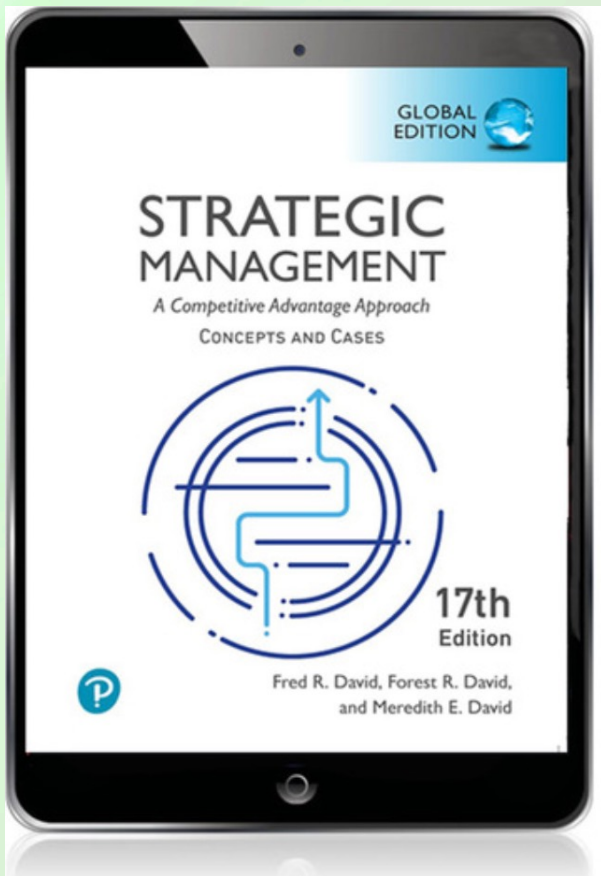




THE INTERNAL AUDIT

Chapter Six

6-1

CHAPTER OBJECTIVES

1. Be able to work out breakeven analysis business problems.
2. Describe how to perform an internal strategic-management audit.
3. Discuss the Resource-Based View (RBV) in strategic management.
4. Discuss key interrelationships among the functional areas of business.

6-2

CHAPTER OBJECTIVES

5. Identify the basic functions or activities that make up management, marketing, finance/accounting production/operations, research and development, and management information systems.
6. Explain how to determine and prioritize a firm's Internal strengths and weaknesses.
7. Explain the importance of financial ratio analysis.
8. Discuss the nature and role of management information systems in strategic management.
9. Develop an Internal Factor Evaluation (IFE) Matrix.
10. Explain cost/benefit analysis value chain analysis, and benchmarking as strategic-management tools.

