CIA Part 3
Business Knowledge for Internal Auditing

Part 3, Domain I
Business Acumen

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Section A: Organizational Objectives, Behavior, and Performance

Learning Outcomes

1. Describe the strategic planning process and key activities (objective setting, globalization and competitive considerations, alignment to the organization's mission and values, etc.). Basic Level.
2. Examine common performance measures (financial, operational, qualitative vs. quantitative, productivity, quality, efficiency, effectiveness, etc.). Proficient Level.
3. Explain organizational behavior (individuals in organizations, groups, and how organizations behave, etc.) and different performance management techniques (traits, organizational politics, motivation, job design, rewards, work schedules, etc.). Basic Level.
4. Describe management's effectiveness to lead, mentor, guide people, build organizational commitment, and demonstrate entrepreneurial ability. Basic Level.

Strategic Planning

A. **Strategic planning** refers to the efforts an organization utilizes to set up its strategic goals, identify the firm's future direction, strengthen its operations, identify and allocate required resources, and determines the road map on which an organization chooses to fulfill its mission. The strategic planning process involves various levels of planning which cover varying time horizons.

B. Each level of planning involves three steps as follows:

   1. **Setting the objectives** of the organization.
   2. **Formulating the strategy** which is usually the result of a detailed SWOT analysis. The SWOT analysis provides information on the following:
      a. **Strengths** (an internal factor) – what the organization is good at, in order to select a strategy that capitalizes on the identified strengths.
      b. **Weaknesses** (an internal factor) – what the organization is not good at, in order to select a strategy that improves the weaknesses or avoid them.

   c. **Opportunities** (an external factor) – what the available opportunities are that the organization could pursue.
   d. **Threats** (an external factor) – what events might adversely affect the organization in the process of achieving its objectives so that the organization can mitigate or avoid.
3. **Implementing the strategy**

C. The plan durations or time horizons may generally be classified under four categories:
1. **Mission –** usually spells out the goal of the organization.
2. **Long-term plans –** usually covering periods of more than 5 years.
3. **Intermediate plans –** typically covering periods of 1-5 years.
4. **Short-term plans –** typically covering periods of less than 1 year.

D. Strategic planning focuses on identifying the organization's current position, the future goal, and the tools and resources required to reach this goal. The process can typically be summarized as follows:
1. Analyze and assess the current situation of the organization and the market, including the external and internal factors.
2. Set the goals and determine the strategy of where it is going and why. For example:
   a. Increase product diversification → Increase an organization's market share.
   b. Increase quality of products → Realize competitive advantage in quality.
   c. Increase involvement in the community → Gain public acknowledgement.
3. Determine how it is going to implement the strategy. For example:
   a. Utilize knowledge from subject matter experts in products that require improvements.
   b. Invest in R&D.
   c. Expand horizontally or vertically.

E. Significance of strategic planning is highlighted by what it provides to the organization:
1. **Purpose and sense of direction** as they provide what the organization, and each of its units, should be doing and what they should be achieving.
2. **Coordination** since it highlights the interactions between the various groups and functions within the organization and provides an indicator of how each function fits into the whole system.

3. **Control** as plans would highlight who is responsible for what in the process of achieving organizational objectives.
4. **Participation** of all levels of management in steering the organization, each from their position.

F. **Levels of Planning**

1. **Corporate-Level**
    a. **Plan –** at the corporate level, the organization should define the mission and goals of the organization including defining the business they are engaged in, who are the customers they plan to serve, which of their needs they plan to satisfy, and how they will satisfy those needs. It is prepared by top management and should normally provide the framework for all other plans.
    b. **Strategy –** the strategy at the corporate level would indicate what courses of action the organization will take to achieve its mission. This would include in which industry and in which markets it will compete.
    c. **Time horizon** – usually long-term but may include some intermediate-term plans.
2. **Business-Level**
    a. **Plan –** at the business level, the plan would define the long-term goals and more detailed plans of how the organization will achieve its mission. These plans are normally developed by managers of divisions and reviewed by corporate or senior level managers.
    b. **Strategy –** the strategy at the business level would indicate how the business will compete in its selected industries and markets.
    c. **Time horizon** – usually medium-term, but may include some short-term plans
3. **Functional-Level**
    a. **Plan –** at the functional level, the plan would define the more specific goals that would enable the business to achieve its goals. These plans are normally developed by functional managers and reviewed by division managers.
    b. **Strategy –** the strategy at the business level would indicate how the function will achieve its plans.
    c. **Time horizon** – usually short-term but may include some intermediate-term plans.

G. **Mission –** the mission should provide the organization with a sense of direction by setting challenging but reasonably achievable goals. A good mission is one that remains valid indefinitely allowing the organization to maximize its long-term ability to create value. For example:

1. “We produce videos” would be a product-oriented definition of a business while “we provide entertainment” would be a more appropriate market-oriented mission. As was evident, the concept of videos has almost become obsolete with the introduction of DVDs and later cable’s pay-for-view concept and online downloading.
2. “We produce gasoline” would be a product-oriented definition of a business while “we supply energy” would be a more appropriate market-oriented mission.

Mission Statement Extracts of Well-Known Companies	
Walt Disney	“to be one of the world’s leading producers and providers of entertainment and information”
Merck	“to provide society with superior products and services”
Pepsi	“to be the world’s premier consumer products company focused on convenient foods and beverages”
Coke	“to refresh the world” “to inspire moments of optimism and happiness” “to create value and make a difference”
Microsoft	“to help people and businesses throughout the world realize their full potential”
3M	“to actively contribute to sustainable development through environmental protection, social responsibility and economic progress”
DHL	“to simplify the lives of our customers” “make our customers, employees and investors more successful” “make a positive contribution to the world” “always demonstrate respect when achieving our results”

Types of Competition

Any firm generally competes in one of four competitive environments. These environments are relevant to a particular industry in a particular market during a particular period of time. For example, a company may be a monopoly in a certain market for one of its products, may operate as an oligopoly in a different market with the same product. The four competitive environments are:

– Pure competition
– Monopolistic competition
– Oligopoly
– Monopoly

A. **Pure Competition** is the situation in which there are numerous firms in an industry producing almost standardized products and none can individually influence market prices. Characteristics of the market under pure competition:
   1. Large number of both suppliers and buyers.
   2. Products are standard among competitors.
   3. No collusion between the suppliers.
   4. No entry barriers to the market.
   5. No one firm is able to control the market prices.
   6. Lack of competition on any factor other than price.

