

The Internal Environment

by Sophia



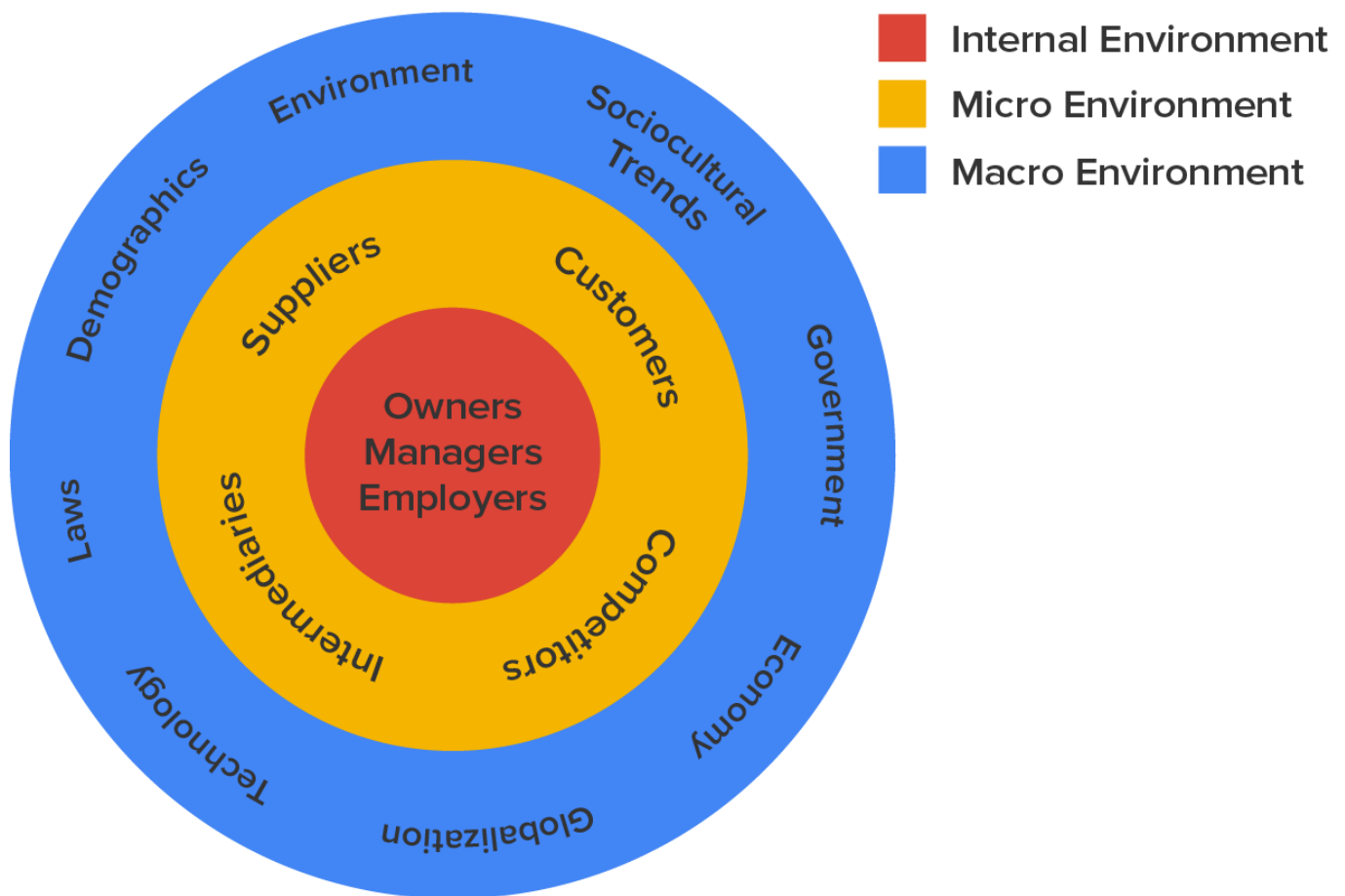
WHAT'S COVERED

In this lesson, you will learn about the relevance of a firm's competitive environment for strategic decision-making. You will also learn how and why managers conduct internal analysis of their firms. Specifically, this lesson will cover:

1. Internal Environment
2. Resources and Capabilities
3. The Value Chain
4. Using Resources and Capabilities to Build an Advantage Over Rivals
- 4a. Using VRIO

1. Internal Environment

A firm's internal environment is illustrated in the diagram below by the innermost circle. The **internal environment** consists of members of the firm itself, investors in the firm, and the assets a firm has. Employees and managers are good examples; they are firm members who have skills and knowledge that are valuable assets to their firms. Evaluating a firm's internal environment is not just a matter of counting heads, however. Successful firms have a wide range of resources and capabilities that they can use to maintain their success and grow into new ventures. A thorough analysis of a firm's internal situation provides a manager with an understanding of the resources available to pursue new initiatives, innovate, and plan for future success.



TERM TO KNOW

Internal Environment

Innermost layer of a firm's competitive environment, including members of the firm itself (such as employees and managers), investors in the firm, and the resources and capabilities of a firm.

2. Resources and Capabilities

A firm's resources and capabilities are the unique skills and assets it possesses. **Resources** are things a firm has to work with, such as equipment, facilities, raw materials, employees, and cash. Employees, for example, bring skill sets and expertise to the job, representing significant resources. If a company were to lose key employees, the loss of resources would significantly impact the business. **Capabilities** are things a firm can do, such as deliver good customer service or develop innovative products to create value. For example, the firm may have pricing as a key capability, with a range of options, that if needed, could include lower prices. Both are the building blocks of a firm's plans and activities, and both are required if a firm is going to compete successfully against its rivals. Firms use their resources and leverage their capabilities to create products and services that have some advantage over competitors' products.

⇒ **EXAMPLE** A firm might offer its customers a product with higher quality, better features, or lower prices.

Not all resources and capabilities are equally helpful in creating success, though. Internal analysis identifies exactly which assets bring the most value to the firm.



TERMS TO KNOW

Resources

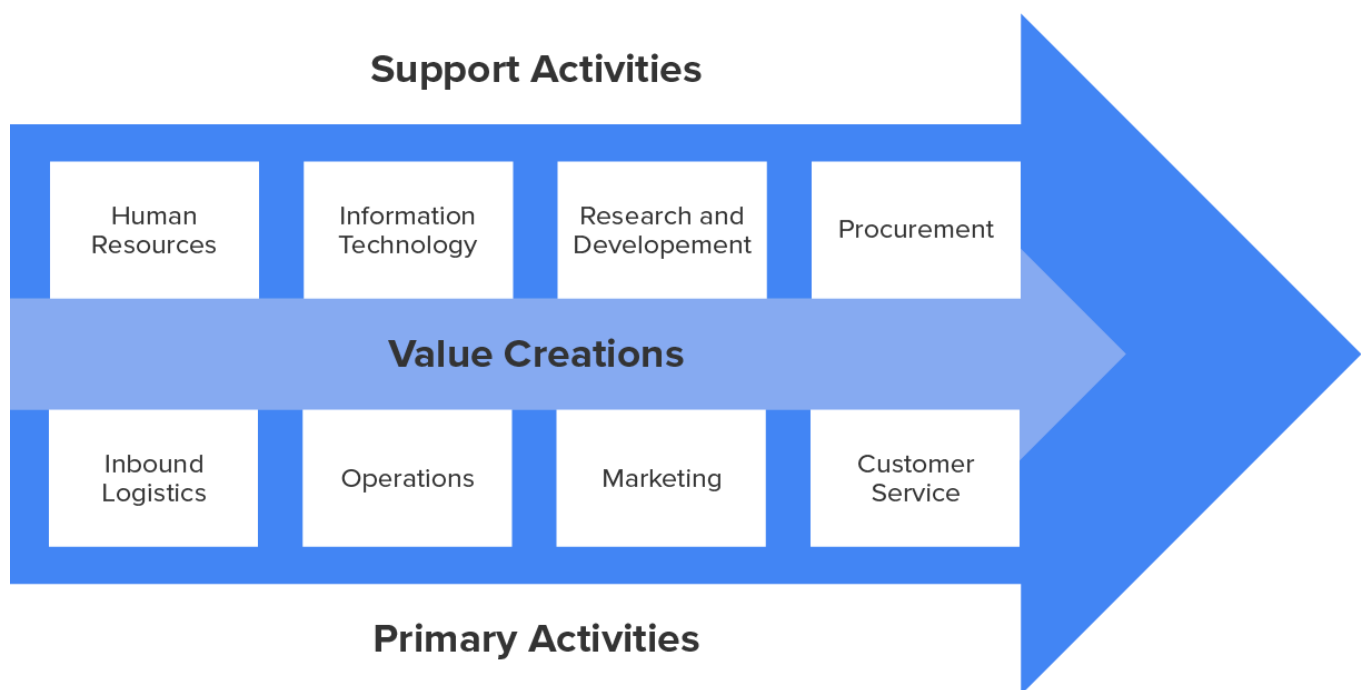
Things a firm has, such as cash and skilled employees, that it can use to create products or services.