6-3

A COMPREHENSIVE STRATEGIC-MANAGEMENT MODEL

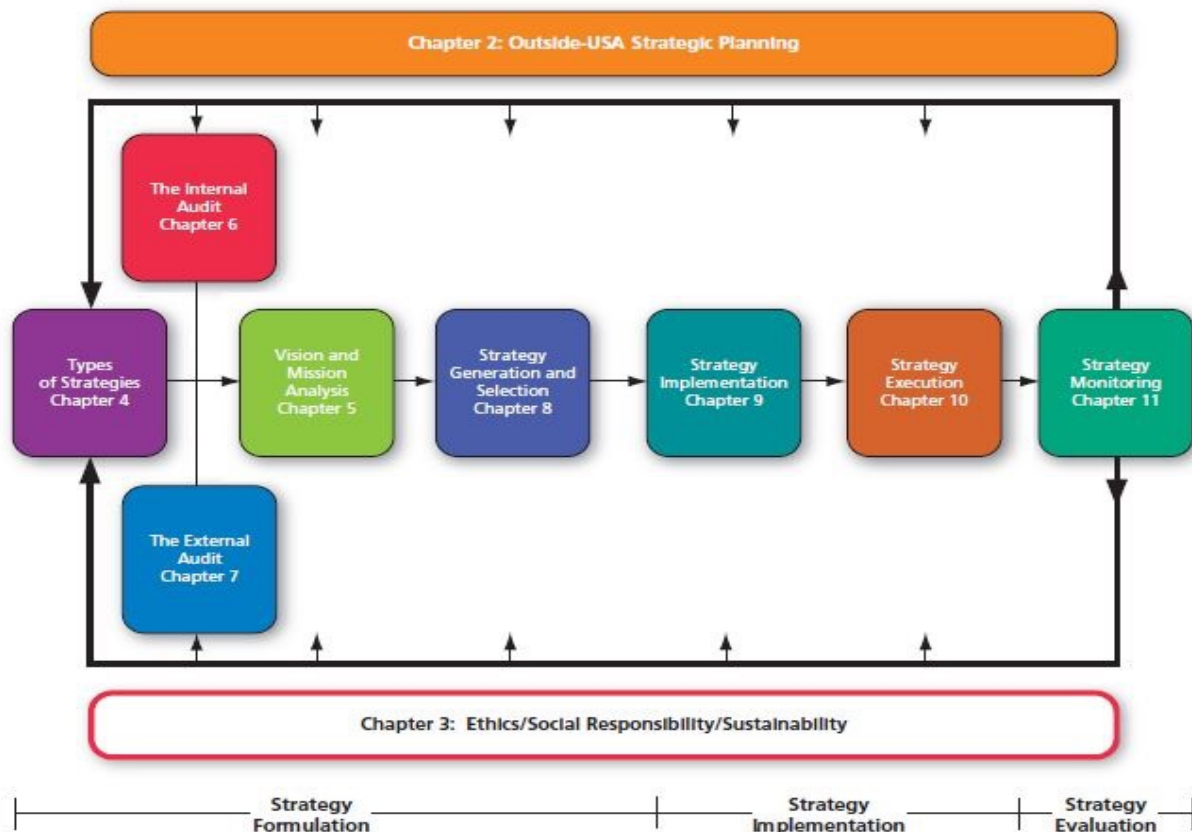


FIGURE 3-1

A Comprehensive Strategic-Management Model

6-4

KEY INTERNAL FORCES

- ▶ **Distinctive competencies**
 - ▶ A firm's strengths that cannot be easily matched or imitated by competitors
- ▶ **Building competitive advantages involves taking advantage of distinctive competencies.**

Weaknesses $\Rightarrow$ Strengths $\Rightarrow$ Distinctive Competencies $\Rightarrow$ Competitive Advantage

FIGURE 6-2

The Process of Gaining Competitive Advantage in a Firm

6-5

THE PROCESS OF PERFORMING AN INTERNAL AUDIT

- ▶ **The internal audit**
 - ▶ Requires gathering and assimilating information about the firm's management, marketing, finance/accounting, production/operations, research and development (R&D), and management information systems operations
 - ▶ Provides more opportunity for participants to understand how their jobs, departments, and divisions fit into the whole organization

6-6

THE RESOURCE-BASED VIEW (RBV)

► The Resource-Based View (RBV) approach

- contends that internal resources are more important for a firm than external factors in achieving and sustaining competitive advantage

6-7

THE RESOURCE-BASED VIEW (RBV)

Proponents of the RBV contend that organizational performance will primarily be determined by internal resources that can be grouped into three all-encompassing categories:

- physical resources,
- human resources, and
- organizational resources

6-8

THE RESOURCE-BASED VIEW (RBV)

- ▶ For a resource to be valuable, it must be either
 - (1) rare,
 - (2) hard to imitate, or
 - (3) 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.

6-9

TABLE 6-1 Example Cultural Products Defined

Rites	Planned sets of activities that consolidate various forms of cultural expressions into one event.
Ceremonial	Several rites connected together.
Ritual	A standardized set of behaviors used to manage anxieties.
Myth	A narrative of imagined events, usually not supported by facts.
Saga	A historical narrative describing the unique accomplishments of a group and its leaders.
Legend	A handed-down narrative of some wonderful event, usually not supported by facts.
Story	A narrative usually based on true events.
Folktale	A fictional story.
Symbol	Any object, act, event, quality, or relation used to convey meaning.
Language	The manner in which members of a group communicate.
Metaphors	Shorthand of words used to capture a vision or to reinforce old or new values.
Values	Life-directing attitudes that serve as behavioral guidelines.
Belief	An understanding of a particular phenomenon.
Heroes/Heroines	Individuals greatly respected.