B. **Monopolistic Competition** is the situation in which there is a large number of firms that differentiate their products from those of competitors.
   1. Firms would slightly differentiate their products and normally would set their own price.
   2. E.g., the clothing industry and the furniture industry.

C. **Oligopoly** is the situation in which the market has only few sellers and usually also has substantial entry restrictions. Under this state of competition, a small number of sellers would make interdependent pricing and output decisions.
   1. In an oligopoly competitive environment, competition is usually non-price competitions. Firms that price above the going price will become too expensive, and thus buyers will prefer the competitors while firms that price below the going price will force other firms to respond creating a price war that is harmful to all market players.
   2. Firms usually seek non-price competition such as product and/or service differentiation.
   3. Barriers to collusion are greater when:
      a. There is a higher number of firms in the industry.
      b. The firms' costs are different.
      c. The firms' products are differentiated.
      d. Weak economy such as during recessions.
   4. E.g., car manufacturers, telecommunication carriers, airplane manufacturers, and internet service providers.

D. **Monopoly** is the market situation in which there is only one provider (of the good or service) and no direct competitors.
   1. The monopolist sets the price thus the firm is the price setter and the customers are price takers.
   2. The firm represents the entire industry.
   3. E.g., utility companies and usually state-owned services.

Structural Analysis of Industries

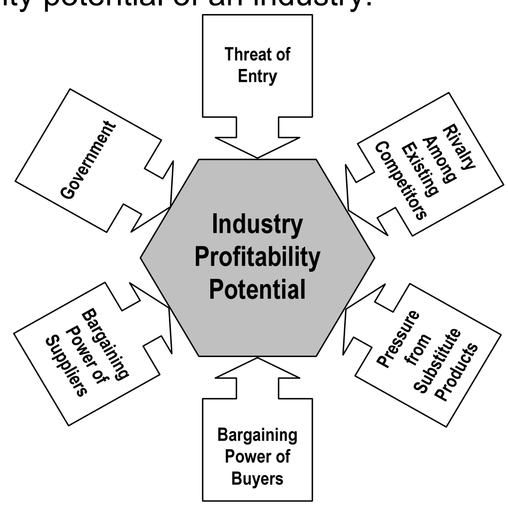
According to Michael E. Porter, the key aspect of a firm's competitive environment is the industry/industries in which it competes, and therefore, the structural analysis of a firm's industry/industries dictates the primary competitive rules of the business in addition to highlighting the available strategies that the firm may apply. The structural analysis of a firm usually involves:

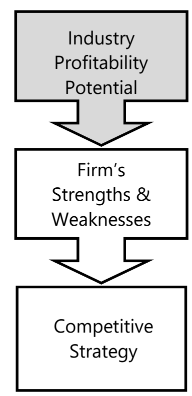
- Analyzing the profitability potential of an industry,
- Identifying the strengths and weaknesses of the firm, and
- Choosing a competitive strategy.

The structural analysis of industries through entry into new businesses relies on the work of Michael E. Porter's "Competitive Strategy – Techniques for Analyzing Industries and Competitors" from THE FREE PRESS, A Division of Simon & Schuster Inc., 1230 Avenue of the Americas, New York, NY 10020.

A. **Profitability Potential of an Industry –** the collective force of the following competitive forces determines the profitability potential of an industry:

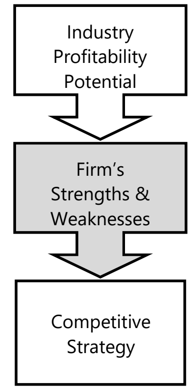
- Threat of entry
- Intensity of rivalry among existing competitors
- Pressure from substitute products
- Bargaining power of buyers
- Bargaining power of suppliers
- Governments



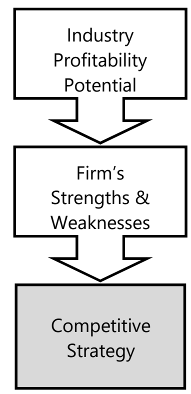


Passing Tip:	The collective force of Porter's basic competitive forces determines the long-term profitability of an industry and their analysis is only one step in the definition of the strategy.

B. **Identifying Strengths and Weaknesses –** upon diagnosing the forces affecting competition in an industry and their underlying causes, the firm would be in a position to identify its strengths and weaknesses relative to its industry and to formulate its competitive strategy. In addition, the firm may conduct **competitive profiling** which involves identifying the firm's major competitors and their relevant strengths and weakness.



C. **Choosing a Competitive Strategy –** an effective competitive strategy would create a "defendable" position against the above mentioned six competitive forces by taking offensive and/or defensive actions as appropriate. Generally speaking, this "defendable" competitive strategy involves the following possible approaches:



1. **Positioning –** involves positioning the firm so that its capabilities provide the best defense against its existing competitive forces. This is achieved through taking defensive actions against strong competitive forces and finding positions in the industry where the forces are weakest.
2. **Influencing the Balance of Forces –** by adopting an offensive strategy, the firm may not only cope with the forces but may also be able to alter their causes.
3. **Anticipating Change of Forces** and exploiting such change by altering its strategies and choosing alternative appropriate strategies.

