## Chapter Four: The Internal Assessment

## The Nature of an Internal Audit

All organizations have strengths and weaknesses in the functional areas of business. No enterprise is equally strong or weak in all areas. Internal strengths/weaknesses, coupled with external opportunities/threats and a clear statement of mission, provide the basis for establishing objectives and strategies.

Objectives and strategies are established with the intention of capitalizing upon internal strengths and overcoming weaknesses.

**The Process of Performing an Internal Audit**

The process of performing an *internal audit* closely parallels the process of performing an external audit. Representative Managers and employees from throughout the firm need to be involved in determining a firm’s strengths and weaknesses. 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.

Compared to the external audit, the process of performing an internal audit provides more opportunity for participants to understand how their jobs, departments, and divisions fit into the whole organization. This is a great benefit because managers and employees perform better when they understand how their work affects other areas and activities of the firm.

**The Process of Gaining Competitive Advantage in a Firm**

Weaknesses **⇒**Strengths **⇒**Distinctive Competencies **⇒**Competitive Advantage

Performing an internal audit requires gathering, assimilating, and evaluating information about the firm’s operations. Critical success factors, consisting of both strengths and weaknesses, can be identified and prioritized in the manner discussed above.

Strategic management is a **highly interactive process** that requires effective coordination among management, marketing, finance/accounting, production/operations, R&D, and management information systems managers. Although the strategic-management process is overseen by strategists, success requires that managers and employees from all functional areas work together to provide ideas and information. Financial managers, for example, may need to restrict the number of feasible options available to operations managers, or R&D managers may develop products for which marketing managers need to set higher objectives. A key to organizational success is effective coordination and understanding among managers from all functional business areas. Through involvement in performing an internal strategic-management audit, managers from different departments and divisions of the firm come to understand the nature and effect of decisions in other functional business areas in their firm. Knowledge of these relationships is critical for effectively establishing objectives and strategies.

A failure to recognize and understand relationships among the functional areas of business can be detrimental to strategic management, and the number of those relationships that must be managed increases dramatically with a firm’s size, diversity, geographic dispersion, and the number of products or services offered. Governmental and nonprofit enterprises traditionally have not placed sufficient emphasis on relationships among the business functions. Some firms place too great an emphasis on one function at the expense of others.

The changes in the environment may create opportunities, which the organizations try to exploit or may bring threats for the organizations, which the latter tries to neutralize. However, in order to develop successful strategies to exploit such opportunities anddefend the threats, analysis of an organization’s capabilities is important for strategy making which aims at producing a good fit between a country’s resource capability and its external situation.

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 is very essential and is called the Resource Based View (RBV) of strategy. That is all the resources of the organization should mobilized to achieve the objectives.

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 time allow firms to gain competitive edge over competitors even with relatively lesser resources and lesser advantageous position.

**i. Relationship among the Functional Areas of Business**

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***ii. Integrating strategy and culture***: relationships among a firm’s functional business activities can perhaps be exemplified best by focusing on organizational culture. Organizational culture can be defined as “a pattern of behavior developed by an organization as it learns to cope with its problem of external adaptation and internal integration that has worked well enough to be considered valid and to be taught to new members as the correct way to perceive, think, and feel.”

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

1. **Available resources**: are those resources that are basic to the capability of any organization:

* Physical resources
* Human resources
* Financial resources
* Intellectual capital

2. **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 is difficult to imitate. Some organizations have patented products of services that give them advantage; for some service organizations, unique resources may be particularly the people working in that organization.

3. **Core competencies**: competency refers to the ability to perform. The difference in performance between organizations in the same market is rarely explainable by differences in their resource base, since resources can usually be imitated or traded. Superior performances are actually determined by the way in which resources are deployed to create competences in the organization’s activities.

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, provide ways that are difficult to imitate.

Valuable asset capability or competence is due to the following:

* **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 b/c it will be widely available from a variety of sources. Inimitability however does not last for long and at some point competition matches or even betters any offering. Therefore, firms should make 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 becomes a more stringent test for valuing resources, capabilities and competencies.
* **Superiority:** - competencies are valuable only if they manifest themselves as competitive advantages and these means that they are superior to those held by rivals. “Being good is not enough and a firm must be better than its competitor.”

**1. Quantitative and Qualitative Assessment**

Since every organization’s 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.

Financial data is the most basic and universally accepted approach in assessing a firm. Financial analysis emphasizes on the study of financial ratios (ratio analysis)

1. Profitability ratios
2. Liquidity ratios
3. Leverage ratios
4. Activity ratios

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 understanding basic concepts of what customers’ value and how they feel about a given product.

