Chapter 4

Internal Situation Analysis: Evaluating a Company's Resources, Cost Position, and Competitive Strength

Chapter Learning Objectives

LO1. Understand how to evaluate a company's internal situation, including its collection of competitively valuable resources and capabilities.

LO2. Grasp how and why activities performed internally by a company and those performed externally by its suppliers and forward channel allies determine a company's cost structure and ability to compete successfully.

LO3. Learn how to evaluate a company's competitive strength relative to key rivals.

LO4. Understand the role and importance of industry and competitive analysis and internal situation analysis in identifying strategic issues company managers must address.

In Chapter 3 we described how to use the tools of industry and competitive analysis to assess a company's external environment and lay the groundwork for matching a company's strategy to its external situation. In this chapter we discuss the techniques of evaluating a company's internal situation, including its collection of valuable resources and capabilities, its relative cost position, and its competitive strength versus its rivals. The analytical spotlight will be trained on five questions:

1. How well is the company's strategy working?
2. What are the company's competitively important resources and capabilities?
3. Are the company's prices and costs competitive?
4. Is the company competitively stronger or weaker than key rivals?
5. What strategic issues and problems merit front-burner managerial attention?

The answers to these five questions complete management's understanding of "*Where are we now?*" and position the company for a good strategy situation fit required of the *"Three Tests of a Winning Strategy"* (see Chapter 1, page 9).

Question 1: How Well Is the Company's Strategy Working?

The two best indicators of how well a company's strategy is working are (1) whether the company is achieving its stated financial and strategic objectives and (2) whether the company is an above-average industry performer. Persistent shortfalls in meeting company performance targets and weak performance relative to rivals are reliable warning signs that the company suffers from poor strategy making, less-than-competent strategy execution, or both. Other indicators of how well a company's strategy is working include:

- Trends in the company's sales and earnings growth.
- Trends in the company's stock price.
- The company's overall financial strength.
- The company's customer retention rate.
- The rate at which new customers are acquired.
- Changes in the company's image and reputation with customers.
- Evidence of improvement in internal processes such as defect rate, order fulfillment, delivery times, days of inventory, and employee productivity.

The stronger a company's current overall performance, the less likely the need for radical changes in strategy. The weaker a company's financial performance and market standing, the more its current strategy must be questioned. (A compilation of financial ratios most commonly used to evaluate a company's financial performance and balance sheet strength is presented in the Appendix on pages 240–241).

Question 2: What Are the Company's Competitively Important Resources and Capabilities?

As discussed in Chapter 1, a company's business model and strategy must be well-matched to its collection of resources and capabilities. An attempt by management to create and deliver customer value in a manner that depends on resources or capabilities that are deficient and cannot be readily acquired is unwise and positions the company for failure. A company's competitive approach requires a tight fit with a company's internal situation and is strengthened when it exploits resources that are competitively valuable, rare, hard to copy, and not easily trumped by rivals' equivalent substitute resources. In fact, many companies pursue ***resource-based strategies*** *that attempt to exploit company resources in a manner that offers value to customers in ways rivals are unable to match.*[1]

A **resource-based strategy** uses a company's valuable and rare resources and competitive capabilities to deliver value to customers in ways rivals find it difficult to match.

For example, a company pursuing a cost-based advantage might invest in super-efficient distribution centers that give it the capability to distribute its products at a lower cost than rivals. Walmart is well-known for its low-cost distribution and its distribution efficiency is one factor in its ability to underprice rivals. Over a period of more than a decade, Dell has put considerable time and money into cultivating relationships with its key suppliers that give it unmatched supply chain capabilities. Real-time information sharing between Dell and its suppliers allows many Dell plants to operate with only several hours' inventory of certain parts and components because the suppliers have online access to Dell's daily production schedule. Competitively valuable resources and capabilities can also facilitate differentiation in the marketplace. Because Fox News and CNN have the capability to devote more air time to breaking news stories and get reporters on the scene very quickly compared to the major networks like ABC, NBC, and CBS, many viewers turn to the cable networks when a major news event occurs.

[1] In the past decade, there's been considerable research into the role a company's resources and competitive capabilities play in crafting strategy and in determining company profitability. The findings and conclusions have coalesced into what is called the resource-based view of the firm. Among the most insightful publications on the topic are Birger Wernerfelt, "A Resource-Based View of the Firm," *Strategic Management Journal,* September–October 1984, pp. 171–180; Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 99–120; Margaret A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal,* March 1993, pp. 179–191; Birger Wernerfelt, "The Resource-Based View of the Firm: Ten Years After," *Strategic Management Journal* 16 (1995), pp. 171–174; Jay B. Barney, "Looking Inside for Competitive Advantage," *Academy of Management Executive* 9, no. 4 (November 1995), pp. 49–61; Christopher A. Bartlett and Sumantra Ghoshal, "Building Competitive Advantage through People," *MIT Sloan Management Review* 43, no 2, (Winter 2002), pp. 34–41; Danny Miller, Russell Eisenstat, and Nathaniel Foote, "Strategy from the Inside Out: Building Capability-Creating Organizations," *California Management Review* 44, no. 3 (Spring 2002), pp. 37–54; and Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007).

Identifying Competitively Important Resources and Capabilities

Common types of valuable resources and competitive capabilities that management should consider when crafting strategy include:

- *A skill, specialized expertise, or competitively important capability*—examples include skills in low-cost operations, proven capabilities in creating and introducing innovative products, cutting-edge supply chain management capabilities, expertise in getting new products to market quickly, and expertise in providing consistently good customer service.
- *Valuable physical assets*—such as state-of-the-art plants and equipment, attractive real estate locations, or ownership of valuable natural resource deposits.
- *Valuable human assets and intellectual capital*—an experienced and capable workforce, talented employees in key areas, collective learning embedded in the organization, or proven managerial know-how.[2]
- *Valuable organizational assets*—proven quality control systems, proprietary technology, key patents, and a strong network of distributors or retail dealers.
- *Valuable intangible assets*—a powerful or well-known brand name or strong buyer loyalty.
- *Competitively valuable alliances or cooperative ventures*—alliances or joint ventures that provide access to valuable technologies, specialized know-how, or geographic markets.