Competitive Strategies

Michael E. Porter discusses three generic competitive strategies:

- Cost Leadership
- Differentiation
- Focus

A. **Cost Leadership**

1. Cost leadership is a strategy that focuses on controlling costs while not ignoring the other attributes of quality and service.
2. **Characteristics and Attributes**
    a. Tight controls over direct costs and overhead.
    b. Minimizing other costs such as research and development, advertising, sales, and service costs.

c. Emphasis on learning curves and experience to achieve cost reductions.

d. Efficient-scale “right-size” facilities that minimize the production cost per unit of output.

B. **Differentiation**

1. Differentiation is a strategy that focuses on differentiating the firm’s products and/or services to create an image of uniqueness.

2. **Characteristics and Attributes**

   a. The firm offers differentiated products (differentiated designs, brand image, technology, features, customer service, dealer network, or other dimensions).

   b. Achievement of differentiation may require a trade-off with costs as a result of increased spending on research, product design, use of high-quality materials, and/or intensive customer service.

C. **Focus**

1. Focus is a strategy that focuses on a particular target such as buyer group, segment of the product line, or geographic market, etc.

2. **Characteristics and Attributes**

   a. The focus strategy relies on the ability of the firm to serve its strategic target market more effectively and/or more efficiently i.e., the firm either achieves differentiation with respect to its target, or cost-leadership or both.

   b. A firm achieving focus would probably either have a low-cost position with its target and/or high differentiation, and thus it is able to achieve above-average returns.

   c. Focus allows the firm to select targets that are either least vulnerable to substitutes or where competitors are weakest.

   d. Implied limitation on the achievable market share.

D. Porter’s three strategies may also be combined with other strategies such as:

1. **Market leader strategies** are employed by the major competitors that dominate a market.

2. **Market challenger strategies** are employed by runner-up companies that aggressively attack competitors (market leaders) to get more market share.

3. **Market follower strategies** are used by runner-up companies that follow competitors’ (market leaders’) product offers, pricing, and market programs without directly challenging them.

Passing Tip:	Any combination of the above strategies is possible. For example, a firm may pursue a: – **Cost-focus strategy** whereby the firm becomes a cost leader for a particular market segment. – **Cost-differentiation strategy** attempts to provide a product at different costs in different market segments.

Competitive Analysis

To adopt a competitive strategy that distinguishes the firm from its competitors, the firm should also critically analyze its competitors. The firm should analyze all its significant existing competitors and its future potential competitors. Porter identifies four diagnostic components to a competitor analysis:

- Future Goals
- Assumptions
- Current Strategy
- Capabilities

A. **Future Goals**

1. Business unit goals
2. The corporate parent and business unit goals
3. Portfolio analysis and competitor's goals – when the competitor is part of a diversified company, analyzing the parent company's objectives and requirements from the business unit should reflect the competitor's goals within the parent company's portfolio.
4. Competitors' goals and strategic positioning – it is possible that by analyzing competitors' goals, the firm is able to strategically position itself where it and all its competitors are content.

B. **Assumptions –** each firm operating in an industry would normally have assumptions about itself, its industry, and its competitors. As part of the competitors' analysis, the firm should identify each competitor's assumptions as they would normally guide the way the firm behaves and the way it reacts to events. Amongst the assumptions that should be identified are the following:

1. Competitor's belief about its current market positioning.
2. Competitor's strong historical or emotional identification with particular products.
3. Cultural, regional, and/or national differences that affect competitor's perception and assignment of significance to events.
4. Competitor's organizational values that may affect the perception of events.

5. Competitor's estimates of future industry trends and future demand.
6. Competitor's beliefs about the goals and capabilities of its competitors.
7. Competitor's history in the business.
8. Managers' backgrounds, their previous operating environments, and their historical success.

C. **Current Strategy –** the third diagnostic component of a competitor's analysis would be its current strategy as earlier discussed.

D. **Capabilities –** the fourth diagnostic component of a competitor's analysis would relate to its capabilities including an analysis of its strengths and weaknesses.

E. By identifying and analyzing the competitor's future goals, assumptions, current strategies, and capabilities, the firm would be able to assess likely offensive and defensive responses that its competitors may take:

1. **Offensive Moves** are those moves that the competitor may initiate. The four diagnostic components would assist the firm in assessing the following:
    a. The level of the competitor's satisfaction with its current position which may predict its offensive moves.
    b. If the competitor does initiate any moves, what would be the probable moves that the competitor takes?
    c. Based on its goals and capabilities, what would be the strength and seriousness of the moves?
2. **Defensive Capabilities** refer to the competitor's likely responses to moves made by the firm or by other competitors in the industry. Using the above competitor analysis, the firm is able to assess the competitor's response in terms of:
    a. ***Vulnerability*** – refers to which strategic moves or industry events the competitor would be most vulnerable to. For example, what moves may affect the competitor's profits more than the firm's or what moves would require a high capital investment by the competitor that it cannot risk.
    b. ***Provocation*** – refers to what moves would the competitor be likely to retaliate to (these would be the moves that would significantly threaten the competitor).
    c. ***Effectiveness of retaliation*** – if the competitor does retaliate, what moves or events is the competitor hindered from reacting to quickly and/or effectively, and what moves or events would the competitor react to ineffectively.

Industry Evolution

Being able to predict an industry's evolution will provide the firm with an edge since it will be able to adapt its strategies before its competition.

A. Industry evolution is usually the result of forces that create incentives or necessitate change. Evolutionary processes tend to push the industry towards a "potential" structure that may rarely be entirely and completely predicted beforehand.

B. Evolutionary Processes – although duration and direction vary amongst industries, almost all industries will be subject to the following interacting processes that affect their evolution.

