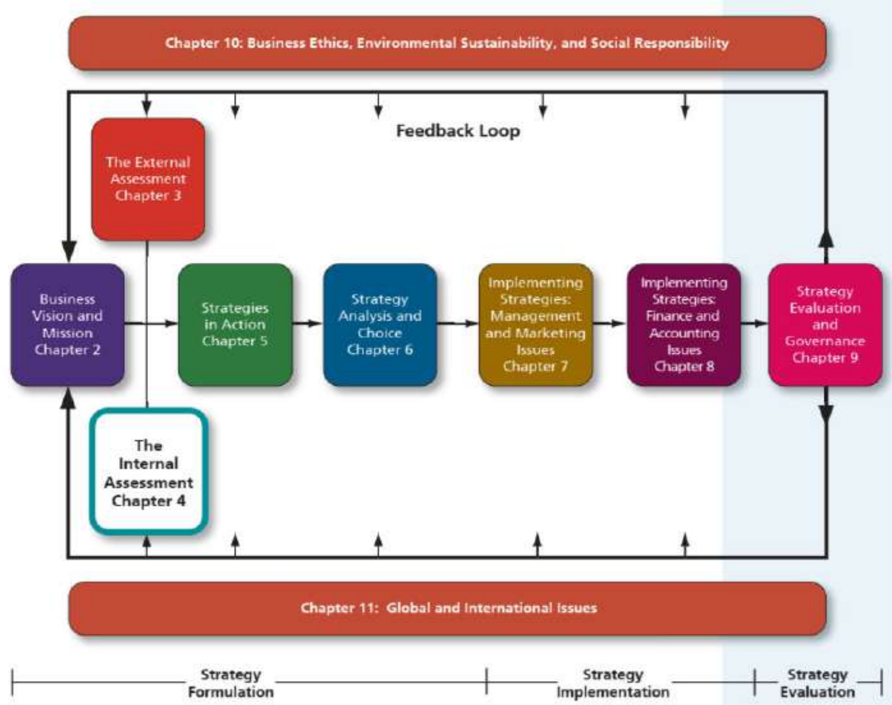
Chapter 4

The Internal Assessment

The Comprehensive, Integrative Strategic-Management Model



Learning Objectives

- *After studying this chapter, you should be able to do the following:*
  - *Describe the nature and role of an internal assessment in formulating strategies.*
  - *Discuss the nature and role of management in formulating strategies.*
  - *Discuss the nature and role of marketing in formulating strategies.*
  - *Discuss the nature and role of finance and accounting in formulating strategies.*
  - *Discuss management information systems (MIS) in terms of formulating strategies.*
  - *Explain how to develop and use an Internal Factor Evaluation (IFE) Matrix.*

Preface

- *This chapter focuses on identifying and evaluating a firm's strengths and weaknesses in the functional areas of business.*
- *Careful evaluation of a business' functional areas is necessary to determine the firm's core competencies.*
- *One excellent way to evaluate the effectiveness of a firm's strategy is to study the firm's financial performance relative to competitors and industry averages.*

The Internal Assessment Phase

- *All organizations have strengths and weaknesses in the functional areas of business.*
- *No enterprise is equally strong or weak in all areas.*
- *Objectives and strategies are established with the intention of capitalizing on internal strengths and overcoming weaknesses.*

Resource-Based View (RBV)

- *The resource-based view (RBV) approach to competitive advantage contends that internal resources are more important for a firm than external factors in achieving and sustaining competitive advantage.*
- *Proponents of RBV theory contend that a firm's performance is primarily determined by internal resources that enable the firm to exploit opportunities and neutralize threats.*
- *A firm's resources can be*
  - *tangible, such as labor, capital, land, plant, and equipment,*
  - *intangible, such as culture, knowledge, brand equity, reputation, and intellectual property.*

Empirical Indicators

- *A resource can be considered valuable to the extent that it is*
  - *rare,*
  - *hard to imitate,*
  - *not easily substitutable.*
- *These three characteristics of resources enable a firm to implement strategies that improve its efficiency and effectiveness and lead to a sustainable competitive advantage.*
- *The more a resource(s) is rare (not held by many firms in the industry), hard to imitate (hard to copy or achieve), and not easily substitutable (invulnerable to threat of substitution from different products), the stronger a firm's competitive advantage will be and the longer the advantage will last.*
- *Valuable resources comprise strengths that a firm can capitalize on to prosper in a given industry.*