6-10

INTEGRATING STRATEGY AND CULTURE

- ▶ Organizational culture significantly affects business decisions and thus must be evaluated during an internal strategic-management audit.
- ▶ If strategies can capitalize on cultural strengths, such as a strong work ethic or highly ethical beliefs, then management often can swiftly and easily implement changes.

6-11

MANAGEMENT

- ▶ The *functions of management* consist of five basic activities: planning, organizing, motivating, staffing, and controlling.
- ▶ These activities are important to assess in strategic planning because an organization should continually capitalize on its management strengths and improve on its management weaknesses.

6-12

TABLE 6-3 The Basic Functions of Management

Function	Description	Stage of Strategic-Management Process When Most Important
Planning	Planning consists of all those managerial activities related to preparing for the future. Specific tasks include forecasting, establishing objectives, devising strategies, developing policies, and setting goals.	Strategy Formulation
Organizing	Organizing includes all those managerial activities that result in a structure of task and authority relationships. Specific areas include organizational design, job specialization, job descriptions, job specifications, span of control, unity of command, coordination, job design, and job analysis.	Strategy Implementation
Motivating	Motivating involves efforts directed toward shaping human behavior. Specific topics include leadership, communication, work groups, behavior modification, delegation of authority, job enrichment, job satisfaction, needs fulfillment, organizational change, employee morale, and managerial morale.	Strategy Implementation
Staffing	Staffing activities are centered on personnel or human resource management. Included are wage and salary administration, employee benefits, interviewing, hiring, firing, training, management development, employee safety, affirmative action, equal employment opportunity, union relations, career development, personnel research, discipline policies, grievance procedures, and public relations.	Strategy Implementation
Controlling	Controlling refers to all those managerial activities directed toward ensuring that actual results are consistent with planned results. Key areas of concern include quality control, financial control, sales control, inventory control, expense control, analysis of variances, rewards, and sanctions.	Strategy Evaluation

6-13

MANAGEMENT AUDIT CHECKLIST OF QUESTIONS

1. Does the firm use strategic-management concepts?
2. Are company objectives and goals measurable and well communicated?
3. Do managers at all hierarchical levels plan effectively?
4. Do managers delegate authority well?
5. Is the organization's structure appropriate?

6-14

MANAGEMENT AUDIT CHECKLIST OF QUESTIONS

6. Are job descriptions and job specifications clear?
7. Is employee morale high?
8. Are employee turnover and absenteeism low?
9. Are organizational reward and control mechanisms effective?

6-15

MARKETING

► Marketing

- the process of defining, anticipating, creating, and fulfilling customers' needs and wants for products and services

6-16

FUNCTIONS OF MARKETING

Customer analysis

Selling products/services

Product and service planning

Pricing /Distribution

Marketing research

Cost benefit analysis

6-17

MARKETING

► Customer analysis

- the examination and evaluation of consumer needs, desires, and wants
- involves administering customer surveys, analyzing consumer information, evaluating market positioning strategies, developing customer profiles, and determining optimal market segmentation strategies
- essential in developing an effective mission statement

6-18

TABLE 6-4 Desirable Characteristics of Ads Today

1. Take direct aim at competitors; so leaner, meaner, and to the point.
2. Be less lavish and glamorous, requiring less production dollars to develop.
3. Be short and sweet, mostly 10- and 15-second ads rather than longer than 30 seconds.
4. “Make you feel good” or “put you in a good mood” because (a) ads can be more easily avoided than ever and (b) people are experiencing hard times and seek comfort.
5. Be more pervasive such as on buses, elevators, cell phones, and trucks.
6. Appear less on websites as banner ads become the new junk mail.
7. Red will overtake the color orange as the most popular ad color.
8. More than ever emphasize low price and value versus rivals.
9. More than ever emphasize how the product or service will make your life better.

