UNIT 6 INTERNAL ANALYSIS

Objectives

After reading the unit you should be able to:

- understand the concept of internal analysis and its contribution to strategy formulation;
- type of resources which organizations possess and their strategic importance;
- concept of core competence and guidelines to assess what resources and abilities constitute core competency of a firm;
- understand the concept of value chain framework;
- methods for assessing internal strengths and weaknesses; and
- know the comparison standards.

Structure

6.1 INTRODUCTION

In unit 5 you have learnt how the ever changing nature of external environment, both at macro and micro level affect an organisation's business. The changes in the environment may create opportunities, which the organisations try to exploit or may bring threats for the organisations, which the latter tries to control or neutralize. However, in order to develop successful strategies to exploit such opportunities or control the threats, analysis of an organisation's capabilities is important for strategy making which aims at producing a good fit between a country's resource capability and its external situation. Internal analysis helps us understand the organizational capability which influence the evolution of successful strategies.

Many of the issues of strategic development are concerned with changing strategic capability better to fit a changing environment. However, looking at strategic development from a different perspective i.e. stretching and exploiting the organizations capability to create opportunities, it again becomes important to understand these capabilities. The above two perspectives together are called the Resource Based View (RBV) of strategy.

Professionals from different organizations suggest that a firm's overall strengths and weaknesses and its ability to execute are often found more important to its performance than environmental factors. Internal capabilities and process execution at times allow firms to gain competitive edge over competitors even with relatively lesser resources and lesser advantageous position.

6.2 TYPES OF RESOURCES

There are three types of resources – **assets, capabilities and competencies**, which have been identified under Resource Based View of the firm (RBV). Strategic thinkers explaining the RBV suggest that the organizations are collections of tangible and intangible assets combined with capabilities to use those assets. These help organizations develop understanding these three types of resources and help us to know how a firm's internal strength and weaknesses affect its ability to compete.

Assets

The factors of production used by firms in providing its customers with valuable goods and services are called **assets**. These assets are of two types- tangible assets and intangible assets. Any physical means a firm uses to provide value to its customers form its tangible assets. Similarly, intangible assets are equally valuable for firms but their physical presence cannot be felt or seen. For example, a brand name is a very important resource for any organization even though it is intangible.

Few examples of tangible assets	Few examples of tangible assets
Firm's property and equipment	Brand name, which is trusted
R & D firm's patents	Knowledgeable workforce
Distribution network	Robust Organization structure
IT network system	Organizational Culture

Capabilities

In order to take full advantage of its assets the organization needs to develop skills, as experience suggests that with similar assets two different firms may add value of different amount for themselves. This difference can only be explained by the differences these organizations carry their capabilities in utilizing these assets. For example, in a sector like management education, in a typical segment you will find institutions more or less with similar resources and infrastructure, however, the quality of their output in terms of new professionals for business may be starkly different for different institutions. This is greatly reflected in the type of organizations that pick them up for employment and the kind of job responsibilities they are offered. This difference in output can be explained on account of the skills which these institutions carry with themselves. This position has been found true in case of many Indian companies as well as the multinational corporations.

Competencies

Most simply put, it refers to the ability to perform. Experts from field of strategy, using the term 'distinctive competencies' refer to the critical bundle of skills that an organization can draw on to distinguish itself from competitors. However, in order to have a better understanding of the concept, you need to understand first the resources, which are available to an organization and how they differentiate themselves as competencies or core competencies.

Strategic Importance of Resources

1) Available Resources: are those resources that are basic to the capability of any organization which can be listed broadly as:

***Physical Resources*:** Few examples may be buildings, machinery or operational capacity. However, the specific condition and capability of each resource determines their usefulness.

***Human Resources*:** Traditionally or in today's knowledge economy both, people are considered as 'the most valuable asset' of an organization. Knowledge and skill of people together prove to be a great asset.

Financial Resources of an organization may lie in capital, cash, debtors and creditors and providers of money.

***Intellectual capital*:** Intangible resources include the knowledge that has been captured in patents, brands, business systems and relationships with associates. In knowledge economy intellectual capital is considered as a major asset of many organizations.

Figure 6.1 shows a relationship between the resources, competencies and the competitive advantange.

