

The External Audit

Chapter Seven

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CHAPTER OBJECTIVES

1. Discuss the nature and role of labor unions in the USA as a corporate strategic issue.
2. Describe how to conduct an external strategic-management audit.
3. Discuss 10 major external forces that affect organizations: economic, social, cultural, demographic, environmental, political, governmental, legal, technological, and competitive.
4. Describe key sources of external information.
5. Discuss important forecasting tools used in strategic management.

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CHAPTER OBJECTIVES (CONT.)

6. Discuss the importance of monitoring external trends and events.
7. Explain how to develop an EFE Matrix.
8. Explain how to develop a Competitive Profile Matrix.
9. Discuss the importance of gathering competitive intelligence.
10. Describe the trend toward cooperation among competitors.
11. Discuss market commonality and resource similarity in relation to competitive analysis.

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EXTERNAL AUDIT

► External audit

- focuses on identifying and evaluating trends and events beyond the control of a single firm
- reveals key opportunities and threats confronting an organization so that managers can formulate strategies to take advantage of the opportunities and avoid or reduce the impact of threats

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THE NATURE OF AN EXTERNAL AUDIT

- ▶ The external audit is aimed at identifying key variables that offer actionable responses
- ▶ Firms should be able to respond either offensively or defensively to the factors by formulating strategies that take advantage of external opportunities or that minimize the impact of potential threats.

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A COMPREHENSIVE STRATEGIC-MANAGEMENT MODEL

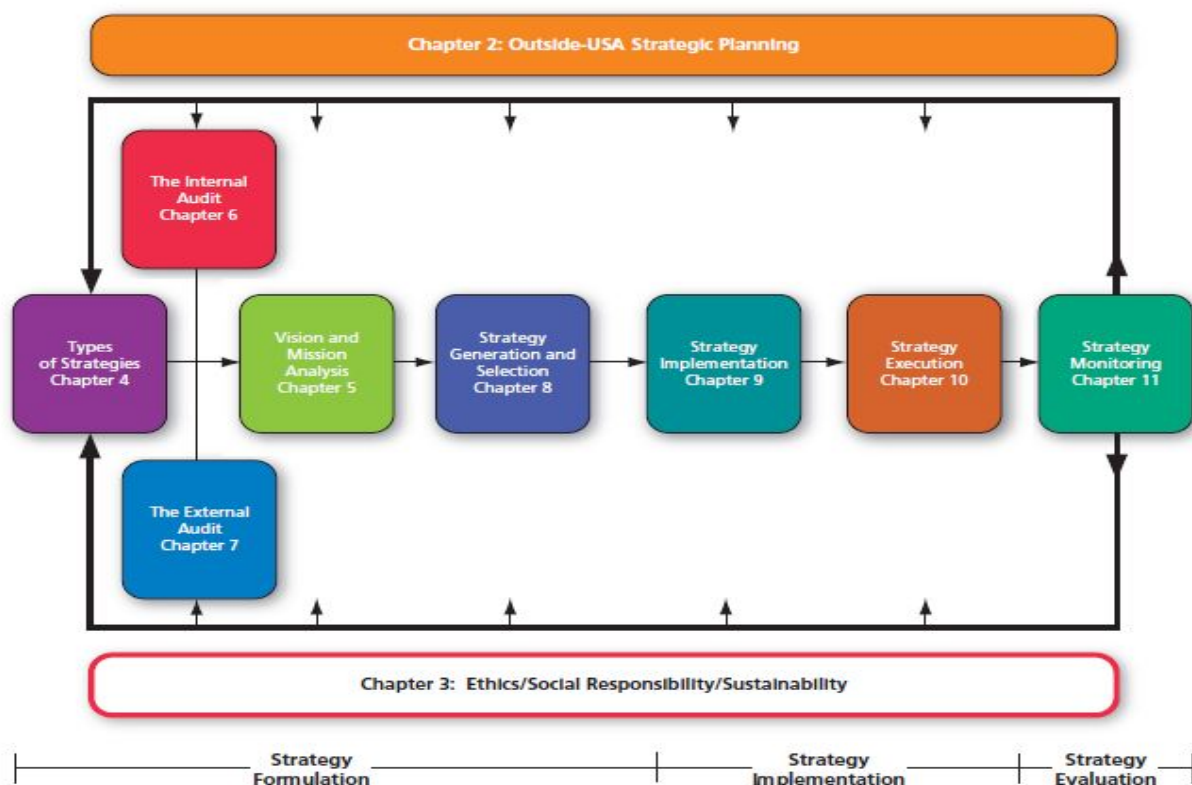


FIGURE 3-1

A Comprehensive Strategic-Management Model

KEY EXTERNAL FORCES

External forces can be divided into five broad categories:

1. economic forces
2. social, cultural, demographic, and natural environment forces
3. political, governmental, and legal forces
4. technological forces
5. competitive forces

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RELATIONSHIPS BETWEEN KEY EXTERNAL FORCES AND AN ORGANIZATION

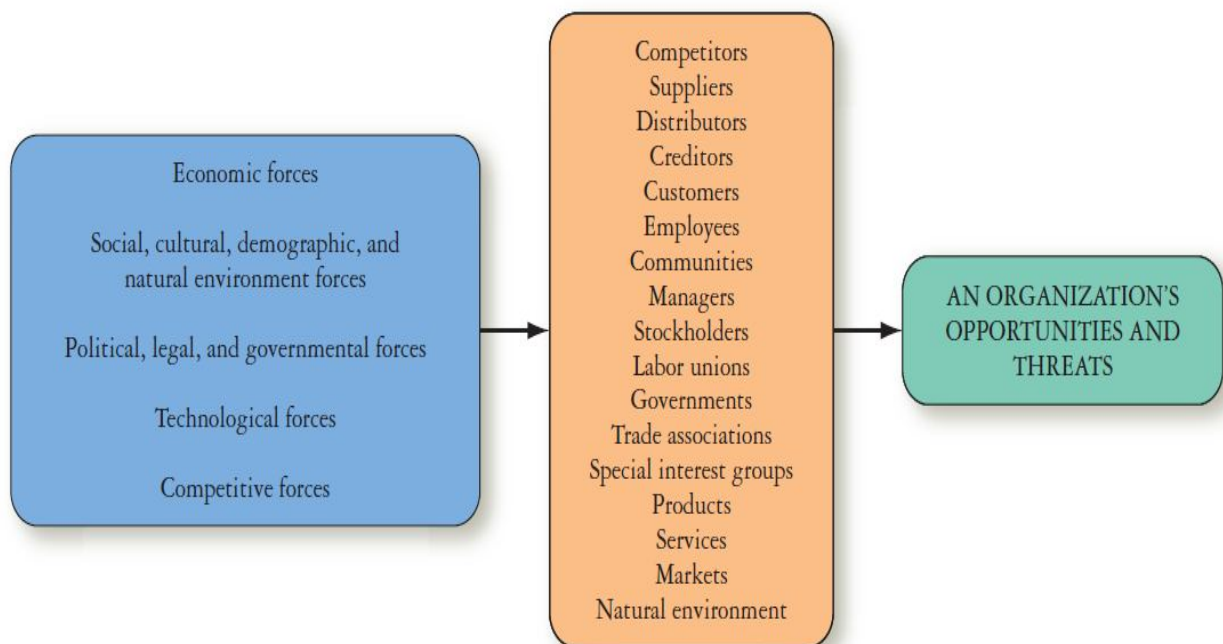


FIGURE 7-2

Relationships Between Key External Forces and an Organization

THE PROCESS OF PERFORMING AN EXTERNAL AUDIT

- ▶ First, gather competitive intelligence and information about economic, social, cultural, demographic, environmental, political, governmental, legal, and technological trends.

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THE PROCESS OF PERFORMING AN EXTERNAL AUDIT

- ▶ Information should be assimilated and evaluated
- ▶ A final list of the most important key external factors should be communicated

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THE PROCESS OF PERFORMING AN EXTERNAL AUDIT

Key *external factors* should be:

1. important to achieving long-term and annual objectives
2. measurable
3. applicable to all competing firms, and
4. hierarchical in the sense that some will pertain to the overall company and others will be more narrowly focused on functional or divisional areas

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THE INDUSTRIAL ORGANIZATION (I/O) VIEW

- The *Industrial Organization (I/O)* approach to competitive advantage advocates that external (industry) factors are more important than internal factors in a firm for achieving competitive advantage.

