds available)18

Marketing Audit Checklist of Questions

The following questions about marketing must be examined in strategic planning:

1. Are markets segmented effectively?

2. Is the organization positioned well among competitors?

3. Has the firm’s market share been increasing?

4. Are present channels of distribution reliable and cost effective?

5. Does the firm have an effective sales organization?

6. Does the firm conduct market research?

7. Are product quality and customer service good?

8. Are the firm’s products and services priced appropriately?

9. Does the firm have an effective promotion, advertising, and publicity strategy?

10. Are marketing, planning, and budgeting effective?

11. Do the firm’s marketing managers have adequate experience and training?

12. Is the firm’s Internet presence excellent as compared to rivals?

Finance/Accounting

Financial condition is often considered the single best measure of a firm’s competitive position

and overall attractiveness to investors. Determining an organization’s financial strengths and

weaknesses is essential to effectively formulating strategies. A firm’s liquidity, leverage, work-

ing capital, profitability, asset utilization, cash flow, and equity can eliminate some strategies

as being feasible alternatives. Financial factors often alter existing strategies and change imple-

mentation plans.

Especially good websites from which to obtain financial information about firms are pro-

vided in Table 4-5.

Finance/Accounting Functions

According to James Van Horne, the functions of finance/accounting comprise three decisions:

the investment decision, the financing decision, and the dividend decision.19 Financial ratio

analysis is the most widely used method for determining an organization’s strengths and weak-

nesses 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, mar-

keting, production, research and development, and management information systems activities.

Financial ratios are equally applicable in for-profit and nonprofit organizations. Even though

nonprofit organizations obviously would not have return-on-investment or earnings-per-share

ratios, they would routinely monitor many other special ratios. For example, a church would

monitor the ratio of dollar contributions to number of members, while a zoo would monitor

dollar food sales to number of visitors. A university would monitor number of students divided

by number of professors. Therefore, be creative when performing ratio analysis for nonprofit

organizations because they strive to be financially sound just as for-profit firms do.

The investment decision, also called capital budgeting, is the allocation and reallocation

of capital and resources to projects, products, assets, and divisions of an organization. Once

strategies are formulated, capital budgeting decisions are required to successfully implement

strategies. The financing decision determines the best capital structure for the firm and includes

examining various methods by which the firm can raise capital (for example, by issuing stock,

increasing debt, selling assets, or using a combination of these approaches). The financing deci-

sion must consider both short-term and long-term needs for working capital. Two key financial

ratios that indicate whether a firm’s financing decisions have been effective are the debt-to-

equity ratio and the debt-to-total-assets ratio.

Dividend decisions concern issues such as the percentage of earnings paid to stockholders,

the stability of dividends paid over time, and the repurchase or issuance of stock. Dividend deci-

sions determine the amount of funds that are retained in a firm compared to the amount paid out

to stockholders. Three financial ratios that are helpful in evaluating a firm’s dividend decisions

are the earnings-per-share ratio, the dividends-per-share ratio, and the price-earnings ratio. The

benefits of paying dividends to investors must be balanced against the benefits of internally re-

taining funds, and there is no set formula on how to balance this trade-off. For the reasons listed

here, dividends are sometimes paid out even when funds could be better reinvested in the busi-

ness or when the firm has to obtain outside sources of capital:

1. Paying cash dividends is customary. Failure to do so could be thought of as a stigma. A

dividend change is considered a signal about the future.

2. Dividends represent a sales point for investment bankers. Some institutional investors can

buy only dividend-paying stocks.

3. Shareholders often demand dividends, even in companies with great opportunities for rein-

vesting all available funds.

4. A myth exists that paying dividends will result in a higher stock price.

Most companies have ceased cutting and instead are raising their dividend payout. General

Electric raised its quarterly dividend twice in 2010. Honeywell Inc. recently raised its annual

dividend 10 percent to $1.33 a share while Germany’s Siemens AG raised its dividend 68

percent to $3.57 a share. Siemens strives to pay out 30 to 50 percent of its net income to share-

holders. S&P says there were 59 dividend increases in the fourth quarter of 2010 alone, up 25

percent from 2009. S&P expects that more than 50 percent of the S&P 500 firms will raise their

dividend payout in 2011.20

McDonald’s has raised its dividend payout for 35 years in a row, including recent years.