Determining the Competitive Power of a Company Resource

What is most telling about a company's aggregation of resources is how powerful they are in the marketplace. The competitive power of a resource is measured by how many of the following four tests it can pass:[3]

1. *Is the resource really competitively valuable?* All companies possess a collection of resources and capabilities—some have the potential to contribute to a competitive advantage while others may not. Apple's operating

[2] Many business organizations are coming to view cutting-edge knowledge and the intellectual resources of company personnel as a valuable competitive asset and have concluded that explicitly managing these assets is an essential part of their strategy. See Michael H. Zack, "Developing a Knowledge Strategy," *California Management Review* 41, no. 3 (Spring 1999), pp. 125–145; and Shaker A. Zahra, Anders P. Nielsen, and William C. Bogner, "Corporate Entrepreneurship, Knowledge, and Competence Development," *Entrepreneurship Theory and Practice*, Spring 1999, pp. 169–189.

[3] See Jay B. Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 105–109; and Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007). Also see M. A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal* 14 (1993), pp. 179–191; and David J. Collis and Cynthia A. Montgomery, "Competing on Resources: Strategy in the 1990s," *Harvard Business Review* 73, no. 4 (July–August 1995), pp. 120–123.

system for its MacIntosh PCs is by most accounts a world beater (compared to Windows Vista) but Apple has failed miserably in converting its resource strength in operating system design into competitive success in the global PC market.

2. *Is the resource rare—is it something rivals lack?* Companies have to guard against pridefully believing that their collection of resources and competitive capabilities is more powerful than that of their rivals. Who can really say whether Coca-Cola's consumer marketing prowess is better than Pepsi-Cola's or whether the Mercedes-Benz brand name is more powerful than that of BMW or Lexus? Although many retailers claim to be quite proficient in product selection and in-store merchandising, a number run into trouble in the marketplace because they encounter rivals whose capabilities in product selection and in-store merchandising are equal to or better than theirs.
3. *Is the resource hard to copy or imitate?* The more difficult and more expensive it is to imitate a company's resource or capability, the greater its potential competitive value. Resources tend to be difficult to copy when they are unique (a fantastic real estate location, patent protection), when they must be built over time (a brand name, a strategy supportive organizational culture), and when they carry big capital requirements (a cost-effective plant to manufacture cutting-edge microprocessors). Walmart's competitors have failed miserably in their attempts over the past two decades to match its state-of-the-art distribution capabilities.
4. *Can the resource be trumped by substitute resource strengths and competitive capabilities?* Resources that are competitively valuable, rare, and costly to imitate lose their ability to offer competitive advantage if rivals possess equivalent substitute resources. For example, manufacturers relying on automation to gain a cost-based advantage in production activities may find their technology-based advantage nullified by rivals' use of low-wage offshore manufacturing. Resources can contribute to a competitive advantage only when resource substitutes don't exist.

Understanding the nature of competitively important resources allows managers to identify resources or capabilities that should be further developed to play an important role in the company's future strategies. In addition, management may determine that it doesn't possess a resource that independently passes all four tests listed here with high marks, but does have a *bundle of resources* that can be leveraged to support its business model and strategy. Although Nike's resources dedicated to research and development, marketing research, and product design are matched relatively well by rival adidas, its cross-functional design process allows it to set the pace for innovation in athletic apparel and footwear and consistently outperform adidas and other rivals in the marketplace. Nike's footwear designers get ideas for new performance features from the professional athletes who endorse its products and then work alongside footwear materials researchers, consumer trend analysts, color designers, and marketers to design new models that are presented to a review committee. Nike's review committee is made up of hundreds of individuals who evaluate prototype details such as shoe proportions and color designs, the size of the swoosh, stitching patterns, sole color and tread pattern, and insole design. About 400 models are approved by the committee each year, which are sourced from contract manufacturers and marketed in more than 180 countries. The bundling of Nike's professional endorsements, R&D activities, marketing research efforts, styling expertise, and managerial know-how has become an important source of the company's competitive advantage and has allowed it to remain number one in the athletic footwear and apparel industry for more than 20 years.

Companies that lack a stand-alone resource that is competitively powerful may nonetheless develop a competitive advantage through **bundled resources.**

Resource-based strategies can also be directed at eroding or at least neutralizing the competitive potency of a particular rival's resources and capabilities by identifying and developing **substitute resources** to accomplish the same purpose. For example, Amazon.com lacks a big network of retail stores to compete with those operated by rival Barnes & Noble, but Amazon's much larger, readily accessible, and searchable book inventory—coupled with its short delivery times and free shipping on orders over $25—are more attractive to many busy consumers than visiting a big-box bookstore. In other words, Amazon has carefully and consciously developed a set of competitively valuable resources that are proving to be effective substitutes for competing head-to-head against Barnes and Noble without having to invest in hundreds of brick-and-mortar retail stores. Whereas many cosmetics companies sell their products through department stores and specialty retailers, Avon and Mary Kay Cosmetics have substituted for the lack of a retail dealer network by assembling a direct sales force numbering in the hundreds of thousands—their sales associates can personally demonstrate products to interested buyers in their homes or at parties, take orders on the spot, and deliver the items to buyers' homes.[4]

Rather than try to match the resources and capabilities possessed by a rival company, a company may develop entirely different resources and capabilities that substitute for the strengths of the rival.

Resources and Capabilities as the Foundation of Competitive Advantage

One of the most important aspects of identifying resources and capabilities that can become the basis for competitive advantage has to do with a company's competence level in performing key pieces of its business—such as supply chain management, R&D, production, distribution, sales and marketing, and customer service. A company's proficiency in conducting different facets of its operations can range from merely the ability to perform an activity to a competence, core competence, or distinctive competence:

1. A **competence** is an internal activity an organization performs with proficiency. Some competencies relate to fairly specific skills and expertise (like just-in-time inventory control or picking locations for new stores) and may be performed in a single department or organizational unit.

[4] For a more detailed discussion, see George Stalk, Philip Evans, and Lawrence E. Schulman, "Competing on Capabilities: The New Rules of Corporate Strategy," *Harvard Business Review* 70, no. 2 (March–April 1992), pp. 57–69.

Other competencies, however, are inherently multidisciplinary and cross-functional. A competence in continuous product innovation, for example, comes from the bundled efforts of people and groups with expertise in market research, new product R&D, design and engineering, cost-effective manufacturing, and market testing.

A **competence** is an activity that a company performs well.

2. A **core competence** is a proficiently performed internal activity that is *central* to a company's strategy and competitiveness. A core competence is a highly valuable capability because of the contribution it makes to the company's success in the marketplace. A company may have more than one core competence in its resource portfolio, but rare is the company that can legitimately claim more than two or three core competencies. Most often, *a core competence is knowledge-based, residing in people and in a company's intellectual capital and not in its assets on the balance sheet.* Moreover, a core competence is more likely to be grounded in cross-department combinations of knowledge and expertise rather than being the product of a single department or work group. Facebook has a core competence in anticipating features that will appeal to Internet users who maintain social networking sites. The ability of Internet users to share information, photos, videos, and interesting news stories with friends and others made Facebook the world's largest social networking site as of 2009 with more than 90 million unique visitors each month.