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THE INDUSTRIAL ORGANIZATION (I/O) VIEW

- Firm performance is based more on industry properties

Economies of scale

Barriers to market entry

Product differentiation

The economy

Level of competitiveness

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ECONOMIC FORCES

TABLE 7-1 Key Economic Variables to Be Monitored

Shift to a service economy in the USA	Import/export factors
Availability of credit	Demand shifts for different categories of goods and services
Level of disposable income	Income differences by region and consumer groups
Propensity of people to spend	Price fluctuations
Interest rates	Export of labor and capital from the USA
Inflation rates	Monetary policies
Money market rates	Fiscal policies
Federal government budget deficits	Tax rates
Gross domestic product trend	European Economic Community (EEC) policies
Consumption patterns	Organization of Petroleum Exporting Countries (OPEC) policies
Unemployment trends	Coalitions of Lesser Developed Countries (LDC) policies
Worker productivity levels	
Value of the dollar in world markets	
Stock market trends	
Foreign countries' economic conditions	

TABLE 7-2 Advantages and Disadvantages of a Weak Dollar for Domestic Firms

Advantages	Disadvantages
1. Leads to more exports	1. Can lead to inflation
2. Leads to lower imports	2. Can cause rise in oil prices
3. Makes U.S. goods cheaper to foreign consumers	3. Can weaken U.S. government
4. Combats deflation by pushing up prices of imports	4. Makes it unattractive for Americans to travel globally
5. Can contribute to rise in stock prices in short run	5. Can contribute to fall in stock prices in long run
6. Encourages foreign countries to lower interest rates	
7. Raises the revenues and profits of firms that do business outside the USA	
8. Forces foreign firms to raise prices	
9. Reduces the U.S. trade deficit	
10. Encourages firms to globalize	
11. Encourages foreigners to visit the United States	

SOCIAL, CULTURAL, DEMOGRAPHIC, AND NATURAL ENVIRONMENTAL FORCES

► U.S. Facts

- Aging population
- Less white
- Widening gap between rich & poor
- 2025 = 18.5% population > 65 years
- 2075 = no ethnic or racial majority

SOCIAL, CULTURAL, DEMOGRAPHIC, AND NATURAL ENVIRONMENTAL FORCES

► Facts

- World population 7 billion
- World population = 8 billion by 2028
- World population = 9 billion by 2054
- U.S. population > 310 million

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TABLE 7-3 Key Social, Cultural, Demographic, and Natural Environment Variables

Childbearing rates	Attitudes toward retirement
Number of special-interest groups	Attitudes toward leisure time
Number of marriages	Attitudes toward product quality
Number of divorces	Attitudes toward customer service
Number of births	Pollution control
Number of deaths	Attitudes toward foreign peoples
Immigration and emigration rates	Energy conservation
Social Security programs	Social programs
Life expectancy rates	Number of churches
Per capita income	Number of church members
Location of retailing, manufacturing, and service businesses	Social responsibility
Attitudes toward business	Attitudes toward careers
Lifestyles	Population changes by race, age, sex, and level of affluence
Traffic congestion	Attitudes toward authority
Inner-city environments	Population changes by city, county, state, region, and country
Average disposable income	Value placed on leisure time
Trust in government	Regional changes in tastes and preferences
Attitudes toward government	Number of women and minority workers
Attitudes toward work	Number of high school and college graduates by geographic area
Buying habits	Recycling
Ethical concerns	Waste management
Attitudes toward saving	Air pollution
Sex roles	Water pollution
Attitudes toward investing	Ozone depletion
Racial equality	Endangered species
Use of birth control	
Average level of education	
Government regulation	

POLITICAL, GOVERNMENTAL, AND LEGAL FORCES

- The increasing global interdependence among economies, markets, governments, and organizations makes it imperative that firms consider the possible impact of political variables on the formulation and implementation of competitive strategies.

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TABLE 7-4 Some Political, Governmental, and Legal Variables

Government regulations or deregulations	Sino American relationships
Changes in tax laws	Russian American relationships
Special tariffs	European American relationships
Political action committees	African American relationships
Voter participation rates	Import–export regulations
Number, severity, and location of government protests	Government fiscal and monetary policy changes
Number of patents	Political conditions in foreign countries
Changes in patent laws	Special local, state, and federal laws
Environmental protection laws	Lobbying activities
Level of defense expenditures	Size of government budgets
Legislation on equal employment	World oil, currency, and labor markets
Level of government subsidies	Location and severity of terrorist activities
Antitrust legislation	Local, state, and national elections

AMERICAN LABOR UNIONS

- ▶ The extent that a state is unionized can be a significant political factor in strategic planning decisions as related to manufacturing plant location and other operational matters
- ▶ The size of American labor unions has fallen sharply in the last decade due in large part to erosion of the U.S. manufacturing base

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TECHNOLOGICAL FORCES

The *Internet* has changed the very nature of opportunities and threats by:

- ▶ altering the life cycles of products,
- ▶ increasing the speed of distribution,
- ▶ creating new products and services,
- ▶ erasing limitations of traditional geographic markets,
- ▶ changing the historical trade-off between production standardization and flexibility.