   1. Long-run changes in growth resulting from:
      a. Changes in demographics.
      b. Changes in the needs' trends.
      c. Changes in the relative position of substitutes.
      d. Changes in the position of complementary products.
      e. Changes in the penetration of the customer group.
      f. Product changes.
   2. Changes in buyer segments served.
   3. Learning by buyers.
   4. Reduction of uncertainty.
   5. Diffusion of proprietary knowledge.
   6. Accumulation of experience.
   7. Expansion (or contraction) in scale.
   8. Changes in input costs and exchange rates.
   9. Innovation
      a. Product
      b. Marketing
      c. Process
   10. Structural change in adjacent industries.
   11. Government policy change.
   12. Entry and exit by firms into the industry.

Industry Environments

Competitive strategies typically differ as they relate to three types of industries:

– Fragmented industries
– Emerging industries
– Declining industries
– Global industries (which could be fragmented, emerging, or declining)

A. **Fragmented industries** are those industries in which no single firm has a significant market share that enables it to strongly influence the industry outcome. From a competitive analysis standpoint, the most important feature of these industries' environments is the lack of market leaders with the power to shape industry events.

1. **Consolidation to Overcome Fragmentation**

   a. Creating economies of scale or experience curve.

   b. Standardize diverse market needs.

   c. Neutralize or split off aspects most responsible for fragmentation.

   d. Make acquisitions for a critical mass.

   e. Recognize industry trends early.

2. **Coping with Industry Fragmentation**

   a. Tightly managed decentralization to allow small, autonomous operations supported by tight central control.

   b. Increase added-value of an otherwise undifferentiated product or service.

   c. Specialization by product type, product segment, customer type, and/or by type of order.

   d. Concentrating on a geographic area and servicing this area intently.

   e. Maintaining low overhead, low-skilled employees, tight cost control, and attention to products, thus competing on price, but producing above average return.

   f. Backward integration allowing the firm to gain a competitive advantage, increase its return and reducing costs, and pressuring firms that are unable to integrate.

Passing Tip:	Backward integration is a form of vertical integration (explained later) that involves the purchase of suppliers in order to reduce dependency such as when the suppliers are not reliable, or to improve efficiency if resource demands justify it.

3. **Steps to Formulate Strategy**
    a. Conduct an industry structural and competitive analysis.
    b. Identify the reasons giving rise to the fragmentation.
    c. Using the industry analysis and the causes for the fragmentation. An analysis for each of the causes should be conducted to assess whether fragmentation may be overcome.
    d. If overcoming fragmentation is a possibility, the firm should assess the profitability of overcoming it, and where should the firm be positioned to do so.
    e. If fragmentation is inevitable, an assessment of measures to cope with it would be the next step.

Passing Tip:	Strategies such as chaining, franchising, and horizontal mergers are commonly used in fragmented industries, because there are low barriers to entry. Companies in fragmented industries face many opportunities for differentiation but each opportunity for competitive advantage is small.

Emerging industries are those industries that are either newly formed (or reformed) as a result of new technologies, significant changes in cost relationships, new customer needs, and/or any other economic or social changes that make the new product or service to become viable. From a competitive analysis standpoint, the most important feature of these industries' environments is the lack of the "rules of the game".

1. **The Structural Environment Characteristics of Emerging Industries**
    a. Technological uncertainty.
    b. Strategic uncertainty.
    c. High initial costs and steep cost reductions with time.
    d. The greatest proportion of newly formed companies that the industry will ever experience.
    e. First-time buyers.
    f. Short time horizon.
    g. Subsidies from a variety of governmental and nongovernmental sources.

2. **Early Mobility Barriers**
    a. Proprietary technology.
    b. Access to distribution channels.
    c. Access to raw materials and other inputs of appropriate quality and cost.
    d. Capital barriers resulting from risk since investors will require a higher rate of return on their investments.
3. **Industry Development Constraints**
    a. Inability to obtain raw materials and components.
    b. Period of rapid escalation of raw material prices.
    c. Lack of supporting infrastructure including distribution channels, service facilities, trained individuals, etc.
    d. Absence of product or technological standardization affecting supplies and complementary products.
    e. Perceived by buyers with a high likelihood of obsolescence.
    f. Inconsistent product quality between various firms that would have negative effects on customers.
    g. The newness of the industry will affect the image and credibility with the financial community.
    h. Regulatory approval requirements that may be delayed.
    i. Unpredictable unit costs which will ultimately affect pricing.
    j. Response from threatened entities.
4. **Formulating Strategy**
    a. Timing entry as the time of entry would affect the level of entry barriers but also affects the risk. Early entry would have the following advantages:
        i. A pioneering firm will develop and enhance its reputation.
        ii. Initiate the learning process especially in industries where imitating others is not an option.
        iii. Establishing customer loyalty.
        iv. Cost advantages from early commitment to supplies of raw materials, distribution channels, etc.
    b. **Risks** associated with early entry include:
        i. A radical change in later stages of development of the competition and market segmentation that will require costly changeovers.
        ii. High costs in creating the need and educating customers where the product or service cannot be made proprietary to the firm.
        iii. Costly competition in the early phases.
        iv. Technological changes that make early investments obsolete.

c. **Coping with competitors**

i. The firm's resources in the early phases are best diverted at building its own strengths and developing the industry rather than at responding to vigorous competitors.

ii. In some cases, encouraging other competitors to enter the industry is required to develop the market.

C. **Declining industries** are those industries that have had declining sales over a sustained period. For the industry to be considered in its declining stage, the decreasing sales should not be attributable to a recession or other similar coincidental economic, social, and/or temporary factors.

1. **Demand Attributes** during decline include:

a. ***Uncertainty*** of demand.

b. ***Rate and pattern of demand decline*** is affected by numerous factors making it difficult for firms to identify appropriate strategies.

c. ***Structure of remaining demand pockets*** will also differ between industries and would affect what strategy the firm adopts during this phase.