6-19

PRODUCT AND SERVICE PLANNING

► **Product and service planning**

- includes activities such as test marketing; product and brand positioning; devising warranties; packaging; determining product options, features, style, and quality; deleting old products; and providing for customer service
- important when a company is pursuing product development or diversification

6-20

PRICING

- ▶ Five major stakeholders affect *pricing* decisions: consumers, governments, suppliers, distributors, and competitors
- ▶ Sometimes an organization will pursue a forward integration strategy primarily to gain better control over prices charged to consumers

6-21

DISTRIBUTION

- ▶ **Distribution**
 - ▶ includes warehousing, distribution channels, distribution coverage, retail site locations, sales territories, inventory levels and location, transportation carriers, wholesaling, and retailing
 - ▶ especially important when a firm is striving to implement a market development or forward integration strategy

6-22

MARKETING RESEARCH

▶ **Marketing research**

- ▶ **the systematic gathering, recording, and analyzing of data about problems relating to the marketing of goods and services**
- ▶ **can uncover critical strengths and weaknesses**

6-23

COST/BENEFIT ANALYSIS

Three steps are required to perform a cost/benefit analysis:

- 1. compute the total costs associated with a decision**
- 2. estimate the total benefits from the decision**
- 3. compare the total costs with the total benefits**

6-24

MARKETING AUDIT CHECKLIST OF QUESTIONS

1. Are markets segmented effectively?
2. Is the organization positioned well among competitors?
3. Has the firm's market share been increasing?
4. Are present channels of distribution reliable and cost effective?
5. Does the firm have an effective sales organization?
6. Does the firm conduct market research?

6-25

MARKETING AUDIT CHECKLIST OF QUESTIONS

7. Are product quality and customer service good?
8. Are the firm's products and services priced appropriately?
9. Does the firm have an effective promotion, advertising, and publicity strategy?
10. Are marketing, planning, and budgeting effective?
11. Do the firm's marketing managers have adequate experience and training?
12. Is the firm's Internet presence excellent as compared to rivals?

6-26

FINANCE/ACCOUNTING FUNCTIONS

The *functions of finance/accounting* comprise three decisions:

1. the investment decision
2. the financing decision
3. the dividend decision

6-27

FINANCE/ACCOUNTING FUNCTIONS

► Investment decision

- the allocation and reallocation of capital and resources to projects, products, assets, and divisions of an organization

► Financing decision

- determines the best capital structure for the firm and includes examining various methods by which the firm can raise capital

6-28

FINANCE/ACCOUNTING FUNCTIONS

► Dividend decisions

- concern issues such as the percentage of earnings paid to stockholders, the stability of dividends paid over time, and the repurchase or issuance of stock
- determine the amount of funds that are retained in a firm compared to the amount paid out to stockholders

6-29

TABLE 6-6 A Summary of Key Financial Ratios

Ratio	How Calculated	What It Measures
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
Leverage Ratios		
Debt-to-Total-Assets Ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	The percentage of total funds that are 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

6-30

TABLE 6-6 A Summary of Key Financial Ratios

Ratio	How Calculated	What It Measures
Activity Ratios		
Inventory Turnover	$\frac{\text{Sales}}{\text{Inventory of finished goods}}$	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	$\frac{\text{Annual credit sales}}{\text{Accounts receivable}}$	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)

6-31

TABLE 6-6 A Summary of Key Financial Ratios

Ratio	How Calculated	What It Measures
Profitability Ratios		
Gross Profit Margin	$\frac{\text{Sales minus cost of goods sold}}{\text{Sales}}$	The total margin available to cover operating expenses and yield a profit
Operating Profit Margin	$\frac{\text{Earnings before interest and taxes EBIT}}{\text{Sales}}$	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)		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

6-32

TABLE 6-6 A Summary of Key Financial Ratios

Ratio	How Calculated	What It Measures
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

6-33

FINANCE/ACCOUNTING FUNCTIONS

1. How has each ratio changed over time?
2. How does each ratio compare to industry norms?
3. How does each ratio compare with key competitors?

6-34

FINANCE/ACCOUNTING AUDIT CHECKLIST

1. Where is the firm financially strong and weak as indicated by financial ratio analyses?
2. Can the firm raise needed short-term capital?
3. Can the firm raise needed long-term capital through debt and/or equity?
4. Does the firm have sufficient working capital?
5. Are capital budgeting procedures effective?

6-35

FINANCE/ACCOUNTING AUDIT CHECKLIST

7. Are dividend payout policies reasonable?
8. Does the firm have good relations with its investors and stockholders?
9. Are the firm's financial managers experienced and well trained?
10. Is the firm's debt situation excellent?