**2. Comparison Standards**

In order to arrive at some meaningful conclusion regarding strengths and weaknesses, the analysis should be supported by appropriate standards for comparison. The three commonly accepted comparison standards are:

**a) 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. For e.g., in the case of the healthcare sector, such indicators can be; mortality index, doctors per 100 beds…etc. The danger of industry norms comparison is that the whole industry may be performing badly and losing out competitively to other industries.

**B) Historical Comparisons**

Historical comparisons look at the performance of an organization in relation to previous years in order to identify significant changes. Organizations must endeavor to improve their performance over time in order to remain competitive and overpower the performance of competitors. 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/satisfaction 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 relatively lower average.

**c) 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 practice 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 and 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 comparison 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.

**3. SWOT- Analysis**

A systematic approach to understanding the environment is the SWOT analysis. Business firms undertake *SWOT analysis* to understand the external and internal environment. SWOT, which is the acronym for *strengths, weaknesses, opportunities and threats.*Through such an analysis, the strengths and *weaknesses existing* within an organization can be matched with the opportunities and threats operating in the environment so that an effective strategy can be formulated. An effective organizational strategy, therefore, is one that **capitalizes on the opportunities through the use of strengths** and **neutralizes the threats by minimizing the impact of weaknesses**. The process of strategy formulation starts with, and critically depends on, the appraisal of the external and internal environment of an organization.

SWOT Analysis is a [strategic planning](http://en.wikipedia.org/wiki/Strategic_planning#Elements) method used to evaluate the **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats involved in a [business](http://en.wikipedia.org/wiki/Business) venture. It involves specifying the objective of the business venture and identifying the internal and external factors that are favorable and unfavorable to achieving that objective. It summarizes the key issues from the external environment and the internal capabilities of an organization those which become critical for strategy development. SWOT analysis is based on the assumption that if managers can carefully review such strengths, weaknesses, opportunities, and threats, a useful strategy for ensuring organizational success will become evident to them. The environment in which an organization exists can, therefore, be described in terms of the opportunities and threats operating in the external environment apart from the strengths and weaknesses existing in the internal environment. An understanding of the external environment, in terms of the opportunities and threats, and the internal environment, in terms of the strengths and weaknesses, is crucial for the existence, growth and profitability of any organization.

**SWOT analysis diagram**

|  |  |
| --- | --- |
| **Strengths**  • What does your organisation do better than others?  • What are your unique selling points?  • What do you competitors and customers in your market perceive as your strengths?  • What is your organisations competitive edge? | **Opportunities**  • What political, economic, social-cultural, or technology (PEST) changes are taking place that could be favourable to you?  • Where are there currently gaps in the market or unfulfilled demand?  • What new innovation could your organisation bring to the market? |
| **Weakness**  • What do other organisations do better than you?  • What elements of your business add little or no value?  • What do competitors and customers in your market perceive as your weakness? | **Threats**  • What political, economic, social-cultural, or technology (PEST) changes are taking place that could be unfavourable to you?  • What restraints to you face?  • What is your competition doing that could negatively impact you? |

The four environmental influences could be described as follows:

A. **Strengths**

***Strength***is an inherent capacity which an organization can use to gain strategic advantage over its competitors. An example of strength is superior research and development skills which can be used for new product development so that the company gains competitive advantage.

Two factors contribute to your strengths: [**ability**](http://www.1000ventures.com/business_guide/crosscuttings/capabilities_corporate.html) and **resources** available.

**Ability** is evaluated on 3 counts:

1. ***Versatility:*** your [ability to adapt](http://www.1000ventures.com/business_guide/mgmt_inex_adaptive_org.html) to an ever changing environment.
2. ***Growth:*** your ability to maintain a continuing growth.
3. ***Markets:*** your ability to penetrate or create new markets.

The strength of **resources** has three dimensions:

1. ***Availability:*** your ability to obtain the resources needed.
2. ***Quality:*** the quality and up-to-datedness of the resources employed.
3. ***Allocation:*** your ability to distribute resources both effectively and efficiently.

Firm’s strengths are its resources and capabilities that can be used as a basis for developing a competitive advantage. Example:

* Patents
* Strong brand names
* Good reputation among customers
* Cost advantages from proprietary know-how
* Exclusive access to high grade natural resources
* Favorable access to distribution networks

**B. Weaknesses**

***Weakness***is an inherent limitation or constraint which creates a strategic disadvantage. An example of a weakness is over dependence on a single product line, which is potentially risky for a company in times of crisis. Your weaknesses are determined through failures, defeats, losses and inability to match up with the dynamic situation and rapid change. The weaknesses may be rooted in lack of managerial skills, insufficient [quality](http://www.1000ventures.com/business_guide/mgmt_quality.html), technological backwardness, inadequate systems or processes, slow deliveries, or shortage of resources. There are three possible outcomes to the analysis of your weaknesses.