2. **Exit barriers** may be present resulting from the following:

a. ***Durable and specialized assets*** that can only be used in this industry.

b. ***High fixed costs of exit*** that the firm has to incur which reduce the liquidation value of the business.

c. ***Strategic exit barriers***

i. *Interrelatedness* such as when the business is part of a group and should be maintained for strategic group reasons.

ii. *Access to financial markets* may become limited if the firm leaves the industry.

iii. *Vertical integration* is present and the decline is in one of the integrated business not both.

d. ***Information barriers*** that hinder the firm's ability to identify poorly performing business within an interrelated group.

e. ***Managerial or emotional barriers*** that hinder management's ability to decide objectively.

f. ***Governmental and social barriers*** that prevent the firm from winding down a business.

g. ***Mechanism for asset disposition*** is an exit barrier when assets are disposed of to a party that maintains them in the business. The party operating them will probably adopt a strategy that would harm competitors but would not have been possible with the original owners.

3. **Rivalry tends to be volatile** during the decline phase as a result of falling sales as discussed earlier in this section.
4. **Available competitive strategies** during the decline phase include:
   a. **Leadership** attempt to seek leadership in market share.
   b. **Niche** attempt to create or defend a strong position in a particular segment from the available remaining pockets.
   c. **Harvest** attempt to take advantage of existing strengths to manage a controlled disinvestment.
   d. **Quick divest** liquidates the unit as early as possibly during the decline stage.

<table>
<tr><th colspan="4">Competitive Strategies For Declining Industries</th></tr>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">Relative market strength to reap sales from remaining pockets</td></tr>
<tr><td>Strong</td><td>Weak</td></tr>
<tr><td rowspan="2">Outlook for industry structure during decline</td><td>Favorable</td><td>Leadership or Niche</td><td>Harvest or Quick Divest</td></tr>
<tr><td>Unfavorable</td><td>Niche or Harvest</td><td>Quick Divest</td></tr>
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Competition in Global Industries

A. **Methods of Engaging in International Business** – normally, a firm can engage in international business using one of three methods:
   1. **Licensing** refers to granting other firms the right and know-how to produce or market products/services in a given territory in return for a fee.
      a. **Advantages** include gaining exposure to foreign markets with minimal risks.
      b. **Disadvantages** include potential for losing control over the related markets, low financial return, and strengthening of a future potential competitor (the licensee).
   2. **Export** refers to the movement of goods produced in one territory to the related markets.
   3. **Direct foreign investment** is considered the most sophisticated form of involvement in the global market since it has the highest costs associated with it and it implies that the firm will be doing careful assessments to reduce the risks associated with the investment.
      a. **Advantages** include exploiting cheaper costs for factors of production, reducing shipping costs, gaining better and more controlled access to foreign markets, and enhancing the firm’s global image.
      b. **Disadvantages** include high risks associated with exposure to foreign currency fluctuations, potentially higher exit barriers, expropriation, and other foreign restrictions on investments in their territories.

B. **Sources and Impediments to Global Competition**

1. **Sources** of global competitive advantage
    a. Comparative advantage which exists when a country has significant advantages in costs or accessibility to factors of production, and their quality.
    b. Global experience improves the learning curve when selling a product that is subject to a high obsolescence factor.
    c. Economies of scale as follows:
        i. Production economies of scale may exist beyond the potential of the local market.
        ii. Logistical economies of scale which increase the sales volume, and thus reduce the per unit fixed costs.
        iii. Marketing economies of scale may be present.
        iv. Economies of scale in purchasing.
    d. Product differentiation when a product has a global presence.
    e. Increased returns from proprietary product technology that will be introduced beyond the domestic market.
    f. Mobility of production allows for investments that could be used in more than one market. For example, oil rigs cost anywhere between $20-40 million. Operating only a few in a limited market will not provide the investing firm with a payback on its investment, while having the ability to move them around and increase their numbers, will allow the firm more projects to allocate its fixed costs, and thus investing in experts and machinery would be justified.
2. **Impediments to Global Competition**
    a. **Economic Impediments**
        i. Relatively high transportation and storage costs.
        ii. Differing product needs across borders.
        iii. Established distribution channels are required to facilitate the introduction of the product into global markets.
        iv. Sales force requirements for products that require the manufacturer's sales force.
        v. Local service and repair may not be efficiently established.
        vi. Sensitivity to lead times in some industries that require short lead times between the manufacturer and the market.
        vii. Complex segmentation within geographic markets which will thus require varieties of the product.
        viii. Global competition requires demand for the product in large key markets.

b. **Managerial Impediments**
    i. Differing marketing tasks across borders even for the same product.
    ii. Intensive local services impede centralized management and require local management to compete with local rivals.
    iii. Rapidly changing technology that may require product and process redesign to adjust it to local markets.

c. **Institutional Impediments**
    i. Include a variety of governmental impediments aimed at encouraging local institutions while harming global competition including (tariffs, import quotas, subsidies, etc.).
    ii. Resource limitations to expand and/or research global markets.

C. **Evolution to Global Industries** – the majority of currently existing global industries have evolved into them over time, rather than beginning as global industries.

1. **Environmental Triggers to Globalization**
    a. Increased scale economies that reduce costs.
    b. Decreasing transportation and/or storage costs have encouraged globalization of industries.
    c. Stable and strongly established distribution channels make it easier for foreign firms to penetrate the market.
    d. Increased costs in the factors of production make global competition more lucrative.
    e. Narrowed national economic and social circumstances increase the potential for global competition.
    f. Reduced government constraints that are being promulgated by world bodies.
2. **Strategic Innovations Stimulating Globalization**
    a. Product redefinition that makes it appealing to the global market.
    b. Identification of poorly serviced market segments in large markets.
    c. Reduced costs of adapting an otherwise standard product to meet demand across borders.
    d. Design changes that lead to more standardized components.
    e. Disintegration of products in the countries that require local manufacturing so that parts are manufactured internationally and assembled locally.
3. Access to large markets such as the European market, the US, and/or China grants leverage to firms once they are in.