Key Internal Forces

- *An internal strategic-management assessment includes analysis of how strong or weak a firm is in each functional area of business, including management, marketing, finance, accounting, etc.*
- *Uniqueness or distinctive competences a firm has or lacks in each area provides the foundation for identifying strength and weakness factors.*
- *Strengths that cannot be easily matched or imitated by competitors are called* ***distinctive competencies****.*
- *Competitive advantages generally arise more from strengths, uniqueness, and distinctive competencies than from weaknesses.*
- *Weaknesses are unlikely to develop into sustainable competitive advantages.*

Management

- *There are four basic activities that comprise management:*
  - *Planning, consists of all managerial activities related to preparing for the future, such as establishing objectives, devising strategies, and developing policies. (Strategy Formulation)*
  - *Organizing includes all managerial activities that result in a structure of task and authority relationships, such as organizational design, job specialization, job descriptions, span of control, job design, and job analysis. (Strategy Implementation)*
  - *Motivating involves efforts directed toward shaping human behavior, such as leadership, communication, teamwork, job enrichment, and HRM. (Strategy Implementation)*
  - *Controlling refers to all managerial activities that compare actual results with planned results, such as quality control, financial control, inventory control, expense control, analysis of variances, rewards, and sanctions. (Strategy Evaluation)*

Marketing

- *Marketing can be described as the process of defining, anticipating, and fulfilling consumers' needs and wants.*
- *Marketing is about satisfying current and potential customers' needs.*
- *Marketing consists of five basic activities:*
  1. *Marketing research and target market analysis,*
  2. *Product planning,*
  3. *Pricing products,*
  4. *Promoting products,*
  5. *Placing or distributing products.*

Finance and Accounting

- *Financial condition is often considered the single-best measure of a firm's competitive position and overall attractiveness to investors.*
- *Finance and accounting activities can be categorized into three decision areas:*
  - *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.*
  - *the financing decision, determines the best capital structure for the firm and includes examining various methods by which the firm can raise 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.***
  - *the dividend decision, concern issues such as the dollar amount per share to pay quarterly to stockholders, the stability of dividends paid over time, and the repurchase or issuance of stock. 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****.*

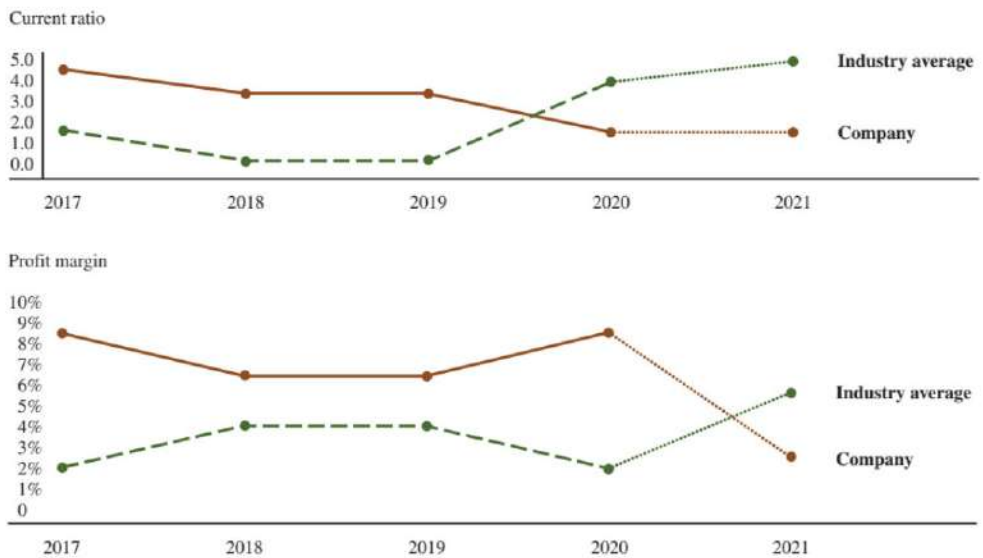
Financial Ratio Analysis

- *The most widely used method for determining an organization's strengths and weaknesses in the investment, financing, and dividend areas.*