Among all S&P 500 companies, 255 increased their dividends in 2010, up from 157 in 2009,

and that trend is accelerating as firms’ cash reserves grow. In addition to boosting dividend

payouts, companies are also buying back their own stock more often and in larger amounts.

Investors love dividends and other methods companies use to return capital to shareholders.

Other companies recently raising their dividend rate are Tyco International Ltd. (to $0.25 per

share per quarter from $0.21), Staples, Inc. (to $0.10 per quarter from $0.09), Prudential PLC (to

23.85 pence from 19.85), Bank of Nova Scotia (to C$0.52 from C$0.49 per share per quarter),

Qualcomm Inc. (from $0.19 to $0.215 per share per quarter), and Applied Materials, Inc.(to

$0.08 from $0.07 per share per quarter).

Basic Types of Financial Ratios

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, illustrated in Figure 4-3, is a useful technique that incorporates both the time and in-

dustry average dimensions of financial ratios. Note that the dotted lines reveal projected ratios.

Some websites, such as those provided in Table 4-5, calculate financial ratios and provide data

with charts. Page 110

roduction/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, transforma-

tions, 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. As indicated in Table 4-7, Roger Schroeder suggested that production/operations

management comprises five functions or decision areas: process, capacity, inventory, workforce,

and quality.

Most automakers require a 30-day notice to build vehicles, but Toyota Motor fills a buyer’s

new car order in just five days. Honda Motor was considered the industry’s fastest producer, fill-

ing orders in 15 days. Automakers have for years operated under just-in-time inventory systems,

but Toyota’s 360 suppliers are linked to the company via computers on a virtual assembly line.

The new Toyota production system was developed in the company’s Cambridge, Ontario, plant

and now applies to its Solara, Camry, Corolla, and Tacoma vehicles.

Production/operations activities often represent the largest part of an organization’s human

and capital assets. In most industries, the major costs of producing a product or service are in-

curred within operations, so production/operations can have great value as a competitive weapon

in a company’s overall strategy. Strengths and weaknesses in the five functions of production

can mean the success or failure of an enterprise.

Many production/operations managers are finding that cross-training of employees can help

their firms respond faster to changing markets. Cross-training of workers can increase efficiency,

quality, productivity, and job satisfaction. For example, at General Motors’ Detroit gear and axle

plant, costs related to product defects were reduced 400 percent in two years as a result of cross-

training workers. As shown in Table 4-8, James Dilworth outlined implications of several types

of strategic decisions that a company might make.

Singapore rivals Hong Kong as an attractive site for locating production facilities in

Southeast Asia. Singapore is a city-state near Malaysia. An island nation of about 4 million,

Singapore is changing from an economy built on trade and services to one built on information

technology. A large-scale program in computer education for older (over age 26) residents is

very popular. Singapore children receive outstanding computer training in schools. All govern-

ment services are computerized nicely. Singapore lures multinational businesses with great tax

breaks, world-class infrastructure, excellent courts that efficiently handle business disputes,

exceptionally low tariffs, large land giveaways, impressive industrial parks, excellent port facili-

ties, and a government very receptive to and cooperative with foreign businesses. Foreign firms

now account for 70 percent of manufacturing output in Singapore.

In terms of ship container traffic processed annually, Singapore has the largest and busiest

seaport in the world, followed by Hong Kong, Shanghai, Los Angeles, Busan (South Korea),

Rotterdam, Hamburg, New York, and Tokyo. The Singapore seaport is five times the size of the

New York City seaport.2 page 115

Research and Development

Apple Inc. continues to develop and sell new products such as the iPhone and iPad despite

spending less on R&D over the last 10 years than rival Microsoft did even in fiscal 2010 alone.23

Microsoft routinely spends 14 to 15 percent of its sales on R&D, or $8.7 billion in fiscal 2010,

compared to Apple every year spending about 2.5 percent of its annual sales on R&D. The cor-

relation between R&D expenditures and successful product launches is not high. Thus, firms

such as Research in Motion (RIM) and Nokia are reducing their R&D expenditures, especially

as a percent of sales. RIM is spending $1.35 billion in fiscal 2011 on R&D or about 6 percent of

revenues, compared to Nokia spending 13.8 percent of sales in 2010.