D. **Strategic Alternatives in Global Industries**

1. **Broad Line Global Competition** involves taking advantage of the available sources for achieving global competitive advantage and competing worldwide with the **full product line of the industry** to achieve differentiation or an overall low-cost position.
2. **Global Focus** is a strategy that targets **only one segment of the industry** and competes globally in this segment either by differentiating or achieving an overall low-cost position.
3. **National Focus** focusing on a national market and attempting to compete against global firms.
4. **Protected Niche** is applicable in markets where the government requires a high proportion of local content. The firm would establish itself in the market and produce accordingly benefiting from the government's requirements to deter global competitors who do follow suit.

E. **Trends Affecting Global Competition**

1. Reduction in differences among countries.
2. More aggressive industrial policy by some governments towards certain industries favored by these governments. For example, the support being granted by the EU to Airbus (in addition to other factors) is significantly affecting Boeing's market share.
3. National recognition and protection of assets that are considered distinctive from the economic point-of-view such as oil.
4. Freer flow of technology is giving firms in newly developed countries the ability to invest in world-scale facilities.
5. Gradual emergence of new large-scale markets other than the US such as the EU, China, and India.
6. Newly Developed Countries (NDC) competition is increasing in areas that were historically dominated by a few developed countries.

Strategic Decisions

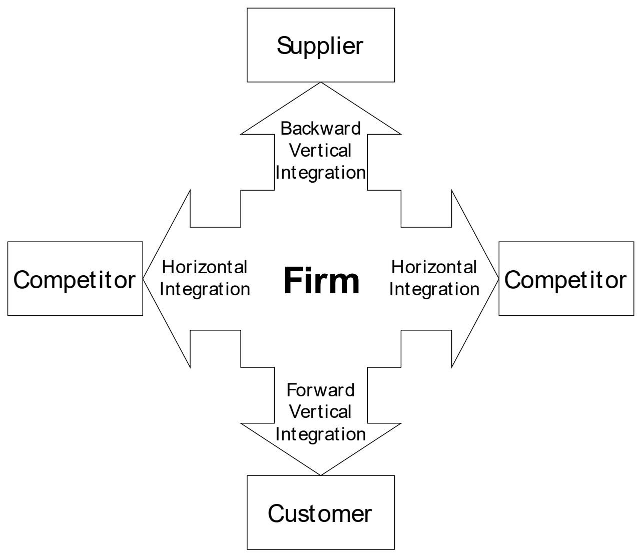
Companies are regularly required to make strategic decisions that have an ongoing and long-lasting effect. The three typical decisions that will be discussed in this text are:

- Strategic analysis of vertical integration
- Capacity expansion
- Entry into new businesses

Strategic Analysis of Vertical Integration

A. **Vertical Integration** refers to the combination of supplying raw materials, production, distribution, selling, and/or other economic processes within one entity. Usually, the vertical integration decisions are “make or buy” decisions based on financial, nonfinancial, and strategic plans. When firms make the decision to integrate vertically, they would face one of two alternatives:

1. The required production volume of the integrated sector is high and thus the units may be produced with efficiency utilizing economies of scale.
2. The required production volume is too low for the integrated sector, and thus the firm faces the dilemma of either producing a small volume with inefficiency or producing efficiently and selling extra output to its competitors.



B. **Strategic Benefits of Integration**

1. Economies of Integration (synergy) – occurs when the value derived from a combination of separate elements is greater than the sum of their individual values.
   a. Economies of combined operations through reducing some costs such as handling, transportation, packaging costs, etc.
   b. Economies of internal control and coordination through reducing costs associated with scheduling, coordinating operations, and responding to emergencies.
   c. Economies of information through reducing the costs of gathering market information.

   d. Economies of avoiding the market through reducing costs of selling, price shopping, negotiating, and market transactions.
   e. Economies of stable relationships through savings on costs associated with buying and selling communications and harmonizing them in a manner that may not be possible when the firms are independent.
2. Tap into technology as the integrated firm will have access to the technologies of both the upstream and downstream units.
3. Assure supply and/or demand since the integrated firm is the supplier/customer of its own business.
4. Offset bargaining power if the power of suppliers or customers is high reaping them above average returns and avoiding input cost distortions.
5. Enhanced ability to differentiate since the integrated firm is able to control the features of its supplied products, and or the features of its demanded products.
6. Elevate entry and mobility barriers if integration reduces costs, and/or increases sales prices. New entrants must be integrated if they wish to be competitive, and existing competitors should integrate thus creating higher barriers.
7. Enter a higher-return business if the return on investment in the integrated unit is higher than the required return on the company’s assets.
8. Defend against foreclosure in the case that the firm’s competitors integrate; they may tie up many of the sources of supply and/or the desired customers or outlets leaving the firm struggling to seek sources of supply and/or customers.

C. **Strategic Costs of Integration**

1. Cost of overcoming mobility barriers caused by cost advantages from proprietary technology or favorable sources of raw materials.
2. Increased operating leverage since an integrated firm would have higher fixed costs.
3. Reduced flexibility to change partners when the upstream or downstream units are not competitive.
4. Higher overall exit barriers as a result of increased specialization of assets, strategic relationships, and/or emotional ties.
5. Capital investment requirements, as integration requires more investments in capital assets.
6. Foreclosure of access to supplier or consumer research and/or know-how as the integrated firm becomes independent from its suppliers/customers.
7. Maintaining balance is required between the upstream and downstream units within the integrated firm, otherwise, excess demand or supply may be created.