A **core competence** is a competitively important activity that a company performs better than other internal activities.

3. A **distinctive competence** is a competitively valuable activity that a company *performs better than its rivals.* Because a distinctive competence represents a uniquely strong capability relative to rival companies, it has significant competitive advantage potential. This is particularly true when the distinctive competence enables a company to deliver standout value to customers (in the form of lower prices or better product performance or superior service). Toyota has worked diligently over several decades to establish a distinctive competence in low-cost, high-quality manufacturing of motor vehicles; its "lean production" system is far superior to that of any other automaker's and the company is pushing the boundaries of its production advantage with a new Global Body assembly line. Toyota's Global Body assembly line costs 50 percent less to install and can be changed to accommodate a new model for 70 percent less than its previous production system.[5] The conceptual differences between a competence, a core competence, and a distinctive competence draw attention to the fact that a company's resources and competitive capabilities are not all equal.[6] Some capabilities

A **distinctive competence** is a competitively important activity that a company performs better than its rivals—therefore offering the potential for competitive advantage.

[5] George Stalk, Jr. and Rob Lachenauer, "Hard Ball: Five Killer Strategies for Trouncing the Competition," *Harvard Business Review* 82, no. 4 (April 2004), p. 65.

[6] For a more extensive discussion of how to identify and evaluate the competitive power of a company's capabilities, see David W. Birchall and George Tovstiga, "The Strategic Potential of a Firm's Knowledge Portfolio," *Journal of General Management* 25, no. 1 (Autumn 1999), pp. 1–16; and David Teece, "Capturing Value from Knowledge Assets: The New Economy, Markets for Know-How, and Intangible Assets," *California Management Review* 40, no. 3 (Spring 1998), pp. 55–79.

and competencies merely enable market survival because most rivals have them. Core competencies are *competitively* more important than competencies because they add power to the company's strategy and have a bigger positive impact on its market position and profitability. Distinctive competencies are even more competitively important. A distinctive competence is competitively potent for three reasons: (1) It gives a company competitively valuable capability that is unmatched by rivals, (2) it has potential for being the cornerstone of the company's strategy, and (3) it can produce a competitive edge in the marketplace.

Taking Inventory of a Company's Internal Resource Strengths and Weaknesses and Its External Opportunities and Threats

An appraisal of a company's resource **s**trengths and **w**eaknesses can be coupled with a listing of external **o**pportunities and **t**hreats to provide an overview of the company's overall situation. Such an assessment, commonly known as **SWOT analysis,** provides the basis for crafting a strategy that capitalizes on the company's strengths, aims squarely at capturing the company's best opportunities, and defends against the threats to its well-being.

SWOT analysis is a simple but powerful tool for sizing up a company's resource strengths and competitive deficiencies, its market opportunities, and the external threats to its future well-being.

IDENTIFYING COMPANY RESOURCE STRENGTHS AND CORE COMPETENCIES A company's resource strengths represent its competitive assets and determine whether its competitive power in the marketplace will be impressively strong or disappointingly weak. A company that is well-endowed with potent resource strengths and core competencies normally has considerable competitive power—especially when its management team skillfully utilizes the company's resources in ways that build sustainable competitive advantage. Companies with modest or weak competitive assets nearly always are relegated to a trailing position in the industry. Table 4.1 lists the kinds of factors to consider in compiling a company's resource strengths and weaknesses.

IDENTIFYING COMPANY RESOURCE WEAKNESSES AND COMPETITIVE DEFICIENCIES A *resource weakness* or *competitive liability* is something a company lacks or does poorly or a condition that puts it at a disadvantage in the marketplace. As a rule, strategies that place heavy demands on areas where the company is weakest or has unproven ability are suspect and should be avoided. A company's resource weaknesses can relate to:

- Inferior or unproven skills, expertise, or intellectual capital in competitively important areas of the business.
- Deficiencies in competitively important physical, organizational, or intangible assets.
- Missing or competitively inferior capabilities in key areas.

Table 4.1

Factors to Consider When Identifying a Company's Strengths, Weaknesses, Opportunities, and Threats

Potential Resource Strengths and Competitive Capabilities

- Core competencies in ______.
- A strong financial condition; ample financial resources to grow the business.
- Strong brand name image/company reputation.
- Economy of scale and/or learning and experience curve advantages over rivals.
- Proprietary technology/superior technological skills/important patents.
- Cost advantages over rivals.
- Product innovation capabilities.
- Proven capabilities in improving production processes.
- Good supply chain management capabilities.
- Good customer service capabilities.
- Better product quality relative to rivals.
- Wide geographic coverage and/or strong global distribution capability.
- Alliances/joint ventures with other firms that provide access to valuable technology, competencies, and/or attractive geographic markets.

Potential Market Opportunities

- Serving additional customer groups or market segments.
- Expanding into new geographic markets.
- Expanding the company's product line to meet a broader range of customer needs.
- Utilizing existing company skills or technological know-how to enter new product lines or new businesses.
- Falling trade barriers in attractive foreign markets.
- Acquiring rival firms or companies with attractive technological expertise or capabilities.

Potential Resource Weaknesses and Competitive Deficiencies

- No clear strategic direction.
- No well-developed or proven core competencies.
- A weak balance sheet; burdened with too much debt.
- Higher overall unit costs relative to key competitors.
- A product/service with features and attributes that are inferior to those of rivals.
- Too narrow a product line relative to rivals.
- Weak brand image or reputation.
- Weaker dealer network than key rivals.
- Behind on product quality, R&D, and/or technological know-how.
- Lack of management depth.
- Short on financial resources to grow the business and pursue promising initiatives.

Potential External Threats to a Company's Future Prospects

- Increasing intensity of competition among industry rivals—may squeeze profit margins.
- Slowdowns in market growth.
- Likely entry of potent new competitors.
- Growing bargaining power of customers or suppliers.
- A shift in buyer needs and tastes away from the industry's product.
- Adverse demographic changes that threaten to curtail demand for the industry's product.
- Vulnerability to unfavorable industry driving forces.
- Restrictive trade policies on the part of foreign governments.
- Costly new regulatory requirements.