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.

Organizations invest in R&D because they believe that such an investment will lead to a

superior product or service and will give them competitive advantages. Research and develop-

ment expenditures are directed at developing new products before competitors do, at improving

product quality, or at improving manufacturing processes to reduce costs.

Effective management of the R&D function requires a strategic and operational partnership

between R&D and the other vital business functions. A spirit of partnership and mutual trust be-

tween general and R&D managers is evident in the best-managed firms today. Managers in these

firms jointly explore; assess; and decide the what, when, where, why, and how much of R&D.

Priorities, costs, benefits, risks, and rewards associated with R&D activities are discussed openly

and shared. The overall mission of R&D thus has become broad-based, including supporting

existing businesses, helping launch new businesses, developing new products, improving prod-

uct quality, improving manufacturing efficiency, and deepening or broadening the company’s

technological capabilities.24

The best-managed firms today seek to organize R&D activities in a way that breaks the

isolation of R&D from the rest of the company and promotes a spirit of partnership between

R&D managers and other managers in the firm. R&D decisions and plans must be integrated

and coordinated across departments and divisions by having the departments share experiences

and information. The strategic-management process facilitates this cross-functional approach to

managing the R&D function.

R&D spending at major corporations declined in 2009 for the first time in 10 years as the

worldwide recession hit most firms hard. Roche Holding AG led all firms in R&D spending at

$9.12 billion, followed by Microsoft at $9.01 billion and Nokia at $8.24 billion. Other large

spenders were Toyota Motor at $7.82 billion and Pfizer at $7.74 billion. Interestingly absent

among the top 10 R&D spenders, Apple spent about 3.1 percent of sales on R&D, roughly half

the typical level for computer and electronic companies. Booz and Co. partner Barry Jaruzelski

remarked that: “Apple succeeds because it has a deep understanding of consumers, is focused on

its projects ‘as opposed to trying to spread their bets,’ and attracts superior talent.”

nternal 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 deter-

mining 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. Many companies use both

approaches to develop new products. A widely used approach for obtaining outside R&D as-

sistance is to pursue a joint venture with another firm. R&D strengths (capabilities) and weak-

nesses (limitations) play a major role in strategy formulation and strategy implementation.

Most firms have no choice but to continually develop new and improved products because

of changing consumer needs and tastes, new technologies, shortened product life cycles, and

increased domestic and foreign competition. A shortage of ideas for new products, increased

global competition, increased market segmentation, strong special-interest groups, and in-

creased government regulations are several factors making the successful development of new

products more and more difficult, costly, and risky. In the pharmaceutical industry, for example,

only one out of every few thousand drugs created in the laboratory ends up on pharmacists’

shelves. Scarpello, Boulton, and Hofer emphasized that different strategies require different

R&D capabilities:

Management Information Systems

Nordstrom Inc. in recent years has tried to stay ahead of competitors by integrating its online

and in-store inventory systems, enabling consumers to see what is available in stores near them.

Nordstrom has a five-star rating system online to track what people think and say in social media

forums. Nordstrom just acquired HauteLook Inc., a fast-growing, online flash sales company

that offered luxury clothes at a discount.

Information ties all business functions together and provides the basis for all managerial

decisions. It is the cornerstone of all organizations. Information represents a major source of

competitive management advantage or disadvantage. Assessing a firm’s internal strengths and

weaknesses in information systems is a critical dimension of performing an internal audit.

A management information system’s purpose is to improve the performance of an enter-

prise by improving the quality of managerial decisions. An effective information system thus

collects, codes, stores, synthesizes, and presents information in such a manner that it answers

important operating and strategic questions. The heart of an information system is a database

containing the kinds of records and data important to managers.