- *Financial ratios are computed from an organization's income statement and balance sheet.*

- *Financial ratios are equally applicable in for-profit and nonprofit organizations, but the ratios vary considerably across types of industries.*

Financial Ratio Trend Analysis



Financial Ratio Analysis

- *Financial ratio analysis should be conducted on three separate fronts:*
  - *How has each ratio changed over time?*
  - *How does each ratio compare to industry norms?*
  - *How does each ratio compare with key competitors?*

A Summary of Key Financial Ratios

Ratio	How Calculated	What It Measures
I. Liquidity Ratios		
Current Ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	The extent to which a firm can meet its short-term obligations
Quick Ratio	$\frac{\text{Current assets minus inventory}}{\text{Current liabilities}}$	The extent to which a firm can meet its short-term obligations without relying on the sale of its inventories
II. Leverage Ratios		
Debt-to-Total-Assets Ratio	$\frac{\text{Total debt}}{\text{Total Assets}}$	The percentage of total funds provided by creditors
Debt-to-Equity Ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	The percentage of total funds provided by creditors versus by owners
Long-Term Debt-to-Equity Ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	The balance between debt and equity in a firm's long-term capital structure
Times-Interest-Earned Ratio	$\frac{\text{Profits before interest and taxes}}{\text{Total interest charges}}$	The extent to which earnings can decline without the firm becoming unable to meet its annual interest costs

A Summary of Key Financial Ratios

III. Activity Ratios		
Inventory Turnover	COGS/Inventory	Whether a firm holds excessive stocks of inventories and whether a firm is slowly selling its inventories compared to the industry average
Fixed Assets Turnover	$\frac{\text{Sales}}{\text{Fixed assets}}$	Sales productivity and plant and equipment utilization
Total Assets Turnover	$\frac{\text{Sales}}{\text{Total assets}}$	Whether a firm is generating a sufficient volume of business for the size of its asset investment
Accounts Receivable Turnover	Sales/Accounts Receivable	The average length of time it takes a firm to collect credit sales (in percentage terms)
Average Collection Period	$\frac{\text{Accounts receivable}}{\text{Total credit sales/365 days}}$	The average length of time it takes a firm to collect on credit sales (in days)
V. Growth Ratios		
Sales	Annual percentage growth in total sales	Firm's growth rate in sales
Net Income	Annual percentage growth in profits	Firm's growth rate in profits
Earnings Per Share	Annual percentage growth in EPS	Firm's growth rate in EPS
Dividends Per Share	Annual percentage growth in dividends per share	Firm's growth rate in dividends per share

A Summary of Key Financial Ratios

IV. Profitability Ratios

Gross Profit Margin	Gross Profit/Sales	The total margin available to cover operating expenses and yield a profit
Operating Profit Margin	$\frac{\text{Earning before interest and taxes EBIT}}{\text{Sales}}$	Profitability without concern for taxes and interest
Net Profit Margin	$\frac{\text{Net income}}{\text{Sales}}$	After-tax profits per dollar of sales
Return on Total Assets (ROA)	$\frac{\text{Net income}}{\text{Total assets}}$	After-tax profits per dollar of assets; this ratio is also called *return on investment* (ROI)
Return on Stockholders' Equity (ROE)	$\frac{\text{Net Income}}{\text{Total stockholders' equity}}$	After-tax profits per dollar of stockholders' investment in the firm
Earnings Per Share (EPS)	$\frac{\text{Net income}}{\text{Number of shares of common stock outstanding}}$	Earnings available to the owners of common stock
Price-Earnings Ratio	$\frac{\text{Market price per share}}{\text{Earnings per share}}$	Attractiveness of firm on equity markets

Management Information Systems

- *Information ties all business functions together and provides the basis for all managerial decisions.*
- *A management information system (MIS) collects, codes, stores, synthesizes, and presents information in such a manner that it aids in operational and strategic decision making.*
- *The heart of an information system is a database containing the kinds of records and data important to managers.*