	Same as Competitors' or **Easy to imitate**	**Better than Competitors'** or **Difficult to imitate**
Resources	Threshold Resources	Unique Resources
Competencies	Threshold competencies	Core competencies

Figure 6.1: Resources, competencies and competitive advantage

2) Threshold Resources

Organizations need a set of threshold resources to perform in any market and there is a continuous need to improve such resources to stay in business. This becomes inevitable because of the competitors and sometimes the new entrants. We can think of many industries in India like automobile, durable goods, telecom etc. which with the foreign players had to acquire new sets of resources as their threshold resources to survive.

3) Unique Resources

Unique resources as defined in strategy texts are those resources, which critically underpin competitive advantage. Their ability to provide value in product is better than competitor's resources and are difficult to imitate. Just think of a big music stores like Planet M or the ones from RPG group, the scale and range of collection of music provides uniqueness to these stores as compared to any of the traditional music shop. Some organizations have patented products or services that give them advantage for some service organizations, unique resources may be particularly the people working in that organization.

4) Core Competencies

Above, we learnt that competencies refer to the ability to perform. The difference in performance between organisations in the same market is rarely explainable by differences in their resource base, since resources can usually be imitated or traded. Superior performance are actually determined by the way in which resources are deployed to create competences in the organisation's activities. An organization needs to achieve a threshold level of competence in all of the activities and processes.

Core competencies are activities or processes that critically underpin an organization's competitive advantage. They create and sustain ability to meet the critical success factors of particular customer groups better than other provides ways that are difficult to imitate. Again as put forward by the resource based view, a series of guidelines are discussed below, which you can use to asses what constitutes a valuable asset capability or competence.

Scarcity **:** This is a very basic test to understand its resource value. Just in case any resource is widely available, then it's not likely to be a source of competitive advantage.

Inimitability : A resource that is easy to imitate is of little competitive advantage because it will be widely available from a variety of sources. e. g. services / design etc. Inimitability however does not last for long and at some point competition matches or even betters any offering. However, firm's should make an effort which may temporarily limit imitation. Physical uniqueness, causal ambiguity or scale deterrence are few ways how organizations attempt doing this.

Durability **:** Hyper competitive market conditions have a tendency to make competitive advantage less and less sustainable. Durability in such situations become a more stringent test for valuing resources, capabilities and competencies.

Superiority **:** Competencies are valuable only if they manifest themselves as competitive advantages and this means that they are superior to those held by rivals. Being good is not enough and a firm must be better than its competitor.

The above points lead to determining how a firmís internal resources might be linked to producing a competitive advantage and which resources actually fit in so as to produce a competitive advantage.

Activity 1

Identify an organisation of your choice. Enumerate its threshold resources, unique resources, threshold competencies, core competencies.

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Frameworks for Identifying What to Assess

We will now discuss different frameworks to assess the strengths and weaknesses of the firms.

Managers commonly use two frameworks to guide analyses of firm's strengths and weaknesses – **Critical success factors(CSF) and The Value Chain Analysis**.

6.3 THE CRITICAL SUCCESS FACTOR (CSF)

Critical success factors are those which contribute to organization's success in a competitive environment and therefore the organization needs to improve on them since poor results may lead to declining performance. Organizations depending on the environment they operate in and their own internal conditions can identify relevant critical success factors. However, literature on strategy suggests few general sources of critical success factors that have been identified based on empirical research. They are as follows:

***Industry Characteristics*:** Industry specific critical success factors are factors critical for the performance of an industry. For example in hospitality industry excellent and customized service, wide presence and an excellent booking and reservation system is critical. Similarly for an airline industry fuel efficiency, load factors and an excellent reservation system are critical.

Competitive Position: Critical success factors for a firm may also be determined by its relative position with respect to its competitors. In some instances, industry is dominated by few large players and their actions lead to determining the critical success factors for the industry which smaller players have to ensure for their success. For example, for the pathological laboratory centers earlier the CSF was authentic, hygienic and scientific testing facilities until few big players added service features like door to door sample collection or home delivery of reports. Very soon approachability and ease became the additional CSFs for the players.

General environment viewed from any of the dimensions may determine the CSFs. Most simply put in years of drought, availability of water is at premium and having access to assured source of water can become the critical success factor for many industries like tanneries etc. For the same industry considering environmental norms, adhering to anti pollution standards becomes critical success factor.

Organizational Developments – On many occasions developments within the organizations, force internal considerations to become temporary critical success factors.

