CHAPTER 02 TEST BANK

Chapter 2. Internal Audit of Strategic Assets: Resources and Competencies

1. *In the strategic planning and management process, what is the purpose of performing an internal audit of strategic assets? In answering that question, define the term "strategic assets".*

- An organization's "strategic assets" are all the resources and competencies that it possesses that might be deployed in the implementation of its strategies or that might impact the choice of those strategies. The purpose of the internal audit is to determine exactly what strategic assets the organization has to work with in making its strategic plans. The most thoughtful plans take fullest advantage of those assets. A strategy is doomed to failure if it relies on assets that the organization does not currently own. However, an organization may choose to acquire assets necessary for a strategy that it believes to be important to its future.

2. *List and describe briefly the fundamental three methods for viewing, analyzing, and understanding an organization's strategic assets.*

- <u>Financial Performance Analysis:</u> This method examines the most critical strategic asset – an organization's financial resources. The available capital is a primary determinant of what an organization can achieve strategically. Furthermore, financial assets can purchase almost all the other resources required to implement strategies – space, equipment, people, buildings, intellectual property, and skills. The success of the strategies is typically measured in financial terms. Many stakeholders, particularly the owners of for-profit corporations, pay primary attention to dollar metrics.
- A few common measures are traditionally watched as indicators of an organization's fiscal health. Most of them are calculated and followed over a period of time to detect trends.
- Sales, market share, and profits.
- Free cash flow.
- External capital sources.
- Capital project hurdle rate.
- Other capital demands.
- Shareholder value.
- Liquidity ratios, profitability, operating efficiency, and capital structure ratios.
- <u>Resources And Competencies Review:</u> This method consists of an inventory of the various strategy-relevant resources possessed by the organization and the competencies that are manifested through them. It tells the organization what means are available to it for carrying out any strategies that it might have in mind.
- <u>Value Chain Evaluation:</u> This method analyzes an organization's strategic potential by describing the chain of value-adding activities that it performs in creating goods and

services. At each point in the chain, it identifies the assets (resources and competencies) being applied to create value. The method then determines whether those assets are being used as efficiently as possible to create that value, whether the same value could be created in entirely different ways, whether new values could be created at different points in the value chain, and whether the entire value chain could be reengineered to deliver greater value more efficiently. The ultimate strategic purpose of this method is a persistent quest for sustainable competitive advantage.

3. Explain what strategic "resources" and "competencies" are, how they are different from each other, and how they are interrelated.

- Resources are the things that an organization owns and the people that it employs. The resources are either tangible or intangible, and fall into the following categories.
- Tangible (visible, touchable, measurable): financial, organizational systems and structures, physical, technological.
- Intangible (unseen, amorphous): human, creative, perceptual.
- These resources have competencies – latent abilities to perform the activities that animate the value chain. The competencies are usually the product of combinations of resources, the most important being the human ones. A typical competency is reflected in a person operating a piece of equipment or interacting with a system.

4. If you wish to understand an organization's financial capabilities for strategic initiatives, what are five financial metrics that you would look at? Explain how each is calculated and what it tells you about the organization.

- There are several financial metrics that are particularly important in assessing an organization's ability to launch strategic initiatives.
- <u>Liquidity ratios:</u> show how capable an organization is of paying its short-term bills, in other words, how readily it can transform other assets into the cash required to pay those bills. The Current Ratio divides the "current assets" (relatively liquid assets) by the "current liabilities" (short-term debts). The higher the ratio, the better prepared the organization is to pay those debts. This impresses lenders and bondholders who provide the organization's debt capital. The ratio can be too high, meaning that too much money is held in liquid form rather than being invested wisely in long-term strategic projects.
- <u>Profitability:</u> traditionally measured by "operating margin", defines an organization's ability to maintain and grow its operations. This metric shows how much of its revenues are left over after paying the costs of generating those revenues. It is calculated by dividing "operating income" by "operating revenue", resulting in profits as a percentage of revenues. If revenues do not at least equal the operating costs (resulting in exactly zero profit or loss) over an extended period of time, the organization will eventually fail financially. The greater the operating margin percentage, the more internally generated capital the organization has to finance strategic initiatives that expand the scope of its activities.
- <u>Operating efficiency ratios:</u> demonstrate how efficiently an organization is using its assets (measured in dollar terms). They are calculated by dividing the organization's total

revenue by either inventory, fixed assets, or total assets. The higher the resulting number, the more efficiently the organization is utilizing its assets.