The Internal Factor Evaluation (IFE) Matrix

- *An internal assessment reveals key strengths and weaknesses confronting an organization;*
- *This is vital information for managers in formulating strategies that capitalize on strengths and mitigate/overcome/improve upon weaknesses.*
- *When identifying and prioritizing key internal factors in strategic planning, make sure the factors selected meet the following four criteria to the extent possible*
    1. *Actionable (i.e., meaningful and helpful in ultimately deciding what actions or strategies a firm should consider pursuing);*
    2. *Quantitative (i.e., include percentages, ratios, dollars, and numbers to the extent possible);*
    3. *Comparative (i.e., reveals changes over time);*
    4. *Divisional (relates to the firm's products and/or regions (rather than consolidated) so inferences can be drawn regarding what products and regions are doing well or not).*

Steps in Developing an IFE Matrix

1. *Develop a List of Key Internal Factors*
2. *Assign Weights to Key Internal Factors*
3. *Assign Ratings to Key Internal Factors*
4. *Obtain Weighted Scores*
5. *Obtain Total Weighted Score*

1. Develop a List of Key Internal Factors

- *Conduct research to identify 50–100 internal factors (strengths/weaknesses) across management, marketing, finance, accounting, and MIS.*
- *Reduce the list to 20 critical internal factors (10 strengths and 10 weaknesses).*
- *Use rating (1 = least important, 10 = most important) or ranking (1 = most important, 50 = least important) to prioritize factors.*

2. Assign Weights to Key Internal Factors

- *Assign weights to each factor from 0.01 (least important) to 1.0 (most critical).*
- *Weights reflect relative importance of factors for success in the specific industry, not the company.*
- *Highest weights go to factors with the greatest impact on organizational performance across all firms in the industry (regardless of being a strength/weakness).*
- *Sum of all weights must equal 1.0; avoid balancing strengths/weaknesses (e.g., 0.50/0.50 split).*
- *Strengths are listed first, sorted from highest to lowest weight.*
- *Weaknesses follow, also sorted from highest to lowest weight.*

3. Assign Ratings to Key Internal Factors

- *Assign ratings from 1 (poor response) to 4 (superior response) to each factor based on how effectively the firm's strategies address strengths/weaknesses.*
  - *4: Superior response | 3: Above average | 2: Average | 1: Poor.*
- *Strengths generally receive higher ratings (3 or 4) as they form the basis of competitive advantages.*
- *Weaknesses rarely receive 3 or 4 unless there is a compelling justification (e.g., exceptional improvement efforts).*

4. Obtain Weighted Scores

- *Along each row in an IFE Matrix, multiply the factor's weight by its rating to determine a weighted score for each factor.*

5. Obtain Total Weighted Score

- *Sum weighted scores to determine the organization's total weighted score in the IFE Matrix.*
- *Scores well below 2.5, indicate internal weaknesses. Suggest the need for new strategies, vision, mission, or direction.*
- *Scores well above 2.5, reflect a strong internal position. Support continuing current strategies as prudent.*
- *The score serves as a diagnostic tool to assess internal health and guide strategic decision-making.*
- *Aligns strategy adjustments with the firm's competitive standing and resource effectiveness.*

Chapter Summary

- *Management, marketing, finance/accounting, and MIS are central to operations and key sources of competitive advantage.*
- *IFE Matrix, CPM, EFE Matrix, and clear vision/mission statements provide foundational data for crafting competitive strategies.*
- *Engages managers and employees in shaping the firm's future, fostering energy and commitment.*
- *Success hinges on understanding external and internal factors and their interrelationships.*
- *Strategists must leverage positive changes and mitigate negative ones to sustain competitive advantage.*
- *Continuous adjustment to internal/external shifts is vital for long-term survival and strategic success.*

Topics for Further Collaboration …

- *Elon Musk, CEO and Cofounder of Tesla, Inc. and Space Exploration Technologies Corporation (SpaceX) (Page 124 – David Book)*
- *The Sagebrush Lizard versus the Big Oil Man (Page 126 – David Book)*
- *Bitcoin: The New Global Currency (Page 134 – David Book)*