Activity 2

Using the following critical success factors identified for retail industry, pick two large retail stores located in your locality and compare their performance:

	Critical Success Factors	**Retail 1**	**Retail 2**
1.	low sales and administrative expense	....	....
2.	efficient distribution systems	....	....
3.	reputation for value	....	....
4.	organization culture	....	....
5.	top management turnover	....	....
6.	supplier relationships	....	....

6.4 THE VALUE CHAIN FRAMEWORK

This is the other framework most commonly used to guide analysis of any firm's strengths and weaknesses. In this framework, any business is seen as a number of linked activities, each producing value for the customer. By creating additional value, the firm may charge more or is able to deliver same value at a lower cost, either of this leading to a higher profit margin. This ultimately adds to the organization's financial performance.

The value chain framework as shown in Figure 6.2 is a typical value chain within an organization. Using this framework, it is possible to analyze the organization's contributions of individual activities in a business and how they add up to the overall level of customer value, the firm produces. It is divided into two parts i.e. primary activities and support activities. The primary activities constitute of the following:

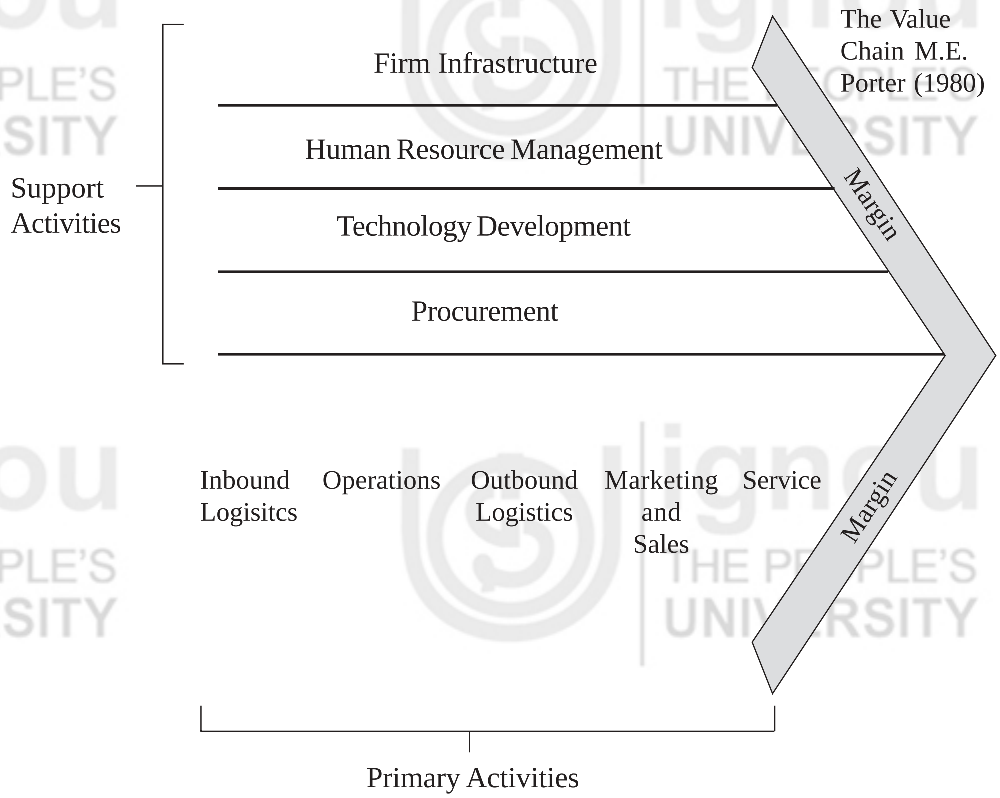

Figure 6.2: The Value Chain Framework

a) **Inbound Logistics** are activities concerned with receiving, storing and distributing the inputs to the product or service. They include materials handling, stock control, transport etc.

b) **Operations Transform** these various inputs into the final product or service – machining, packaging, assembly testing etc.

c) **Outbound Logistics** collect, store and distribute the product to customers. For tangible products this would be warehousing, materials handling, transportation etc. In the case of services they may be more concerned with arrangements for bringing customers to the service if it is a fixed location (e.g. entertainment show).

d) **Marketing and Sales** makes consumers/ users aware of the product or service so that they are able to purchase it. This includes sales administration, advertising, selling and so on.

e) **Services** activities helps improving the effectiveness or efficiency of primary activities.