Nearly all companies have competitive liabilities of one kind or another. Whether a company's resource weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and whether they are offset by the company's resource strengths. Sizing up a company's complement of resource capabilities and deficiencies is akin to constructing a *strategic balance sheet,* where resource strengths represent *competitive assets* and resource weaknesses represent *competitive liabilities.*

A company's resource strengths represent competitive assets; its resource weaknesses represent competitive liabilities.

IDENTIFYING A COMPANY'S MARKET OPPORTUNITIES Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying its market opportunities and appraising the growth and profit potential each one holds. (See Table 4.1, under "Potential Market Opportunities.") Depending on the prevailing circumstances, a company's opportunities can be plentiful or scarce and can range from wildly attractive to unsuitable.

In evaluating the attractiveness of a company's market opportunities, managers have to guard against viewing every *industry* opportunity as a suitable opportunity. Not every company is equipped with the resources to successfully pursue each opportunity that exists in its industry. Some companies are more capable of going after particular opportunities than others. *The market opportunities most relevant to a company are those that match up well with the company's financial and organizational resources and capabilities, offer the best growth and profitability, and present the most potential for competitive advantage.*

IDENTIFYING THREATS TO A COMPANY'S FUTURE PROFITABILITY Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Threats can stem from the emergence of cheaper or better technologies, rivals' introduction of new or improved products, the entry of lower-cost foreign competitors into a company's market stronghold, new regulations that are more burdensome to a company than to its competitors, vulnerability to a rise in interest rates, the potential of a hostile takeover, unfavorable demographic shifts, or adverse changes in foreign exchange rates. (See Table 4.1, under "Potential External Threats to a Company's Future Prospects.")

External threats may pose no more than a moderate degree of adversity or they may be so imposing as to make a company's situation and outlook quite tenuous. On rare occasions, market shocks can throw a company into an immediate crisis and battle to survive. Many of the world's major airlines have been plunged into unprecedented financial crisis because of a combination of factors: rising prices for jet fuel, a global economic slowdown that has affected business and leisure travel, mounting competition from low-fare carriers, shifting traveler preferences for low fares as opposed to lots of in-flight amenities, and "out-of-control" labor costs. It is management's job to identify the threats to the company's future prospects and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

THE VALUE OF A SWOT ANALYSIS A SWOT analysis involves more than making four lists. The most important parts of SWOT analysis are:

Simply making lists of a company's strengths, weaknesses, opportunities, and threats is not enough; the payoff from SWOT analysis comes from the conclusions about a company's situation and the implications for strategy improvement that flow from the four lists.

1. Drawing conclusions from the SWOT listings about the company's overall situation.
2. Translating these conclusions into strategic actions to better match the company's strategy to its resource strengths and market opportunities, correcting problematic weaknesses, and defending against worrisome external threats.

Question 3: Are the Company's Costs and Prices Competitive?

Company managers are often stunned when a competitor cuts its prices to "unbelievably low" levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be buying its way into the market with super-low prices that are below its costs—it may simply have substantially lower costs. One of the most telling signs of whether a company's business position is strong or precarious is whether its prices and costs are competitive with industry rivals.

Price and cost comparisons are especially critical in industries where price competition is typically the ruling market force. But even in industries where products are differentiated, rival companies have to keep their costs in line with rivals offering a similar mix of differentiating features. Two analytical tools are particularly useful in determining whether a company's prices and costs are competitive: value chain analysis and benchmarking.

Company Value Chains

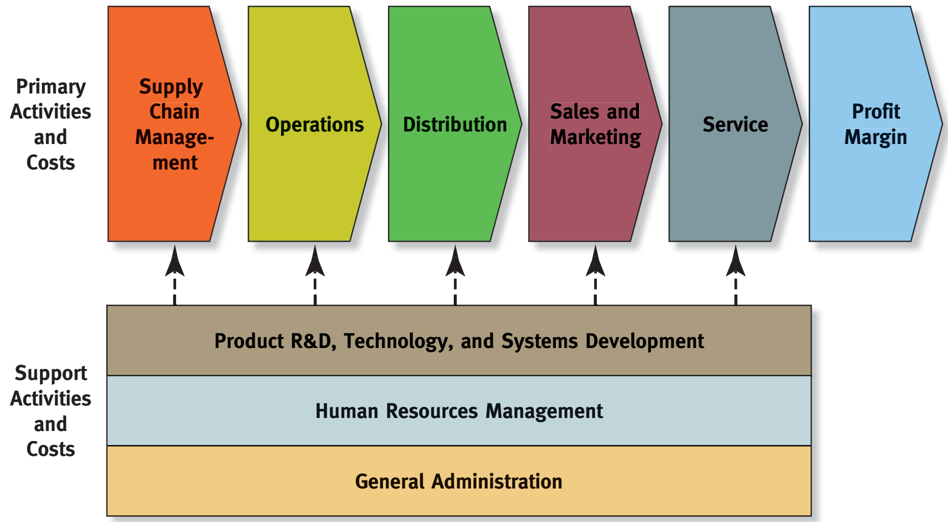
Every company's business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. All of the various activities that a company performs internally combine to form a **value chain,** so-called because the underlying intent of a company's activities is to do things that ultimately *create value for buyers.* A company's value chain also includes an allowance for profit because it is customarily part of the price (or total cost) borne by buyers.

A company's **value chain** identifies the primary activities that create customer value and related support activities.

As shown in Figure 4.1, a company's value chain consists of two broad categories of activities: the *primary activities* that are foremost in creating value for customers and the requisite *support activities* that facilitate and enhance the performance of the primary activities.[7] For example, the primary activities for a big box retailer include merchandise selection and buying, store layout and product display, advertising, and customer service; its support activities

[7] The value chain concept was developed and articulated by professor Michael Porter at the Harvard Business School and is described at greater length in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), Chapters 2 and 3.