8. Dulled incentives since the selling firm's sales is guaranteed eliminating the incentives for improvement and the buying firm will not negotiate to obtain the best possible deals.
9. Differing managerial requirements may exist between an upstream and downstream business that might be managed by one team in an integrated firm.

Capacity Expansion

A. **Capacity expansion** is amongst the most significant strategic decisions faced by firms as measured by both the amount of required capital and the complexity of the decision-making problem. Capacity expansion is also referred to as market penetration since it involves growth of existing products and/or development of existing markets. As summarized by Michael E. Porter, the elements of the capacity expansion decision include:

   1. Determine the firm's options for the size and type of capacity additions.
   2. Assess probable future demand and cost of inputs.
   3. Assess probable technological changes and probability of obsolescence.
   4. Predict capacity additions by each competitor based on the competitor's expectations about the industry.
   5. Add these to determine industry supply and demand balance and resulting industry prices and costs.
   6. Determine expected cash flows from capacity addition.
   7. Test the analysis for consistency.

B. According to Porter, one key issue associated with capacity expansion is overbuilding capacity. He states that "there seems to be a strong tendency toward overbuilding of capacity, particularly in commodity businesses, that goes far beyond that due to mistaken attempts at preemption." The following are conditions leading to overbuilding capacity which becomes more severe when more than one factor is present in an industry:

   1. **Technological**
      a. The necessity to add capacity in large lumps.
      b. There are economies of scale or a significant learning curve from adding large capacity.
      c. Long lead times in adding capacity.
      d. Increased minimum efficient scale with capacity, thus if the number of plants in the industry does not decrease, all existing plants will tend to increase capacity creating a major overcapacity in the industry.
      e. Changes in production technology which usually result in new additions while maintaining old equipment operational.

2. **Structural**
    a. Significant exit barriers cause old capacity to remain in the industry.
    b. Forcing by suppliers through subsidies, easy financing, and lower prices.
    c. Building credibility in the market-place and particularly with large customers.
    d. Integrated competitors who are also the firm's distributors, so if the firm is unable to meet the market demand, there is a potential of losing market share to its distributors.
    e. Capacity share affects demand in some industries, where customers approach only large capacity firms e.g., airlines.
    f. Age and type of capacity affects demand in some industries, and thus having the most modern will yield competitive benefits.
3. **Competitive**
    a. Large number of firms that have the strengths and resources to add significant capacity all seeking market share.
    b. Lack of credible market leader(s), as a strong leader (or group of leaders) can orchestrate an orderly expansion through their announcements and actions.
    c. New entrants often create or aggravate the overbuilding problem.
    d. First mover advantages encourage firms to build capacity early when the future prospects of the market are favorable.
4. **Information Flow**
    a. Inflation of future expectations.
    b. Divergent assumptions or perceptions amongst competitors about their relative size and capacity.
    c. Breakdown of market signaling prevents firms from obtaining adequate information about the industry and the competitors.
    d. Structural change either requiring firms to invest in new capacity, or turmoil that affects each firm's perception of its relative strength.
    e. Financial community pressure when competitors have invested, and the firm did not.
5. **Managerial**
    a. Production orientation of management that makes them concentrate on their plant's capacity rather than on marketing and finance aspects of the business.
    b. Asymmetric aversion to risk occurs when managers believe that their positions are more secure with a large capacity so if there is demand, they are able to meet it, whereas, if demand is low, they are in the same boat as other competitors.

6. **Governmental**
   a. Perverse tax incentives that encourage firms to invest by providing them tax incentives and possibly subsidies.
   b. Desire for indigenous (native) industry pushes the government to encourage certain industries in the hope of marketing products in the global market.
   c. Pressures to increase or maintain employment.

Entry into New Businesses

A firm may be interested in expanding its portfolio and entering new businesses. Entry into new businesses may be consummated in one of two ways:

– Entry through internal development
– Entry through acquisition

A. **Entry Through Internal Development**

1. Entry through internal development involves the setup of a new business within an industry including the setup of production capacity, distribution channels, sales force, etc. The entering firm would typically have to deal with the structural entry barriers and the expected reaction of other firms within the industry.
2. According to Porter, to analyze the entry decision, the firm will need to balance the following costs and benefits:
   a. The required investment for fixed assets and startup costs.
   b. Any additional investments required to overcome structural entry barriers.
   c. The expected cost of competitors' retaliation vs. the expected cash flows.
3. Traditional capital budgeting analysis tend to oversimplify the feasibility study process since assumptions about prices and costs remain unchanged before and after entry, and thus ignoring costs of entry barriers and costs of potential retaliatory measures taken by existing firms.

B. **Entry Through Acquisition**

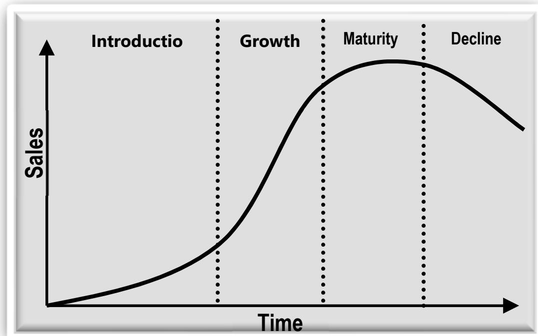
1. Entry through acquisition differs from entry through internal development in that no new player is added to the industry. Changes occur within the industry without the addition of new capacity into the industry.
2. An efficient market generally exists for the purchase and sale of companies whereby abnormal profits from making an acquisition are eliminated.
3. The market price is subject to demand and supply factors, however, unless there are strong reasons otherwise, the current owners of a business will only sell it if the sales price equals or exceeds the net present value of future cash flows (usually referred to as the floor).