Each of the groups of primary activities is linked to support activities which are as follows:

a) **Procurement:** This is a process for acquiring the various resource inputs to the primary activities and this is present in many parts of the organization.

b) **Technology Development:** There are key technologies attached to different activities which may be directly linked with the product or with processes or with resource inputs.

c) **Human Resource Management:** This is an area involved with recruiting, managing, training, developing and rewarding people within the organization. This categorization of the activities as primary or support may be found true for organizations in general, however it is always better to have one's own judgment in identifying activities for particular firms in consideration.

Exhibit 1 shows some of the guiding points for evaluating primary activities.

Exhibit 1: Select guiding points for evaluating primary activities

a) **Inbound Logistics**
- Soundness of material and inventory control systems
- Efficiency of raw material warehousing activities

b) **Operations**
- Productivity of equipment compared to that of key competitors
- Appropriate automation of production processes
- Effectiveness of control systems to improve quality and reduce cost
- Efficiency of plant layout and work flow design

c) **Outbound Logistics**
- Timeliness and efficiency of delivery of finished goods and services
- Efficiency of finished goods warehousing activities

d) **Marketing and Sales**
- Effectiveness of market research to identify customer segments and needs
- Innovation in sales promotion and advertising
- Evaluation of alternate distribution channels
- Motivation and competence of sales force
- Development of an image of quality and a favourite reputation
- Extent of market dominance within the market segment or overall market

e) **Customer Service**
- Means to solicit customer input for product improvements
- Promptness of attention to customer complaints
- Appropriateness of warranty and guarantee policies
- Ability to provide replacement parts and repair services

Exhibit 2 shows some guiding points for evaluating support activities.

Exhibit 2: Select guiding points for evaluating Support activities

Firm Infrastructure
- Coordination and integration
- Level of Information system
- Quality of planning system
- Timely and accurate information on environment

Human Resource Management
- Effectiveness of recruitment, training procedures
- Appropriateness of reward systems
- Relationship with trade unions
- Level of employee motivation and job satisfaction

Technology Development
- Success of R & D environment
- Quality of laboratories and other facilities
- Ability of work environment
- Qualification and experience of technical hands

Procurement
- Sources of raw material – time, cost, quality
- Procedures for procurements
- Relationships with reliable suppliers

With the indicative guiding points, you must have realized how with the Value Chain Framework, organizations can use these indicators as a reference point in order to improve its overall ability to create value. Miller suggests that the value chain framework can also be useful in a broader sense while deciding in what and where to specialize in the value activities from product design to the delivery of the final product or service to the final consumer.

Activity 3

Suppose there is a firm which is into fast food business with home delivery facility. Identify the critical success factors for this particular firm's success.

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The Balance Scorecard

This concept offers a well-rounded evaluation that views the firm from different complimentary perspectives as is shown below:

The four perspectives of the Balanced Scorecard

Financial → E V A / Profitability / Growth

Customer → Differentiation / Cost / Quick Response

Operations → Product Development / Demand Management / Order Fulfillment

Organizational → Leadership / Organizational Learning / Ability to change

Source: Adapted from Miller Allex, Strategic Management

Looking at the flow chart we can very well understand that performance as assessed in one perspective supports performance in other areas and therefore we need to consider all four perspectives in carrying out a complete internal analysis. We will discuss this in detail in Block V.

Methods of assessing internal strengths and weaknesses

Having understood the two frameworks which guide managers for assessing any organization's strengths and weaknesses, now we will discuss quantitative and qualitative factors, which help in the internal assessment of any organization.

However, since every organizations' creation of wealth is the primary goal, any assessment has to focus on measuring the variety of means that contribute to the creation of wealth. The creation of wealth depends largely on providing superior value for customers and this is possible when the organizations have efficient and effective operations with necessary capabilities. The required capabilities depend on the employees, their skills and motivation levels.

Normally any quantitative analysis starts with financial analysis, yet in order to have an in-depth assessment of a firm's strengths and weaknesses, managers go deeper into the information available on other areas as well which contribute to the firm's financial performance. Some of these require qualitative measurement while others may require qualitative assessment.