- Free cash flow: is the amount of money that the organization collects and has left for discretionary spending after it has met existing operating and strategic cash commitments. It is in some ways a better indication than profitability measures of its ability to invest in new strategies and continued growth. Free cash flow is money available now rather than accounts receivable that may be collected at some time in the future.
- Capital structure ratios: describe the current mix of capital that an organization is using to fund its operating and strategic endeavors. They reveal the amounts and types of capital currently in use and, by implication, the sources of additional capital that would be available to fund new strategies. Creditors and bond rating firms look at these ratios in evaluating an organization's creditworthiness. A couple examples are the ratio between equity capital and total capital, and debt service coverage (calculated by dividing net income and depreciation and interest income by debt principal payments and interest).
- There are a variety of other financial metrics for which good arguments can be made that they provide useful insights to an organization's strategic capabilities. Simply determine if the student has been able to make that argument.

5. List and explain non-financial metrics that could be used to assess the success of operations and strategies in a physician group practice or in a biotechnology startup.

- Useful non-financial metrics are usually specific to the industry in which the organization operates. Hospitals, physician practices, health plans, pharmaceutical companies, and small biotech startups will look to different metrics. The hospital industry has some of the most well-established non-financial measures of operations. These are some examples.
- Average Length of Stay (ALOS): The length of time in days that the average patient spends in the hospital prior to each discharge. This figure will vary greatly depending on the types of patients admitted to the hospital. Generally, the goal of the total health care system is to reduce ALOS and the associated costs, without impairing a patient's treatment. A lower-than-average ALOS demonstrates operating efficiency and is appealing to health plans and other payers who must cover the costs of treatment at the hospital. On the other hand, if the hospital is reimbursed on a per-diem basis, it has an incentive to prolong ALOS. That is the primary reason that many payers have switched to diagnosis-related groups (DRGs) as the basis for hospital reimbursement.
- Occupancy Rate: This is the percentage of hospital beds that are occupied by patients for whom reimbursements are being received. It is in the hospital's interest to keep its occupancy rate as high as possible, in order to spread the fixed costs of operating the facility over the largest number of patients.
- Outpatient Revenue as a % of Total Revenue: For over two decades, the trend within the health care system has been, to the fullest extent possible, to move patient care from an inpatient to an outpatient basis. The higher this percentage, the more successful a hospital has been in accomplishing that goal. For the same condition, outpatient care is usually less expensive than inpatient care. Of course, that means lower revenues for an institution

that is designed to provide inpatient care. The challenge for hospitals is to find an appropriate role for itself in this transition from inpatient to outpatient care.

- Full-Time Equivalents (FTEs) per Occupied Bed: This figure shows the number of employees in all categories required to support each bed with a patient in it. A lower ratio suggests that the hospital has found a more efficient way to provide services to its patients. However, maintaining staffing levels too low may decrease the quality of those services.
- A large pharmaceutical company will pay attention to metrics like its current drug products (and the revenues they generate) that will be going off patent in the near future, the stages in the development pipeline to which its prospective drugs have progressed, and the overall time that it takes those drugs to move through the pipeline to reach the market. An HMO might be most concerned with its medical expense ratio and its member re-enrollment rate. Metrics like FTEs per physician and the claims denial rate will be of interest to physician practices.

6. Briefly describe each of the characteristics of a competence that might serve as the basis for a "sustainable competitive advantage".

- It must be *valuable* to the organization in the sense that it contributes to product costs or features that customers are willing to pay for, or it can be used to exploit opportunities or defend threats in the external environment.
- It must be *unique* (competitors do not possess it) in order that it can be used to perform activities that competitors cannot perform.
- For the advantage to be sustainable over a period of time, the competence must be difficult, expensive, or impossible for a competitor to *imitate*, and there must be no *substitutes* for it.