A management information system receives raw material from both the external and internal

evaluation of an organization. It gathers data about marketing, finance, production, and person-

nel matters internally, and social, cultural, demographic, environmental, economic, political,

governmental, legal, technological, and competitive factors externally. Data are integrated in

ways needed to support managerial decision making.

There is a logical flow of material in a computer information system, whereby data are input

to the system and transformed into output. Outputs include computer printouts, written reports,

tables, charts, graphs, checks, purchase orders, invoices, inventory records, payroll accounts,

and a variety of other documents. Payoffs from alternative strategies can be calculated and esti-

mated. Data become information only when they are evaluated, filtered, condensed, analyzed,

and organized for a specific purpose, problem, individual, or time.

Even Wal-Mart recognizes the immense importance of information technology. In mid-

2011 Wal-Mart acquired Kosmix, a social media technology provider that has built a platform

that enables users to filter and organize content in social networks in order to connect people

with information that matters to them, in realtime. Kosmix powers a site called TweetBeat, es-

sentially a realtime social media filter for live events. Additionally, the technology is used to

power RightHealth, a popular health and medical information site. Kosmix is now operating as

part of a newly formed group named WalMartLabs, which is creating information technologies

and businesses around social and mobile commerce to support Wal-Mart’s multichannel strat-

egy. This acquisition blurs the line between offline and online shopping. Page 118

Management Information Systems Audit

Questions such as the following should be asked when conducting this audit:

1. Do all managers in the firm use the information system to make decisions?

2. Is there a chief information officer or director of information systems position in the firm

3. Are data in the information system updated regularly?

4. Do managers from all functional areas of the firm contribute input to the information

system?

5. Are there effective passwords for entry into the firm’s information system?

6. Are strategists of the firm familiar with the information systems of rival firms?

7. Is the information system user-friendly?

8. Do all users of the information system understand the competitive advantages that informa-

tion can provide firms?

9. Are computer training workshops provided for users of the information system?

10. Is the firm’s information system continually being improved in content and

user-friendliness?

Start 121

The Internal Factor Evaluation (IFE) Matrix

A summary step in conducting an internal strategic-management audit is to construct an Internal

Factor Evaluation (IFE) Matrix. This strategy-formulation tool summarizes and evaluates the

major strengths and weaknesses in the functional areas of a business, and it also provides a basis

for identifying and evaluating relationships among those areas. Intuitive judgments are required

in developing an IFE Matrix, so the appearance of a scientific approach should not be interpreted

to mean this is an all-powerful technique. A thorough understanding of the factors included is

more important than the actual numbers. Similar to the EFE Matrix and Competitive Profile

Matrix described in Chapter 3, an IFE Matrix can be developed in five steps:

1. List key internal factors as identified in the internal-audit process. Use a total of from 10 to

20 internal factors, including both strengths and weaknesses. List strengths first and then

weaknesses. Be as specific as possible, using percentages, ratios, and comparative num-

bers. Recall that Edward Deming said, “In God we trust. Everyone else bring data.”

2. Assign a weight that ranges from 0.0 (not important) to 1.0 (all-important) to each fac-

tor. The weight assigned to a given factor indicates the relative importance of the factor

to being successful in the firm’s industry. Regardless of whether a key factor is an in-

ternal strength or weakness, factors considered to have the greatest effect on organiza-

tional performance should be assigned the highest weights. The sum of all weights must

equal 1.0.

3. Assign a 1-to-4 rating to each factor to indicate whether that factor represents a major

weakness (rating = 1), a minor weakness (rating = 2) a minor strength (rating = 3) or a

major strength (rating = 4). Note that strengths must receive a 3 or 4 rating and weaknesses

must receive a 1 or 2 rating. Ratings are thus company-based, whereas the weights in step 2

are industry-based.

4. Multiply each factor’s weight by its rating to determine a weighted score for each

variable.

5. Sum the weighted scores for each variable to determine the total weighted score for the

organization.

Regardless of how many factors are included in an IFE Matrix, the total weighted score can

range from a low of 1.0 to a high of 4.0, with the average score being 2.5. Total weighted scores

well below 2.5 characterize organizations that are weak internally, whereas scores significantly

above 2.5 indicate a strong internal position. Like the EFE Matrix, an IFE Matrix should include

from 10 to 20 key factors. The number of factors has no effect upon the range of total weighted

scores because the weights always sum to 1.0.