6.5 QUANTITATIVE ASSESSMENT

As mentioned above, financial data is only the most basic and universally accepted approach in assessing a firm. However we must understand that such an analysis is only the beginning for a thorough internal analysis. It is often found useful to go beyond the financial analysis to fully quantify organization's strengths and weaknesses and therefore it is discussed in detail here.

Financial Quantitative Analysis

Traditionally financial analysis emphasizes on the study of financial ratios which is commonly known as ratio analysis.

i) Profitability ratios provide information regarding a firm's overall economic performance.

ii) Liquidity ratios measure a firm's capacity to meet its short term financial obligations

iii) Leverage ratios indicate a firm's financial risk that is the relative proposition of its debt to its equity.

   The first enables to assess the financial returns of a firm and the associated risk with it is assessed by its financial liabilities or debt. The latter is measured by liquidity or leverage ratios.

iv) Activity ratios reflect a firm's efficient or inefficient use of its resources. The operational part is analyzed by the activity ratios.

Inspite of their wide acceptability, financial analysis does not provide insights into aspects like development time for new products or brand recall value which are also important in understanding strengths and weaknesses from other perspectives. Few of such non-financial quantitative meaures can be listed as – number of patents; quality assessment; new product development; customer complaints; employees turnover, etc.

6.6 QUALITATIVE ASSESSMENT

Often it has been found that quantitative analysis alone is not sufficient to understand any organization's strengths and weaknesses. Particularly the factors related to human resources, organizational culture and its temperament towards creativity and innovation are few which can be understood only through qualitative information. Qualitative information also supplements quantitative data in uderstanding basic concepts of what customers value and how they feel about a given product. The exhibit provides you with few relevant guiding points to assess a broad range of important qualitative factors. A detailed study of qualitative assessment has been taken up in Block V.

6.7 COMPARISON STANDARDS

In order to arrive at some meaningful conclusion regarding strengths and weaknesses, the above analysis should be supported by appropriate standards for comparison, for example, Industry norms, Historical performance and Benchmarks. These are three commonly accepted comparison standards which are often found useful for internal analysis by the organizations.

Industry Norms

The industry norms compare the performance of an organization in the same industry or sector against a set of agreed performance indicators. Data on industry norms are widely available and can be found from several published sources. Using such data and comparing an organization against others in its industry helps the organization understand its true position. In case of the healthcare sector, such indicators can be mortality index, doctors per 100 beds, nurses per 100 beds, waiting time per in-patient's treatment, waiting time per outpatient treatment, patient's trust in doctors.

The danger of industry norms comparison is that the whole industry may be performing badly and losing out competitively to other industries. Another problem with such comparisons may also arise as the boundaries of industries are coming down through competitive activity and industry convergence. For example publishing houses are evolving into multiple media groups working around the infotainment industry.

Moreover talking of industry norms, it is an average indictor and organizations must endeavour in beating them rather meeting them. In order to understand how they have been doing so it is always suggested that industry norm comparisons are supplemented with analysis on organization's own historical performance.

Historical Comparisons

Historical comparisons look at the performance of an organization in relation to previous years in order to identify significant changes. Organizations must endeavour to improve their performance over time in order to remain competitive and overpower the performance of comeptitors. It must try to beat its own best in future, which would call for continuous improvement.

However in case of the historical comparison it also entails scope for complacency since the organizations compare their rate of improvement over years with that of competitors and it is possible that the latter may itself be operating at a relatively lower average. Such historical trends can even be misleading when they entail changes made on a very small base.

Benchmarking

Benchmarking compares an organization's performance against 'best in class' performance wherever that is found. Managers seek out the best examples of a particular practice in other companies as part of an effort to improve the corresponding practice in their own firm.

When the search for best practices is limited to competitors, the process is called competitive benchmarking. Other times managers may seek out the best practices regardless of what industry they are in, called functional benchmarking. Benchmarking provides the motivation annd the means many firms need to seriously rethink how their organizations perform certain tasks.

A comprehensive internal analysis of an organization's strengths and weaknesses must however utilize all three types of comprison standards. For instance, an organization can study industry norms to assess where it stands in terms of number of complaints generated regarding defects during guarantee period of a product. Then it could benchmark the organization that is best at controlling the defects. Based on the benchmarking results it could implement major new programmes and track improvements in these programmes over time using, historical comparisons.