Capabilities

A firm's skill at coordinating and leveraging resources to create value.

3. The Value Chain

Before examining the role of resources and capabilities in firm success, let's take a look at the importance of how a firm uses those factors in its operations. A firm's **value chain** is the progression of activities it undertakes to create a product or service that consumers will pay for. A firm should be adding value at each of the chain of steps it follows to create its product. The goal is for the firm to add enough value so that its customers will believe that the product is worth buying for a price that is higher than the costs the firm incurs in making it. As an example, the diagram below illustrates a hypothetical value chain for some of Walmart's activities.



In this example, note that value increases from left to right as Walmart performs more activities. If an activity adds enough value through its efforts, it will profit when it finally sells its services to customers. If Walmart determines an activity doesn't add enough value they could consider outsourcing the activity to another company. By working with product suppliers (procurement), getting those products to store locations efficiently (inbound logistics), and automatically keeping track of sales and inventory (information technology), Walmart is able to offer its customers a wide variety of products in one store at low prices, a service customers value.

Primary activities, the ones across the bottom half of the diagram, are the actions a firm takes to directly

provide a product or service to customers. **Support activities**, the ones across the top of the diagram, are actions required to sustain the firm that are not directly part of product or service creation.



TERMS TO KNOW

Value Chain

Sequence of activities that firms perform to turn inputs (parts or supplies) into outputs (goods or services).

Primary Activities

Firm activities on the value chain that are directly responsible for creating, selling, or servicing a product or service, such as manufacturing and marketing.

Support Activities

Value chain activities that a firm performs to sustain itself; they do not directly create a product or service but are necessary to support the firm's existence, such as accounting and human resources.

4. Using Resources and Capabilities to Build an Advantage Over Rivals

A firm's resources and capabilities are not just a list of equipment and things it can do. Instead, resources and capabilities are the distinctive assets and activities that separate firms from each other. Firms that can amass critical resources and develop superior capabilities will succeed in competition over rivals in their industry. Strategists evaluate firm resources and capabilities to determine if they are sufficiently unique to help the firm succeed in a competitive industry.

4a. Using VRIO

An analytical tool sometimes used to assess resources and capabilities is called **VRIO**. As usual, this is an acronym developed to remind managers of the questions to ask when evaluating their firms' resources and capabilities. The four questions of VRIO, which focus on value, rarity, imitation, and organization, are described in the table below.

Component of VRIO	Question
Valuable	Does the resource or capability generate value for the firm?
Rare	Is the resource or capability rare among firms in the industry?
Imitation	Would it be difficult or expensive for other firms to imitate the resource or capability?
Organization	Is the firm effectively organized to capture the value that this resource or capability generates?