6-36

PRODUCTION/OPERATIONS

- ▶ **Production/operations function**
 - ▶ consists of all those activities that transforms inputs into goods and services
- ▶ **Production/operations management deals with inputs, transformations, and outputs that vary across industries and markets.**

6-37

TABLE 6-8 The Basic Functions (Decisions) Within Production/Operations

Decision Areas	Example Decisions
1. Process	These decisions include choice of technology, facility layout, process flow analysis, facility location, line balancing, process control, and transportation analysis. Distances from raw materials to production sites to customers are a major consideration.
2. Capacity	These decisions include forecasting, facilities planning, aggregate planning, scheduling, capacity planning, and queuing analysis. Capacity utilization is a major consideration.
3. Inventory	These decisions involve managing the level of raw materials, work-in-process, and finished goods, especially considering what to order, when to order, how much to order, and materials handling.
4. Workforce	These decisions involve managing the skilled, unskilled, clerical, and managerial employees by caring for job design, work measurement, job enrichment, work standards, and motivation techniques.
5. Quality	These decisions are aimed at ensuring that high-quality goods and services are produced by caring for quality control, sampling, testing, quality assurance, and cost control.

6-38

TABLE 6-9 Implications of Various Strategies on Production and Operations

Various Strategies	Implications
1. Low-cost provider	Creates high barriers to entry Creates larger market Requires longer production runs and fewer product changes
2. A high-quality provider	Requires more quality-assurance efforts Requires more expensive equipment Requires highly skilled workers and higher wages
3. Provide great customer service	Requires more service people, service parts, and equipment Requires rapid response to customer needs or changes in customer tastes Requires a higher inventory investment
4. Be the first to introduce new products	Has higher research and development costs Has high retraining and tooling costs
5. Become highly automated	Requires high capital investment Reduces flexibility May affect labor relations Makes maintenance more crucial
6. Minimize layoffs	Serves the security needs of employees and may develop employee loyalty Helps to attract and retain highly skilled employees

6-39

PRODUCTION/OPERATIONS AUDIT CHECKLIST

1. Are supplies of raw materials, parts, and subassemblies reliable and reasonable?
2. Are facilities, equipment, machinery, and offices in good condition?
3. Are inventory-control policies and procedures effective?
4. Are quality-control policies and procedures effective?
5. Are facilities, resources, and markets strategically located?
6. Does the firm have technological competencies?

6-40

RESEARCH AND DEVELOPMENT AUDIT

1. Does the firm have R&D facilities? Are they adequate?
2. If outside R&D firms are used, are they cost-effective?
3. Are the organization's R&D personnel well qualified?
4. Are R&D resources allocated effectively?
5. Are management information and computer systems adequate?
6. Is communication between R&D and other organizational units effective?
7. Are present products technologically competitive?

6-41

MANAGEMENT INFORMATION SYSTEMS

- ▶ A management information system's purpose is to improve the performance of an enterprise by improving the quality of managerial decisions
- ▶ An effective information system thus collects, codes, stores, synthesizes, and presents information in such a manner that it answers important operating and strategic questions

6-42

MANAGEMENT INFORMATION SYSTEMS AUDIT

1. Do all managers in the firm use the information system to make decisions?
2. Is there a chief information officer or director of information systems position in the firm?
3. Are data in the information system updated regularly?
4. Do managers from all functional areas of the firm contribute input to the information system?
5. Are there effective passwords for entry into the firm's information system?

6-43

MANAGEMENT INFORMATION SYSTEMS AUDIT

6. Are strategists of the firm familiar with the information systems of rival firms?
7. Is the information system user-friendly?
8. Do all users of the information system understand the competitive advantages that information can provide firms?
9. Are computer training workshops provided for users of the information system?
10. Is the firm's information system continually being improved in content- and user-friendliness?

6-44

VALUE CHAIN ANALYSIS (VCA)

► Value chain analysis (VCA)

- refers to the process whereby a firm determines the costs associated with organizational activities from purchasing raw materials to manufacturing product(s) to marketing those products
- aims to identify where low-cost advantages or disadvantages exist anywhere along the value chain from raw material to customer service activities

6-45

BENCHMARKING

► Benchmarking

- an analytical tool used to determine whether a firm's value chain activities are competitive compared to rivals and thus conducive to winning in the marketplace
- entails measuring costs of value chain activities across an industry to determine "best practices"