When a key internal factor is both a strength and a weakness, the factor should be included

twice in the IFE Matrix, and a weight and rating should be assigned to each statement. For ex-

ample, the Playboy logo both helps and hurts Playboy Enterprises; the logo attracts customers to

Playboy magazine, but it keeps the Playboy cable channel out of many markets. Be as quantita-

tive as possible when stating factors. Use monetary amounts, percentages, numbers, and ratios

to the extent possible.

An example IFE Matrix is provided in Table 4-9 for a retail computer store. Note that the

two most important factors to be successful in the retail computer store business are “revenues

from repair/service in the store” and “location of the store.” Also note that the store is doing

best on “average customer purchase amount” and “in-store technical support.” The store is hav-

ing major problems with its carpet, bathroom, paint, and checkout procedures. Note also that

the matrix contains substantial quantitative data rather than vague statements; this is excellent.

Overall, this store receives a 2.5 total weighted score, which on a 1-to-4 scale is exactly average/

halfway, indicating there is definitely room for improvement in store operations, strategies, poli-

cies, and procedures.

The IFE Matrix provides important information for strategy formulation. For example, this

retail computer store might want to hire another checkout person and repair its carpet, paint, and

bathroom problems. Also, the store may want to increase advertising for its repair/services, be-

cause that is a really important (weight 0.15) factor to being successful in this business.

Another example IFE Matrix is provided in Table 4-10 for UPS, Inc., the company well known

for its brown trucks. Headquartered in Sandy Springs, Georgia, UPS delivers roughly 15 million

packages daily to 220 countries. Note in Table 4-10 that UPS’s new Worldport expansion is con-

sidered the most important factor to success in the industry as indicated by a weight of 0.09. Also

note the use of many $’s, #’s, and %’s in the factor statements. The total weighted score of 2.84

indicates that UPS is doing pretty well, but there definitely is room for improvement.

In multidivisional firms, each autonomous division or strategic business unit should con-

struct an IFE Matrix. Divisional matrices then can be integrated to develop an overall corporate

IFE Matrix.

Be as divisional as possible when developing a corporate IFE Matrix. Also, in developing an

IFE Matrix, do not allow more than 30 percent of the key factors to be financial ratios, because

financial ratios are generally the result of many other factors so it is difficult to know what par-

ticular strategies should be considered based on financial ratios. For example, a firm would have

no insight on whether to sell in Brazil or South Africa to take advantage of a high ROI ratio.

Special Note to Students

It can be debated whether external or internal factors are more important in strategic planning,

but there is no debate regarding the fact that gaining and sustaining competitive advantage is the

essence or purpose of strategic planning. In the internal portion of your case analysis, emphasize

how and why your internal strengths and weaknesses can be leveraged to both gain competitive

advantage and overcome competitive disadvantage, in light of the direction you are taking the

firm. Maintain your project’s upbeat, insightful, and forward-thinking demeanor during the in-

ternal assessment, rather than being mundane, descriptive, and vague. Focus on how your firm’s

resources, capabilities, structure, and strategies, with your recommended improvements, can

lead the firm to prosperity. Although the numbers absolutely must be there, must be accurate,

and must be reasonable, do not bore a live audience or class with overreliance on numbers.

Periodically throughout your presentation or written analysis, refer to your recommenda-

tions, explaining how your plan of action will improve the firm’s weaknesses and capitalize on

strengths in light of anticipated competitor countermoves. Keep your audience’s attention, inter-

est, and suspense, rather than “reading” to them or “defining” ratios for them.

alternative strategies. The EFE Matrix, Competitive Profile Matrix, IFE Matrix, and clear state-

ments of vision and mission provide the basic information needed to successfully formulate

competitive strategies. The process of performing an internal audit represents an opportunity for

managers and employees throughout the organization to participate in determining the future of

the firm. Involvement in the process can energize and mobilize managers and employees. Page 125

Reference

Strategic Management Concepts and Cases: A Competitive Advantage Approach, Fourteenth Edition

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