FIGURE 4.1 **A Representative Company Value Chain**



PRIMARY ACTIVITIES

- **Supply Chain Management**—Activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts and components, merchandise, and consumable items from vendors; receiving, storing, and disseminating inputs from suppliers; inspection; and inventory management.
- **Operations**—Activities, costs, and assets associated with converting inputs into final product form (production, assembly, packaging, equipment maintenance, facilities, operations, quality assurance, environmental protection).
- **Distribution**—Activities, costs, and assets dealing with physically distributing the product to buyers (finished goods warehousing, order processing, order picking and packing, shipping, delivery vehicle operations, establishing and maintaining a network of dealers and distributors).
- **Sales and Marketing**—Activities, costs, and assets related to sales force efforts, advertising and promotion, market research and planning, and dealer/distributor support.
- **Service**—Activities, costs, and assets associated with providing assistance to buyers, such as installation, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

SUPPORT ACTIVITIES

- **Product R&D, Technology, and Systems Development**—Activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, database capabilities, and development of computerized support systems.
- **Human Resources Management**—Activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; and development of knowledge-based skills and core competencies.
- **General Administration**—Activities, costs, and assets relating to general management, accounting and finance, legal and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Source: Based on the discussion in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 37–43.

include site selection, hiring and training, store maintenance, plus the usual assortment of administrative activities. A hotel chain's primary activities and costs are mainly comprised of reservations and hotel operations (check-in and check-out, maintenance and housekeeping, dining and room service, and conventions and meetings); principal support activities include accounting, hiring and training hotel staff, and general administration. Supply chain management is a crucial activity for Nissan, L.L. Bean, and Petsmart but is not a value chain component at Google or Bank of America. Sales and marketing are dominant activities at Procter & Gamble and Sony but have minor roles at oil drilling companies and natural gas pipeline companies. Whether an activity is classified as primary or supporting varies with each company's business model and strategy, so it is important to view the listing of the primary and support activities in Figure 4.1 as illustrative rather than definitive.

Benchmarking: A Tool for Assessing Whether a Company's Value Chain Activities Are Competitive

Benchmarking entails comparing how different companies perform various value chain activities—how materials are purchased, how inventories are managed, how products are assembled, how customer orders are filled and shipped, and how maintenance is performed—and then making cross-company comparisons of the costs and effectiveness of these activities.[8] The objectives of benchmarking are to identify the best practices in performing an activity and to emulate those best practices when they are possessed by others.

Xerox became one of the first companies to use benchmarking in 1979 when Japanese manufacturers began selling midsize copiers in the United States for $9,600 each—less than Xerox's production costs.[9] Xerox management sent a team of line managers and its head of manufacturing to Japan to study competitors' business processes and costs. With the aid of Xerox's joint venture partner in Japan (Fuji-Xerox), who knew the competitors well, the team found that Xerox's costs were excessive due to gross inefficiencies in the company's manufacturing processes and business practices. The findings triggered a major internal effort at Xerox to become cost-competitive and prompted Xerox to begin benchmarking 67 of its key work processes. Xerox quickly decided not to restrict its benchmarking efforts to its office equipment rivals but to extend them to any company regarded as "world class" in performing *any activity* relevant to Xerox's business. Other companies quickly picked up on Xerox's approach. Toyota managers got their idea for just-in-time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit. Over 80 percent of Fortune 500 companies reportedly use benchmarking for comparing themselves against rivals on cost and other competitively important measures.

Benchmarking is a potent tool for learning which companies are best at performing particular activities and then using their techniques (or "best practices") to improve the cost and effectiveness of a company's own internal activities.

[8] For more details, see Gregory H. Watson, *Strategic Benchmarking: How to Rate Your Company's Performance Against the World's Best* (New York: John Wiley, 1993); Robert C. Camp, *Benchmarking: The Search for Industry Best Practices That Lead to Superior Performance* (Milwaukee: ASQC Quality Press, 1989); Christopher E. Bogan and Michael J. English, *Benchmarking for Best Practices: Winning through Innovative Adaptation* (New York: McGraw-Hill, 1994); and Dawn Iacobucci and Christie Nordhielm, "Creative Benchmarking," *Harvard Business Review* 78, no. 6 (November–December 2000), pp. 24–25.

[9] Jeremy Main, "How to Steal the Best Ideas Around," *Fortune*, October 19, 1992, pp. 102–103.

The tough part of benchmarking is not whether to do it, but rather how to gain access to information about other companies' practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms and by talking to knowledgeable industry analysts, customers, and suppliers. Sometimes field trips to the facilities of competing or noncompeting companies can be arranged to observe how things are done, compare practices and processes, and perhaps exchange data on productivity and other cost components. However, such companies, even if they agree to host facilities tours and answer questions, are unlikely to share competitively sensitive cost information. Furthermore, comparing two companies' costs may not involve comparing apples to apples if the two companies employ different cost accounting principles to calculate the costs of particular activities.

However, a fairly reliable source of benchmarking information has emerged. The explosive interest of companies in benchmarking costs and identifying best practices has prompted consulting organizations (e.g., Accenture, A. T. Kearney, Benchnet—The Benchmarking Exchange, Towers Perrin, and Best Practices, LLC) and several councils and associations (e.g., the APQC, the Qualserve Benchmarking Clearinghouse, and the Strategic Planning Institute's Council on Benchmarking) to gather benchmarking data, distribute information about best practices, and provide comparative cost data without identifying the names of particular companies. Having an independent group gather the information and report it in a manner that disguises the names of individual companies avoids the disclosure of competitively sensitive data and lessens the potential for unethical behavior on the part of company personnel in gathering their own data about competitors.

The Value Chain System for an Entire Industry

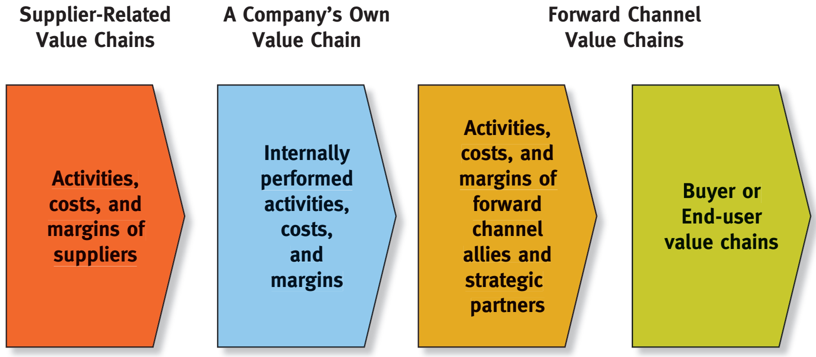
A company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever distribution channel allies it utilizes in getting its product or service to end users.[10] The value chains of forward channel partners are relevant because (1) the costs and margins of a company's distributors and retail dealers are part of the price the consumer ultimately pays, and (2) the activities that distribution allies perform affect customer satisfaction. For these reasons, companies normally work closely with their suppliers and forward channel allies to perform value chain activities in mutually beneficial ways. For instance, motor vehicle manufacturers work closely with their forward channel allies (local automobile dealers) to ensure that owners are satisfied with dealers' repair and maintenance services.[11] Also, many automotive parts

> A company's cost-competitiveness depends not only on the costs of internally performed activities (its own company value chain), but also on costs in the value chains of its suppliers and forward channel allies.

[10] Porter, *Competitive Advantage*, p. 34.