6-46

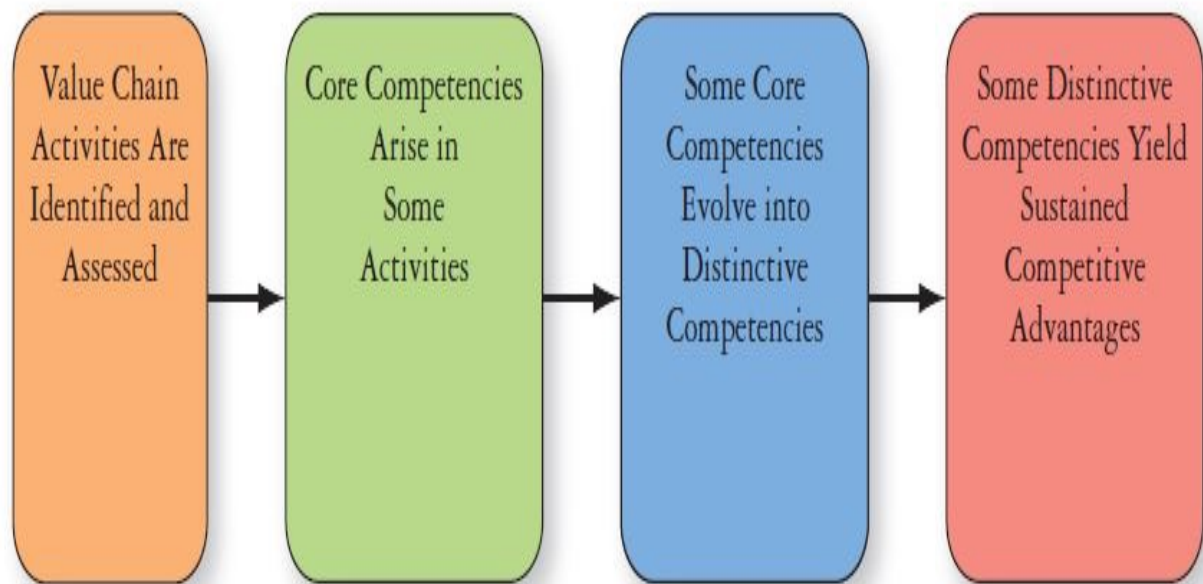


FIGURE 6-8

Transforming Value Chain Activities into Sustained Competitive Advantage

6-47

THE INTERNAL FACTOR EVALUATION (IFE) MATRIX

1. List key internal factors as identified in the internal-audit process
2. Assign a weight that ranges from 0.0 (not important) to 1.0 (all-important) to each factor
3. Assign a 1-to-4 rating to each factor to indicate whether that factor represents a strength or weakness
4. Multiply each factor's weight by its rating to determine a weighted score for each variable
5. Sum the weighted scores for each variable to determine the total weighted score for the organization

6-48

TABLE 6-10 A Sample Internal Factor Evaluation Matrix for a Retail Computer Store

Key Internal Factors	Weight	Rating	Weighted Score
Strengths			
1. Inventory turnover increased from 5.8 to 6.7	0.05	3	0.15
2. Average customer purchase increased from \$97 to \$128	0.07	4	0.28
3. Employee morale is excellent	0.10	3	0.30
4. In-store promotions resulted in 20 percent increase in sales	0.05	3	0.15
5. Newspaper advertising expenditures increased 10 percent	0.02	3	0.06
6. Revenues from repair/service segment of store up 16 percent	0.15	3	0.45
7. In-store technical support personnel have MIS college degrees	0.05	4	0.20
8. Store's debt-to-total assets ratio declined to 34 percent	0.03	3	0.09
9. Revenues per employee up 19 percent	0.02	3	0.06
Weaknesses			
1. Revenues from software segment of store down 12 percent	0.10	2	0.20
2. Location of store negatively impacted by new Highway 34	0.15	2	0.30
3. Carpet and paint in store somewhat in disrepair	0.02	1	0.02
4. Bathroom in store needs refurbishing	0.02	1	0.02
5. Revenues from businesses down 8 percent	0.04	1	0.04
6. Store has no website	0.05	2	0.10
7. Supplier on-time delivery increased to 2.4 days	0.03	1	0.03
8. Often customers have to wait to check out	0.05	1	0.05
Total	1.00		2.50