4. The floor price of a company in an acquisition is calculated under the assumption that the seller keeps operating the business, and thus, its calculation depends on the seller's perception rather than the buyer's perception. Normally, the floor price would be lower if the seller feels compelled to sell. For example, if the seller:
   a. Has estate or other financial problems requiring immediate capital or is unable to sustain sufficient capital supply for required growth.
   b. Lost key managers and is unable to plan for successors for the existing management or perceives managerial weaknesses.
5. There are several market imperfections that may result in an inefficient market price:
   a. The buyer has superior information not available to the seller.
   b. There is a small number of bidders either because the selling firm is large, or because it is too special that only a few buyers are able to operate it.
   c. The current economy or economic forecasts imply poor expected operating results.
   d. The selling company has internal problems.
   e. The selling company's objectives may not necessarily be to maximize the selling price such as the acquirer's reputation or ability to maintain operations.
6. In some cases, the buyer may pay an above average price for a firm if any of the following conditions exist:
   a. The buyer has a distinctive ability to improve the operations of the seller.
   b. The selling firm is in an industry that has a potential for development that would generate above-average returns.
   c. The selling firm is required to help the buyer's position in its existing business.

Product Life Cycle

The product life-cycle is a concept that divides the life-cycle of any product to four stages:

- Introduction
- Growth
- Maturity
- Decline



A. **Stages of the Product Life-Cycle**

1. **Introduction**
    a. The product is launched during this stage into the market usually along with a large-scale marketing program.
    b. The product has probably gone through the phases of idea screening, prototype, and market tests.
    c. This stage is considered the most risky and typically the most expensive as substantial dollars must be spent to seek consumer acceptance of the product.
    d. The marketing program is usually geared towards the product itself rather than the firm's brand. The company is required to create the need for the product in the market and thus an expensive sales promotion is necessary. This normally results in a slow sales growth.
2. **Growth**
    a. The product becomes accepted in the market and the sales, and profits rise rapidly.
    b. The sales and profit outlook of the industry lures competition, and once there are numerous players, the profits begin to decline.
    c. Firms attempt to differentiate themselves by continuously improving product quality and adding new product models and features.
3. **Maturity**
    a. During the early phase of maturity, sales may be increasing but at a decreasing rate, however, this sales increase will ultimately level-off, prices are probably at their lowest, and profits start to decline.
    b. With the fierce competition, firms tend to differentiate their products in order to sustain their operations, and thus, those firms that are unable to differentiate and introduce new products are forced out of the market as a result of declining profits.

4. **Decline**
   a. The product becomes less desirable, and its need diminishes usually in the presence of a better, and/or less expensive product (i.e., sales are likely to decline).
   b. During this stage, all existing firms need to reassess their positions to decide whether they are able to profitably sustain their operations.

B. The length or duration of a product life-cycle is dependent on the product and varies amongst product categories. Both the product life cycle and its duration are assessed relative to a product in a specific market. Some variations of a product life-cycle include:

The product undergoes an extended introductory period before gaining widespread consumer acceptance.

1. The entire life-cycle duration is relatively short such as is the case in a product or style that becomes immensely popular overnight and declines almost as quickly.
2. The product's mature stage lasts almost indefinitely particularly when a cost-effective replacement is not available.

C. **Life-Cycle Management** differs between firms that are able to control the length of each stage and those that need to determine how best to optimize their firm's performance within that particular product's life-cycle. The latter firms need to predict the probable shape of the particular product's life-cycle, and therefore, adapt their strategies for each phase as follows:

1. **Introductory Phase –** during the introductory phase, the firm has the choice between the following:
   a. Entering the new market during that phase as prompted by its desire to build a dominant market position and potentially, reducing the interests and effectiveness of future competitors.
   b. Waiting till the early growth stages which is an effective strategy for large companies with the marketing resources to overwhelm the smaller innovative firms.
2. **Growth –** during this phase, the firm's decisions are critical as they influence how many competitors enter the market and how well the firm's brand within a product category is positioned in the near and distant future. Typically, the firm should:
   a. Develop and enhance a promotional strategy that creates and strengthens the consumers' desire to buy the firm's product.
   b. Expand the distribution network.

c. Consider product improvements and enhancements.

d. Consider the opportunities for cost reductions since the impact (i.e., cost savings) would be most significant as a result of large production volumes.

3. **Maturity –** during the maturity phase, the firm should seek strategies that would maintain or boost sales of the product. Typical strategies include:

   a. Modification and enhancement of the product.

   b. New and effective promotion.

   c. Fiercely advertising the product for high quality and low price.

   d. Identifying, devising, or highlighting new uses for the product.

4. **Decline –** during the decline stage, management should ensure the efficiency of the marketing and production programs and all unprofitable sizes or models are discontinued. If the firm is unable to achieve high efficiency, abandonment of the product should be considered.

D. Recent approaches to strategy formations are concentrating on attempting to keep their products in the early growth phases to avoid the disadvantages of the introductory and mature phases. This is achieved by using one of two different strategies:

1. Attempting to reduce the introductory phase of a new product by removing it from a category with hostile competition (that it may potentially become associated with) and positioning it in a more desirable category.

2. Attempting to bring back a product or service from the maturity phase to the growth phase.

   a. For a service, a company would undergo such a market positioning by stripping down a current service associated with complicated formalities and conditions to a simpler and easier to understand, acquire, and use while also providing only some of the additional features that were considered highly important by customers. For example, JetBlue has succeeded in implementing such a strategy by offering simple bookings with single-trip fares, only one class of seating, no meals, but providing the customers with first-class on-board entertainment and leather seats. This positioning was between the top-end and low-end carriers which proved very profitable for the firm.

   b. For a product in the maturity phase, a product is positioned to disassociate itself from the current positioning and identifying new uses that would put it in the early growth phase of a new category. It would combine features of products in different categories, to create a new category.