[11] M. Hegert and D. Morris, "Accounting Data for Value Chain Analysis," *Strategic Management Journal* 10 (1989), p. 180; Robin Cooper and Robert S. Kaplan, "Measure Costs Right: Make the Right Decisions," *Harvard Business Review* 66, no. 5 (September–October 1988), pp. 96–103; and John K. Shank and Vijay Govindarajan, *Strategic Cost Management* (New York: Free Press, 1993), especially Chapters 2–6, 10.

FIGURE 4.2 **Representative Value Chain for an Entire Industry**



Source: Based in part on the single-industry value chain displayed in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), p. 35.

suppliers have built plants near the auto assembly plants they supply to facilitate just-in-time deliveries, reduce warehousing and shipping costs, and promote close collaboration on parts design and production scheduling. Irrigation equipment companies, suppliers of grape-harvesting and wine-making equipment, and firms making barrels, wine bottles, caps, corks, and labels all have facilities in the California wine country to be close to the nearly 700 winemakers they supply.[12] The lesson here is that a company's value chain activities are often closely linked to the value chains of their suppliers and the forward allies.

As a consequence, *accurately assessing a company's competitiveness requires that company managers understand an industry's entire value chain system for delivering a product or service to customers, not just the company's own value chain.* A typical industry value chain that incorporates the activities, costs, and margins of suppliers and forward channel allies (if any) is shown in Figure 4.2. However, industry value chains vary significantly by industry. For example, the primary value chain activities in the bottled water industry (spring operation or water purification, processing of basic ingredients used in flavored or vitamin-enhanced water, bottling, wholesale distribution, advertising, and retail merchandising) differ from those for the computer software industry (programming, disk loading, marketing, distribution). Producers of bathroom and kitchen faucets depend heavily on the activities of wholesale distributors and building supply retailers in winning sales to homebuilders and do-it-yourselfers but producers of papermaking machines internalize their distribution activities by selling directly to the operators of paper plants. Concepts & Connections 4.1 shows representative costs for various activities performed by the producers and marketers of music CDs.

Strategic Options for Remedying a Cost Disadvantage

There are three main areas in a company's overall value chain where important differences in the costs of competing firms can occur: a company's own internal activities, the suppliers' part of the industry value chain, and the forward channel portion of the industry chain.

[12] For more on how and why the clustering of suppliers and other support organizations matter to a company's costs and competitiveness, see Michael E. Porter, "Clusters and the New Economics of Competition," *Harvard Business Review* 76, no. 6 (November–December 1998), pp. 77–90.

Concepts & Connections 4.1

ESTIMATED COSTS FOR VALUE CHAIN ACTIVITIES IN THE RECORDING INDUSTRY

The table below presents the representative costs and markups associated with producing and distributing a music CD retailing for $15 in music stores (as opposed to Internet sources).

Value Chain Activities and Costs in Producing and Distributing a CD		
1. Record company direct production costs:		$ 2.40
Artists and repertoire	$0.75	
Pressing of CD and packaging	1.65	
2. Royalties		.99
3. Record company marketing expenses		1.50
4. Record company overhead		1.50
5. Total record company costs		6.39
6. Record company's operating profit		1.86
7. Record company's selling price to distributor/wholesaler		8.25
8. Average wholesale distributor markup to cover distribution activities and profit margins		1.50
9. Average wholesale price charged to retailer		9.75
10. Average retail markup over wholesale cost		5.25
11. Average price to consumer at retail		$15.00

Source: Developed from information in "Fight the Power," a case study prepared by Adrian Aleyne, Babson College, 1999.

REMEDYING AN INTERNAL COST DISADVANTAGE When a company's cost disadvantage stems from performing internal value chain activities at a higher cost than key rivals, then managers can pursue any of several strategic approaches to restore cost parity:[13]

1. *Implement the use of best practices* throughout the company, particularly for high-cost activities.
2. *Try to eliminate some cost-producing activities altogether* by revamping the value chain. Many retailers have found that donating returned items to charitable organizations and taking the appropriate tax deduction results in a smaller loss than incurring the costs of the value chain activities involved in reverse logistics.
3. *Relocate high-cost activities* (such as manufacturing) to geographic areas like China, Latin America, or Eastern Europe where they can be performed more cheaply.
4. *See if certain internally performed activities can be outsourced* from vendors or performed by contractors more cheaply than they can be done in-house.
5. *Invest in productivity enhancing, cost-saving technological improvements* (robotics, flexible manufacturing techniques, state-of-the-art electronic networking).

[13] Some of these options are discussed in more detail in Porter, *Competitive Advantage*, Chapter 3.

6. *Find ways to detour around the activities or items where costs are high*—computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic for metal at many exterior body locations.
7. Redesign the product and/or some of its components to facilitate speedier and more economical manufacture or assembly.
8. Try to make up the internal cost disadvantage by reducing costs in the supplier or forward channel portions of the industry value chain—usually a last resort.

REMEDYING A SUPPLIER-RELATED COST DISADVANTAGE Supplier-related cost disadvantages can be attacked by pressuring suppliers for lower prices, switching to lower-priced substitute inputs, and collaborating closely with suppliers to identify mutual cost-saving opportunities.[14] For example, just-in-time deliveries from suppliers can lower a company's inventory and internal logistics costs, eliminate capital expenditures for additional warehouse space, and improve cash flow and financial ratios by reducing accounts payable. In a few instances, companies may find that it is cheaper to integrate backward into the business of high-cost suppliers and make the item in-house instead of buying it from outsiders.

REMEDYING A COST DISADVANTAGE ASSOCIATED WITH ACTIVITIES PERFORMED BY FORWARD CHANNEL ALLIES There are three main ways to combat a cost disadvantage in the forward portion of the industry value chain: (1) Pressure dealer-distributors and other forward channel allies to reduce their costs and markups; (2) work closely with forward channel allies to identify win-win opportunities to reduce costs—for example, a chocolate manufacturer learned that by shipping its bulk chocolate in liquid form in tank cars instead of 10-pound molded bars, it could not only save its candy bar manufacturing customers the costs associated with unpacking and melting but also eliminate its own costs of molding bars and packing them; and (3) change to a more economical distribution strategy or perhaps integrate forward into company-owned retail outlets. Dell Computer has eliminated all activities, costs, and margins of forward channel allies by adopting a direct sales business model that allows buyers to purchase customized PCs directly from the manufacturer. The direct sales model allows Dell to easily match competitors' prices, while earning larger profit margins.

Question 4: What Is the Company's Competitive Strength Relative to Key Rivals?