1. ***Correction*** of an identified defect.
2. ***Protection*** through cover-up and prevention strategies to reduce the exposure of your weaknesses.
3. ***Aggression*** to divert the attention from your weaknesses.

The absence of certain strengths may be viewed as a weakness. Example:

* Lack of patent protection
* A weak brand name
* Poor reputation among customers
* High cost structure
* Lack of access to the best natural resources
* Lack of access to key distribution channels

**C. Opportunities**

***Opportunity***is a favorable condition in the organization's environment which enables it to consolidate and strengthen its position. An example of an opportunity is growing demand for the products or services that a company provides.

Opportunities are abundant. You must develop a formula which will help you define what comes within the ambit of an opportunity to [focus on those areas](http://www.1000ventures.com/business_guide/biz_devt_opportunity-driven.html)and [pursue those opportunities](http://www.1000ventures.com/business_guide/opportunities_pursuing.html) where effectiveness is possible. The formula must define product/service, target market, capabilities required and resources to be employed, returns expected and the level of risk allowed.

Weaknesses of your competitions are also opportunities for you. You can exploit them in two following ways:

1. [***Marketing warfare***](http://www.1000ventures.com/business_guide/crosscuttings/competing_strategy.html#MarketingWarfare)***:*** attacking the weak leader's position and focusing all your efforts at that point, or making a surprise move into an uncontested area.
2. ***Collaboration:*** you can use your complementary strengths to establish a [strategic alliance](http://www.1000ventures.com/business_guide/strategic_alliances_main.html)with your competitor.

The external environmental analysis may reveal certain new opportunities for profit and growth. Example:

* An unfulfilled customer need
* Arrival of new technologies
* Loosening of regulations
* Removal of international trade barriers

**D. Threats**

***Threat***is an unfavorable condition in the organization's environment which creates a risk for, or causes damage to the organization. An example of a threat is the emergence of strong new competitors who are likely to offer stiff competition to the existing companies in an industry. External threats arise from political, economic, social, technological ([PEST](http://www.1000ventures.com/business_guide/business_environment.html)) forces. Technological developments may make your offerings obsolete. Market changes may result from the changes in the customer needs, competitors' moves, or demographic shifts. The political situation determines government policy and taxation structure.

* Changes in the external environment also may present threats to the firm. Example:
* Shifts in consumer tastes away from the firm’s products
* Emergence of substitute products
* New regulations
* Increased trade barriers

Any organization must try to create a fit with its external environment. The SWOT-diagram is a very good tool for analyzing the internal strengths and weaknesses a corporation and the external opportunities and threats. Organizations may use confrontation matrix as a tool to combine the internal factors with the external factors.

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| --- | --- | --- |
|  | **Opportunities** | **Threats** |
| **Strengths** | S – O Strategies  **Offensive**  Make the most of these | **S – T Strategies**  **Adjust**  **Restore strengths** |
| **Weaknesses** | **W – O Strategies**  **Defensive**  **Watch competition closely** | **W – T Strategies**  **Survive**  **Turnaround** |

**S – O** Strategies: - pursue opportunities that are a good fit to the company’s strengths.

**S – T** Strategies: - identify ways that the firm can use its strengths to reduce its vulnerability to external threats.

**W – O** Strategies: - overcome weaknesses to pursue opportunities

**W – T** Strategies: - establish a defensive plan to prevent the firm’s weaknesses from making it highly susceptible to external threats.

|  |  |
| --- | --- |
| Strengths: | Opportunities:: |
| R and D almost complete  Basis for strong management team  Key first major customer acquired  Initial product can evolve into range of offerings  Located near a major centre of excellence  Very focused management/staff  Well-rounded and managed business | Market segment is poised for rapid growth  Export markets offer great potential  Distribution channels seeking new products  Scope to diversify into related market segments |
| Threats: | Weaknesses |
| Major player may enter targeted market segment  New technology may make products obsolescent  Economic slowdown could reduce demand  Euro/Yen may move against $  Market may become price sensitive  Market segment's growth could attract major competition | Over dependent on borrowings - Insufficient cash resources  Board of Directors is too narrow  Lack of awareness amongst prospective customers  Need to relocate to larger premises  Absence of strong sales/marketing expertise  Overdependence on few key staff  Emerging new technologies may move market in new directions |