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TECHNOLOGICAL FORCES

- ▶ The *Internet* has lowered entry barriers, and redefined the relationship between industries and various suppliers, creditors, customers, and competitors.

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TECHNOLOGICAL FORCES

- ▶ Many firms now have a **Chief Information Officer (CIO)** and a **Chief Technology Officer (CTO)** who work together to ensure that information needed to formulate, implement, and evaluate strategies is available where and when it is needed

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TECHNOLOGICAL FORCES

Technological advancements can:

- ▶ Create new markets
- ▶ Result in a proliferation of new and improved products
- ▶ Change the relative competitive cost positions in an industry
- ▶ Render existing products and services obsolete
- ▶ What is the impact of AI?

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COMPETITIVE FORCES

- ▶ An important part of an external audit is identifying rival firms and determining their strengths, weaknesses, capabilities, opportunities, threats, objectives, and strategies

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COMPETITIVE FORCES

Characteristics of the most competitive companies:

1. Market share matters
2. Use the vision/mission as a guide for all decisions
3. Whether it's broke or not, fix it—make it better
4. Continually adapt, innovate, improve
5. Acquisition is essential to growth
6. People make a difference
7. Strive to stay cost-competitive on a global basis

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TABLE 7-5 Key Questions About Competitors

1. What are the major competitors' strengths?
2. What are the major competitors' weaknesses?
3. What are the major competitors' objectives and strategies?
4. How will the major competitors most likely respond to current economic, social, cultural, demographic, environmental, political, governmental, legal, technological, and competitive trends affecting our industry?
5. How vulnerable are the major competitors to our alternative company strategies?
6. How vulnerable are our alternative strategies to successful counterattack by our major competitors?
7. How are our products or services positioned relative to major competitors?
8. To what extent are new firms entering and old firms leaving this industry?
9. What key factors have resulted in our present competitive position in this industry?
10. How have the sales and profit rankings of major competitors in the industry changed over recent years? Why have these rankings changed that way?
11. What is the nature of supplier and distributor relationships in this industry?
12. To what extent could substitute products or services be a threat to competitors in this industry?

COMPETITIVE INTELLIGENCE PROGRAMS

► **Competitive intelligence (CI)**

- a systematic and ethical process for gathering and analyzing information about the competition's activities and general business trends to further a business's own goals

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COMPETITIVE INTELLIGENCE PROGRAMS

The three basic objectives of a CI program are:

1. to provide a general understanding of an industry and its competitors
2. to identify areas in which competitors are vulnerable and to assess the impact strategic actions would have on competitors
3. to identify potential moves that a competitor might make that would endanger a firm's position in the market

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MARKET COMMONALITY AND RESOURCE SIMILARITY

► Market commonality

- the number and significance of markets that a firm competes in with rivals

► Resource similarity

- the extent to which the type and mount of a firm's internal resources are comparable to a rival