If each question can be answered with a “yes,” then the resource or capability being evaluated can be a source of competitive advantage for the firm.

IN CONTEXT

Technology and Innovation: Uber, Lyft, and the Self-Driving Car: The Transportation of the Future Is Coming Soon

Although the ride-sharing industry is still relatively new, it has seen explosive growth, and its two main rivals, Uber and Lyft, are looking for ways to increase their capacity to serve riders. Both firms, and rivals like them, operate in basically the same way. A person needing a ride uses a smartphone app to alert a nearby person with a car of their location. The driver, usually an independent contractor for the service (meaning they are just a person with a car that has signed up to provide rides in exchange for a portion of the fare the customer pays), picks up the customer and drives them to their destination. Paying for the ride is also handled through the app, and the driver receives about 75–80% of the fare, with Uber or Lyft keeping the balance (Ridester, 2017).

The popularity of ride-sharing services has soared, and both companies are constantly recruiting more drivers. However, both companies have also explored alternatives to independent drivers: self-driving cars. Uber and Lyft have taken different paths to develop this capability. Uber has worked to internally develop its own software technology and self-driving car technology, while Lyft has focused on software interfaces that can accommodate other companies' self-driving cars (Bensinger, 2017). Lyft's partnerships with firms such as Google and GM that are already developing self-driving cars has put it ahead of Uber in the race to get driverless vehicles into its ride-sharing network, and it was able to test self-driving cars in Boston by partnering with NuTonomy in 2017 (Edelstein, 2017). Lyft offered a demonstration to journalists at the Consumer Electronics Show in Las Vegas in 2018, offering rides in self-driving cars developed by Aptiv (O'Kane, 2018). Uber had been testing similar technology in Pittsburgh but suspended its self-driving car program after a fatal pedestrian accident in Arizona (Korosec, 2018).



BRAINSTORM

1. What resource or capability challenges have Uber and Lyft faced because of their fast company growth?
2. What PESTEL factors do you think are contributing to the popularity of ride-sharing services?
3. What industry challenges (think of Porter's Five Forces) does the use of self-driving cars address?



REFLECT

1. What are firm resources and capabilities?
2. Describe a value chain and what the activities in the chain represent.

3. What is VRIO? What questions do the letters stand for, and how does using VRIO help a manager make decisions?



TERM TO KNOW

VRIO

Analytical tool that evaluates a firm's resources and capabilities to determine whether or not it can support an advantage for the firm in the competitive environment: value, rarity, imitation, and organization.



SUMMARY

In this lesson, you learned about the relevance of a firm's competitive **internal environment** for strategic decision-making, providing a manager with an understanding of the resources available to pursue new initiatives, innovate, and plan for future success. The internal environment represents the innermost layer of a firm's competitive environment, including members of the firm itself (such as employees and managers), investors in the firm, and the **resources and capabilities** of a firm. You learned that resources comprise things a firm has, such as cash and skilled employees, that it can use to create products or services, while capabilities are things a firm can do to create value. You also learned that a firm should be adding value at each step of its **value chain** that it follows to create its product. Lastly, you learned about the importance of a firm **using resources and capabilities to build an advantage over rivals**, and that managers can conduct an internal analysis of these assets **using VRIO**, an analytical tool that focuses on value, rarity, imitation, and organization.

Best of luck in your learning!

Source: Access for free at <https://openstax.org/books/principles-management/pages/1-introduction>

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TERMS TO KNOW

Capabilities

A firm's skill at coordinating and leveraging resources to create value.

Primary Activities

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Resources

Things a firm has, such as cash and skilled employees, that it can use to create products or services.

Support Activities

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VRIO

Analytical tool that evaluates a firm's resources and capabilities to determine whether or not it can support an advantage for the firm in the competitive environment: value, rarity, imitation, and organization.

Value Chain

Sequence of activities that firms perform to turn inputs (parts or supplies) into outputs (goods or services).