7. Describe four ways in which an organization can "manage" its resources and competencies in order to assure that they are well matched to the strategies that are planned.

- It can purchase resources required by its proposed strategies.
- It can acquire employees who, alone or in combination with other resources, can demonstrate desired competencies.
- It can train existing employees in the desired competencies.
- It can contract with outside businesses ("outsource") to provide desired resources and competencies that the firm does possess and does not wish to possess.
- It can acquire or merge with other organizations that possess the desired resources and competencies.
- It can enter into various forms of strategic alliance with other organizations to share resources and competencies that each desires.
- The point of this management outlook is that an organization does not have to accept the package of resources and competencies it currently possesses as a given. To serve the interests of the strategies it would like to pursue, it can actively manipulate and adjust that package.

8. Explain the concept of the "internal value chain" as though you were talking to someone with no background in management or strategy.

- The concept of the internal value chain is best portrayed by looking at a company manufacturing a product. Perhaps a manufacturer of wheelchairs. To begin the process of manufacturing such a product, the company will buy certain custom-made parts from other companies. It may also buy some raw materials (metal and plastic) that it shapes into the parts that it needs. The company then combines those parts into subassemblies (wheels, frame, motor, seat) that, in turn, are assembled into the final product. Each wheelchair is put into packaging that permits it to be shipped to the company's customers. If the company handles its own shipping, it puts the packaged wheelchairs on its trucks for delivery to those customers. Before it started buying parts or raw materials and assembling them into finished products, the company will have designed the chairs and created technical drawings and specifications. It may have conducted research into the needs of its customers and the functioning of the chairs. In order to develop customers wishing to purchase the chairs, the company will have engaged in a variety of marketing and promotional activities. To deal with operational problems that occur in the chairs after they are sold, the company will maintain a customer service department.
- It helps to understand how these activities work together to produce an item that has value to customers by arranging them in the sequence that they follow and portraying that sequence graphically. In this case, the sequence begins with research into desirable wheelchair features and the technologies available for providing them. This leads to the activity of creating engineering designs for the chairs that the company chooses to produce. Manufacture begins with the purchase of parts or raw materials. The next activity or link in the sequence is the in-house manufacture of some parts, followed by the combination of parts into sub-assemblies. Those sub-assemblies are integrated into the final wheelchair product. Simultaneously with this process, the marketing function is generating demand for the wheelchairs. The completed chairs are packaged and shipped to the customers (who may be end-users or distributors or medical supply stores) demand the chairs. Occasionally, chairs may be returned to the company for repairs, servicing, or upgrading. The company will maintain a department or function to perform those services.
- Each of the activities in this sequence or chain should add value to the product that the customer receives. If it does not add value, it should not be performed.

9. Describe in detail how an organization can use sophisticated knowledge of its internal value chain to guide its strategic decisions.

- The organization can regularly ensure that every link in the chain is adding value that the customers will pay for.
- It can regularly evaluate any changes in customer value demands and make appropriate adjustments in the value chain.
- It can look for ways to add important value that competitors cannot replicate. This can be accomplished by including different activities in the value chain, performing the same

activities in different ways, rearranging the sequence of activities in the chain, and conducting the interface between activities/links in the chain in unique ways.

10. Discuss the difference between performing an activity better in the existing way and performing it in an entirely different way. Which approach is most effective in gaining competitive advantage and why?

- To perform an activity "better" means improving operational effectiveness. This involves management tools like benchmarking, TQM, partnering, outsourcing, reengineering, lean production, employing more advanced technology, motivating employees better, and eliminating waste It and results in better utilization of inputs, speedier product development, higher product quality, fewer product defects, more efficient asset utilization, and higher productivity. These all are important benefits but they do not lead to sustainable competitive advantage. The management tools that create them are common knowledge and can be employed by any organization.
- Genuine strategy-making that produces an advantage over competitors entails performing activities different from what those competitors are doing or performing the same activities in a different (not just better) way. The differences in activities or performance methods are more easily protected and less likely to be imitated by competitors. If they can be protected against imitation for an extended period of time, the organization has gained a sustainable competitive advantage over its rivals.