SWOT Analysis

SWOT stands for Strengths, Weaknesses, Opportunites and Threats. A SWOT analysis summarizes the key issues from the external environment and the internal capabilities of an organization those which become critical for strategy development. The aim through this is to identify the extent to which the strengths and weaknesses are relevant to and capable of dealing with changes in the business environment. It also reflects whether there are opportunities to exploit further the cometencies of the organization.

	Positive	Negative
Internal factors	**Strengths**	**Weaknesses**
	* Technological skills * Leading Brands * Distribution channels * Customer Loyalty/Relationship * Production quality * Scale * Management	* Absence of important skills * Weak brands * Peer access to distribution * Low customer retention * Unreliable product/service * Sub-scale * Management
External factors	**Opportunities**	**Threats**
	* Changing customer tastes * Liberalisation of geographic markets * Technological advances * Changes in government policies * Lower personal taxes * Change in population age-structure * New distribution channels	* Changing customer tastes * Closing of geographic markets * Technological advances * Changes in government policies * Tax increases * Change in population age structure * New distribution channels

6.8 SUMMARY

Understanding of the strengths and weaknesses of an orlganization comes through the internal analysis. This is important for any organization in order to respond effectively to its environment both micro and macro. Also understanding them enables the organization to stretch its capabilities and create new opportunies for themselves. However managers have to work hard in assessing the capabilities using frameworks like Critical success factors and the Value chain analysis and analyzing them through quantitative or qualitative analysis. The end result goes as an important input for SWOT analysis.

6.9 KEY WORDS

Tangible Assets: Any physical means a firm uses to provide value to its customers.

Intangible Assets: are equally valuable for firms but their physical presence cannot be felt or seen.

Competencies: refers to the ability of an organization to perform.

Core Competencies: are activities or processes that critically underpin an organization's competitive advantage.

Critical Success Factors: are those which contribute to organization's success in a competitive environment.

Financial Quantitative Analysis: traditionally financial analysis emphasizes on the study of financial ratios which is commonly known as ratio analysis.

Industry Norms: compare the performance of an organization in the same industry or sector against a set of agreed performance indicators.

Benchmarking : compares an organization's performance against 'best in class' performance.

SWOT: stands for Strengths, Weaknesses, Opportunities and Threats.

6.10 SELF ASSESSMENT QUESTIONS

1. Explain and identify the type of resources which an organization may possess.
2. What do you understand by the term critical success factor and what is the core competency of an organization?
3. Briefly discuss the value chain framework.
4. How does qualitative analysis support the quantitative analysis of an organization?
5. Identify the difference of various comparison standards and explain how they can be important for internal analysis?
6. Do a SWOT analysis for a firm of your choice.

6.11 REFERENCES AND FURTHER READINGS

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Jr. Thomson A. Arthur, III Strickland A.J. (2003), *Strategic Management*, *Concepts and Cases*, Thirteenth edition, Tata McGraw Hill Publishing, New Delhi.

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Appendix

The following gives a brief list of different ratios used under Ratio Analysis by managers for their organization. However, for their right kind of interpretation and analytical references you are recommended to refer to Chapter on Ratio Analysis from texts on Financial Management.

Ratio analysis evaluates a set of financial ratios, looks at trends in those ratios and compares them to the average values for other companies in the industry.

1. Liquidity Ratio – measures the ability of a company to meet its imminent financial obligations known as liquidity. This indicates how the company is assured in meeting its obligations and is protected from any technical insolvency. Two such ratios are:

   Current Ratios: Current Assets/Current Liabilities

   Quick Ratios: Current Assets – Inventory/Current Liabilities

2. Activity Ratio – measures organizations' efficiency in generating sales and making collections.

   Inventory Turnover = Sales/Inventory

   Average Collection Period = Accounts Receivables/Sales Per day

   Total Asset Turnover = Sales/Total Sales

   Fixed Asset Turnover = Sales/Net Fixed Assets

3. Leverage Ratio – indicates the amount of financing provided by the owners. These ratios evaluate default risk in debt payments.

   Debt ration = Total Liabilities/Total Assets

   Debt on Equity = Total Liability/Total Common Equity

4. Profitability Ratio – the ability to generate profits is a key measure of the managerial success. Some important profit ratios are –

   Profit Margins = Net Income/Sales

   Return on Assets = Net Income/Assets

   Return on Equity = Net Income/Total Common Equity