An additional component of evaluating a company's situation is developing a comprehensive assessment of the company's overall competitive strength. Making this determination requires answers to two questions:

[14] An example of how Whirlpool Corporation transformed its supply chain from a competitive liability to a competitive asset is discussed in Reuben E. Stone, "Leading a Supply Chain Turnaround," *Harvard Business Review* 82, no. 10 (October 2004), pp. 114–121.

1. How does the company rank relative to competitors on each of the important factors that determine market success?
2. All things considered, does the company have a net competitive advantage or disadvantage versus major competitors?

Step 1 in doing a competitive strength assessment is to make a list of the industry's key success factors and other telling measures of competitive strength or weakness (6 to 10 measures usually suffice). Step 2 is to assign a weight to each measure of competitive strength based on its perceived importance in shaping competitive success. (The sum of the weights for each measure must add up to 1.0.) Step 3 is to calculate weighted strength ratings by scoring each competitor on each strength measure (using a 1 to 10 rating scale where 1 is very weak and 10 is very strong) and multiplying the assigned rating by the assigned weight. Step 4 is to sum the weighted strength ratings on each factor to get an overall measure of competitive strength for each company being rated. Step 5 is to use the overall strength ratings to draw conclusions about the size and extent of the company's net competitive advantage or disadvantage and to take specific note of areas of strength and weakness. Table 4.2 provides an example of a competitive strength assessment, using the hypothetical ABC Company against four rivals. ABC's total score of 5.95 signals a net competitive advantage over Rival 3 (with a score of 2.10) and Rival 4 (with a score of 3.70), but indicates a net competitive disadvantage against Rival 1 (with a score of 7. 70) and Rival 2 (with an overall score of 6.85).

Interpreting the Competitive Strength Assessments

Competitive strength assessments provide useful conclusions about a company's competitive situation. The ratings show how a company compares against rivals, factor by factor or capability by capability, thus revealing where it is strongest and weakest. Moreover, the overall competitive strength scores indicate whether the company is at a net competitive advantage or disadvantage against each rival.

In addition, the strength ratings provide guidelines for designing wise offensive and defensive strategies. For example, consider the ratings and weighted scores in Table 4.2. If ABC Co. wants to go on the offensive to win additional sales and market share, such an offensive probably needs to be aimed directly at winning customers away from Rivals 3 and 4 (which have lower overall strength scores) rather than Rivals 1 and 2 (which have higher overall strength scores). ABC's advantages over Rival 4 tends to be in areas that are moderately important to competitive success in the industry, but ABC outclasses Rival 3 on the two most heavily weighted strength factors—relative cost position and customer service capabilities. Therefore, Rival 3 should be viewed as the primary target of ABC's offensive strategies, with Rival 4 being a secondary target.

A company's competitive strength scores pinpoint its strengths and weaknesses against rivals and point to offensive and defensive strategies capable of producing first-rate results.

The point here is that a competitively astute company should utilize the strength scores in deciding what strategic moves to make. When a company has important competitive strengths in areas where one or more rivals are weak,

Table 4.2

Illustration of a Competitive Strength Assessment

		ABC CO.		RIVAL 1		RIVAL 2		RIVAL 3		RIVAL 4	
Key Success Factor/Strength Measure	**Importance Weight**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**
Quality/product performance	0.10	8	0.80	5	0.50	10	1.00	1	0.10	6	0.60
Reputation/image	0.10	8	0.80	7	0.70	10	1.00	1	0.10	6	0.60
Manufacturing capability	0.10	2	0.20	10	1.00	4	0.40	5	0.50	1	0.10
Technological skills	0.05	10	0.50	1	0.05	7	0.35	3	0.15	8	0.40
Dealer network/distribution capability	0.05	9	0.45	4	0.20	10	0.50	5	0.25	1	0.05
New product innovation capability	0.05	9	0.45	4	0.20	10	0.50	5	0.25	1	0.05
Financial resources	0.10	5	0.50	10	1.00	7	0.70	3	0.30	1	0.10
Relative cost position	0.30	5	1.50	10	3.00	3	0.95	1	0.30	4	1.20
Customer service capabilities	0.15	5	0.75	7	1.05	10	1.50	1	0.15	4	0.60
Sum of importance weights	**1.00**										
Weighted overall strength rating			**5.95**		**7.70**		**6.85**		**2.10**		**3.70**

it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has competitive weaknesses in important areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

Question 5: What Strategic Issues and Problems Must Be Addressed by Management?

The final and most important analytical step is to zero in on exactly what strategic issues company managers need to address. This step involves drawing on the results of both industry and competitive analysis and the evaluations of the company's internal situation. The task here is to get a clear fix on exactly what industry and competitive challenges confront the company, which of the company's internal weaknesses need fixing, and what specific problems merit front-burner attention by company managers. *Pinpointing the precise things that management needs to worry about sets the agenda for deciding what actions to take next to improve the company's performance and business outlook.*

Compiling a "worry list" of problems and issues creates an agenda for managerial strategy making.

If the items on management's "worry list" are relatively minor, which suggests the company's strategy is mostly on track and reasonably well matched to the company's overall situation, company managers seldom need to go much beyond fine-tuning the present strategy. If, however, the issues and problems confronting the company are serious and indicate the present strategy is not well suited for the road ahead, the task of crafting a better strategy has got to go to the top of management's action agenda.

Key Points

There are five key questions to consider in analyzing a company's own particular competitive circumstances and its competitive position vis-à-vis key rivals:

1. *How well is the present strategy working?* This involves evaluating the strategy from a qualitative standpoint (completeness, internal consistency, rationale, and suitability to the situation) and also from a quantitative standpoint (the strategic and financial results the strategy is producing). The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance and/or the faster the changes in its external situation (which can be gleaned from industry and competitive analysis), the more its current strategy must be questioned.
2. *What are the company's competitively important resources and capabilities?* A company's resources, competitive capabilities, and core competencies are strategically relevant because they are the most logical and appealing

building blocks for strategy. In fact, many companies pursue *resource-based strategies* that attempt to exploit company resources in a manner that offers value to customers in ways rivals are unable to match. The most potent resource-based strategies exploit resources which are *competitively valuable, rare, hard to copy or imitate, and are not easily trumped by substitute resources.* A *SWOT analysis* is a simple but powerful tool for sizing up a company's resource strengths and competitive deficiencies, its market opportunities, and the external threats to its future well-being. Resource weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company's most attractive opportunities and at defending against threats to its well-being.