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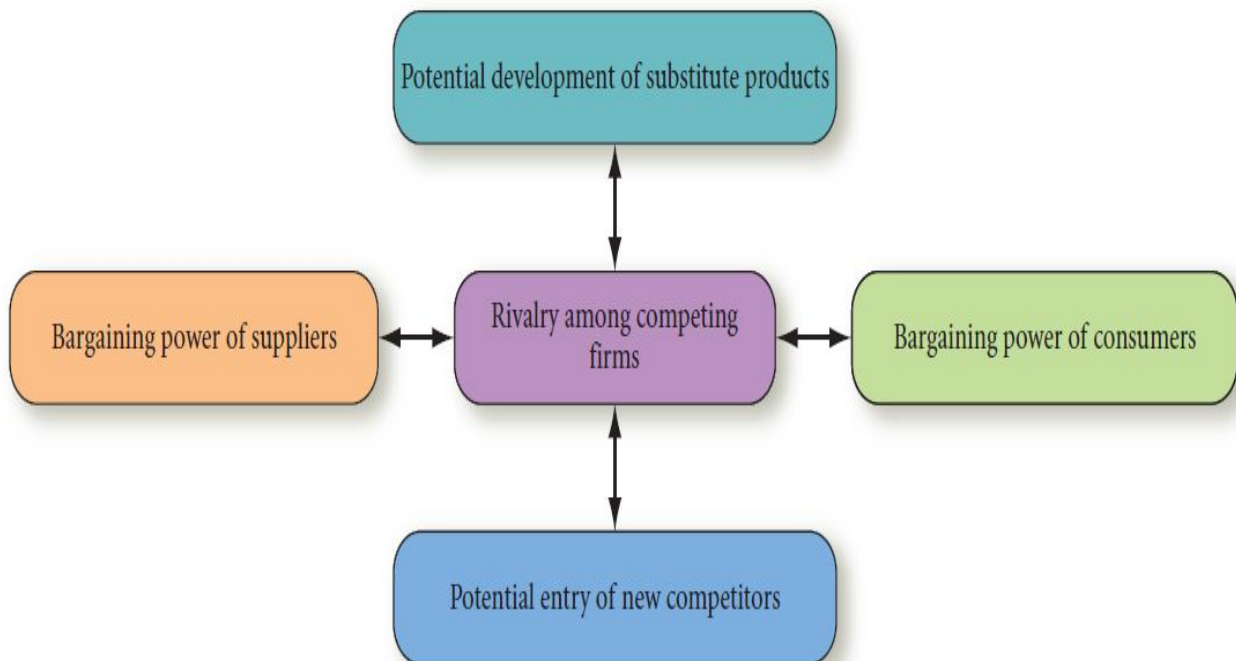


FIGURE 7-4

The Five-Forces Model of Competition

Porter's The Five-Forces Model of Competition

1. Identify key aspects or elements of each competitive force that impact the firm.
2. Evaluate how strong and important each element is for the firm.
3. Decide whether the collective strength of the elements is worth the firm entering or staying in the industry.

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THE FIVE-FORCES MODEL

- ▶ **Rivalry among competing firms**
 - ▶ Most powerful of the five forces
 - ▶ Focus on competitive advantage of strategies over other firms

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THE FIVE-FORCES MODEL

TABLE 7-7 Conditions That Cause High Rivalry Among Competing Firms

1. High number of competing firms
2. Similar size of firms competing
3. Similar capability of firms competing
4. Falling demand for the industry's products
5. Falling product or service prices in the industry
6. When consumers can switch brands easily
7. When barriers to leaving the market are high
8. When barriers to entering the market are low
9. When fixed costs are high among firms competing
10. When the product is perishable
11. When rivals have excess capacity
12. When consumer demand is falling
13. When rivals have excess inventory
14. When rivals sell similar products/services
15. When mergers are common in the industry

THE FIVE-FORCES MODEL

- ▶ **Potential Entry of New Competitors**
 - ▶ Barriers to entry are important
 - ▶ Quality, pricing, and marketing can overcome barriers

BARRIERS TO ENTRY

- ▶ Need to gain economies of scale quickly
- ▶ Need to gain technology and specialized know-how
- ▶ Lack of experience
- ▶ Strong customer loyalty
- ▶ Strong brand preferences
- ▶ Large capital requirements
- ▶ Lack of adequate distribution channels

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BARRIERS TO ENTRY

- ▶ Government regulatory policies
- ▶ Tariffs
- ▶ Lack of access to raw materials
- ▶ Possession of patents
- ▶ Undesirable locations
- ▶ Counterattack by entrenched firms
- ▶ Potential saturation of the market

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THE FIVE-FORCES MODEL

- ▶ **Potential development of substitute products**
 - ▶ Pressure increases when:
 - ▶ Prices of substitutes decrease
 - ▶ Consumers' switching costs decrease

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THE FIVE-FORCES MODEL

- ▶ **Bargaining Power of Suppliers** is increased when there are:
 - ▶ Large numbers of suppliers
 - ▶ Few substitutes
 - ▶ Costs of switching raw materials is high
- ▶ Backward integration is gaining control or ownership of suppliers

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THE FIVE-FORCES MODEL

▶ **Bargaining power of consumers**

- ▶ Customers being concentrated or buying in volume affects intensity of competition
- ▶ Consumer power is higher where products are standard or undifferentiated