3. *Are the company's prices and costs competitive?* One telling sign of whether a company's situation is strong or precarious is whether its prices and costs are competitive with those of industry rivals. Value chain analysis and benchmarking are essential tools in determining whether the company is performing particular functions and activities cost-effectively, learning whether its costs are in line with competitors, and deciding which internal activities and business processes need to be scrutinized for improvement. Value chain analysis teaches that how competently a company manages its value chain activities relative to rivals is a key to building a competitive advantage based on either better competencies and competitive capabilities or lower costs than rivals.
4. *Is the company competitively stronger or weaker than key rivals?* The key appraisals here involve how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success and whether and why the company has a competitive advantage or disadvantage. Quantitative competitive strength assessments, using the method presented in Table 4.2, indicate where a company is competitively strong and weak and provide insight into the company's ability to defend or enhance its market position. As a rule a company's competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.
5. *What strategic issues and problems merit front-burner managerial attention?* This analytical step zeros in on the strategic issues and problems that stand in the way of the company's success. It involves using the results of both industry and competitive analysis and company situation analysis to identify a "worry list" of issues to be resolved in order for the company to be financially and competitively successful in the years ahead. Actually deciding upon a strategy and what specific actions to take is what comes after the list of strategic issues and problems that merit front-burner management attention has been developed.

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

LO1 1. Using the financial ratios provided in the Appendix and the financial statement information for Avon Products below, calculate the following ratios for Avon for both 2007 and 2008:

a. Gross profit margin
b. Operating profit margin
c. Net profit margin
d. Times interest earned coverage
e. Return on shareholders' equity
f. Return on assets
g. Debt-to-equity ratio
h. Days of inventory
i. Inventory turnover ratio
j. Average collection period

Based on these ratios, did Avon's financial performance improve, weaken, or remain about the same from 2007 to 2008?

Assurance of Learning Exercises

CONSOLIDATED STATEMENTS OF INCOME FOR AVON PRODUCTS, INC., 2007–2008
(in millions, except per share data)

Years ended December 31	2008	2007
Net sales	$ 10,588.9	$ 9,845.2
Other revenue	101.2	93.5
Total revenue	10,690.1	9,938.7
Costs, expenses and other:		
Cost of sales	3,949.1	3,941.2
Selling, general and administrative expenses	5,401.7	5,124.8
Operating profit	1,339.3	872.7
Interest expense	100.4	112.2
Interest income	(37.1)	(42.2)
Other expense, net	37.7	6.6
Total other expenses	101.0	76.6
Income before taxes and minority interest	1,238.3	796.1
Income taxes	362.7	262.8
Income before minority interest	875.6	533.3
Minority interest	(0.3)	(2.6)
Net income	$ 875.3	$ 530.7
Earnings per share:		
Basic	$ 2.05	$ 1.22
Diluted	$ 2.04	$ 1.21
Weighted-average shares outstanding:		
Basic	426.36	433.47
Diluted	429.53	436.89

CONSOLIDATED BALANCE SHEETS FOR AVON PRODUCTS, INC., 2007–2008
(in millions, except per share data)

December 31	2008	2007
Assets		
Current assets		
Cash, including cash equivalents of $704.8 and $492.3	$ 1,104.7	$ 963.4
Accounts receivable (less allowances of $127.9 and $141.1)	687.8	795.0
Inventories	1,007.9	1,041.8
Prepaid expenses and other	756.5	715.2
Total current assets	3,556.9	3,515.4
Property, plant and equipment, at cost		
Land	85.3	71.8
Buildings and improvements	1,000.7	972.7
Equipment	1,353.9	1,317.9
	2,439.9	2,362.4
Less accumulated depreciation	(1,096.0)	(1,084.2)
	1,343.9	1,278.2
Other assets	1,173.2	922.6
Total assets	$ 6,074.0	$ 5,716.2
Liabilities and Shareholders' Equity		
Current liabilities		
Debt maturing within one year	$ 1,031.4	$ 929.5
Accounts payable	724.3	800.3
Accrued compensation	234.4	285.8
Other accrued liabilities	581.9	713.2
Sales and taxes other than income	212.2	222.3
Income taxes	128.0	102.3
Total current liabilities	2,912.2	3,053.4
Long-term debt	1,456.2	1,167.9
Employee benefit plans	665.4	388.7
Long-term income taxes	168.9	208.7
Other liabilities (including minority interest of $37.4 and $38.2)	196.4	185.9
Total liabilities	$ 5,399.1	$ 5,004.6
Commitments and contingencies (Notes 13 and 15)		
Shareholders'equity		
Common stock, par value $.25 – authorized 1,500 shares; issued 739.4 and 736.3 shares	$ 185.6	$ 184.7
Additional paid-in capital	1,874.1	1,724.6
Retained earnings	4,118.9	3,586.5
Accumulated other comprehensive loss	(965.9)	(417.0)
Treasury stock, at cost –313.1 and 308.6 shares	(4,537.8)	(4,367.2)
Total shareholders' equity	$ 674.9	$ 711.6
Total liabilities and shareholders' equity	$ 6,074.0	$ 5,716.2

Source: Avon Products, Inc. 2008, 10-K.

LO2 2. Review the information in Concepts & Connections 4.1 concerning the costs of the different value chain activities associated with recording and distributing music CDs through traditional brick-and-mortar retail outlets. Then answer the following questions:

   a. Does the growing popularity of downloading music from the Internet give rise to a new music industry value chain that differs considerably from the traditional value chain? Explain why or why not.
   b. What costs would be cut out of the traditional value chain or bypassed in the event recording studios sell downloadable files of artists' recordings direct to online buyers?
   c. What happens to the traditional value chain if more and more consumers use peer-to-peer file-sharing software to download music from the Internet rather than purchase CDs or downloadable files?

Exercises for Simulation Participants

LO1 LO2 LO3

1. What hard evidence can you cite that indicates your company's strategy is working fairly well (or perhaps not working so well, if your company's performance is lagging that of rival companies)?
2. What resource strengths and resource weaknesses does your company have? What external market opportunities for growth and increased profitability exist for your company? What external threats to your company's future well-being and profitability do you and your co-managers see? What does the preceding SWOT analysis indicate about your company's present situation and future prospects—where on the scale from "exceptionally strong" to "alarmingly weak" does the attractiveness of your company's situation rank?
3. Does your company have any core competencies? If so, what are they?
4. What are the key elements of your company's value chain? Refer to Figure 4.1 in developing your answer.
5. Using the methodology presented in Table 4.2, prepare a competitive strength assessment for your company and two other companies that you and your co-managers consider to be very close competitors.