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CONDITIONS WHERE CONSUMERS GAIN BARGAINING POWER

1. If buyers can inexpensively switch
2. If buyers are particularly important
3. If sellers are struggling in the face of falling consumer demand
4. If buyers are informed about sellers' products, prices, and costs
5. If buyers have discretion in whether and when they purchase the product

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SOURCES OF EXTERNAL INFORMATION

- ▶ **Unpublished** sources include customer surveys, market research, speeches at professional and shareholders' meetings, television programs, interviews, and conversations with stakeholders.
- ▶ **Published** sources of strategic information include periodicals, journals, reports, government documents, abstracts, books, directories, newspapers, and manuals.

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SOURCES OF EXTERNAL INFORMATION

- ▶ www.money.msn.com
- ▶ <http://finance.yahoo.com>
- ▶ www.hoovers.com
- ▶ <http://globaledge.msu.edu/industries/>
- ▶ www.monrningstar.com

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FORECASTING TOOLS AND TECHNIQUES

► **Forecasts**

- educated assumptions about future trends and events
- quantitative, qualitative techniques

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MAKING ASSUMPTIONS

► **Assumptions**

- Best present estimates of the impact of major external factors, over which the manager has little if any control, but which may exert a significant impact on performance or the ability to achieve desired results.

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INDUSTRY ANALYSIS: THE EXTERNAL FACTOR EVALUATION (EFE) MATRIX

- ▶ Economic
- ▶ Social
- ▶ Cultural
- ▶ Demographic
- ▶ Environmental
- ▶ Political
- ▶ Governmental
- ▶ Technological
- ▶ Competitive
- ▶ Legal

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EFE MATRIX STEPS

1. List key external factors
2. Weight from 0 to 1
3. Rate effectiveness of current strategies
4. Multiply weight * rating
5. Sum weighted scores

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TABLE 7-8 EFE Matrix for a Local 10-Theater Cinema Complex

Key External Factors	Weight	Rating	Weighted Score
Opportunities			
1. Rowan County is growing 8 percent annually in population	0.05	3	0.15
2. TDB University is expanding 6 percent annually	0.08	4	0.32
3. Major competitor across town recently ceased operations	0.08	3	0.24
4. Demand for going to cinema growing 10 percent annually	0.07	2	0.14
5. Two new neighborhoods being developed within 3 miles	0.09	1	0.09
6. Disposable income among citizens grew 5 percent in prior year	0.06	3	0.18
7. Unemployment rate in county declined to 3.1 percent	0.03	2	0.06
Threats			
8. Trend toward healthy eating eroding concession sales	0.12	4	0.48
9. Demand for online movies and DVDs growing 10 percent annually	0.06	2	0.12
10. Commercial property adjacent to cinemas for sale	0.06	3	0.18
11. TDB University installing an on-campus movie theater	0.04	3	0.12
12. County and city property taxes increasing 25 percent this year	0.08	2	0.16
13. Local religious groups object to R-rated movies being shown	0.04	3	0.12
14. Movies rented from local Blockbuster store up 12 percent	0.08	2	0.16
15. Movies rented last quarter from Time Warner up 15 percent	0.06	1	0.06
Total	1.00		2.58

INDUSTRY ANALYSIS: COMPETITIVE PROFILE MATRIX (CPM)

- ▶ Identifies firm's major competitors and their strengths & weaknesses in relation to a sample firm's strategic positions
- ▶ Critical success factors include internal and external issues

TABLE 7-10 An Example Competitive Profile Matrix

		Company 1		Company 2		Company 3	
Critical Success Factors	Weight	Rating	Score	Rating	Score	Rating	Score
Advertising	0.20	1	0.20	4	0.80	3	0.60
Product Quality	0.10	4	0.40	3	0.30	2	0.20
Price Competitiveness	0.10	3	0.30	2	0.20	1	0.10
Management	0.10	4	0.40	3	0.20	1	0.10
Financial Position	0.15	4	0.60	2	0.30	3	0.45
Customer Loyalty	0.10	4	0.40	3	0.30	2	0.20
Global Expansion	0.20	4	0.80	1	0.20	2	0.40
Market Share	<u>0.05</u>	1	<u>0.05</u>	4	<u>0.20</u>	3	<u>0.15</u>
Total	1.00		3.15		2.50		2.20