

# MNGT 481: STRATEGIC MANAGEMENT



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## Licensing

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## Preface

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Strategic management is usually among the last courses of the business education curriculum. Taught from a top-management perspective, the course generally involves concepts, cases, and a business game. The balance among the work expected of students in studying concepts and engaging in cases and game vary greatly among institutions and their instructors.

This narrative is written for the strategic management course that is lighter on content and heavier on engagement. The narrative covers principles that are useful in practice. The student is told only what the student must be told, on the presumption that the student is intelligent enough to fill in the gaps, a presumption that should be reasonable for anyone aspiring to a top management position. Moreover, this narrative differs from many others as follows:

1. Strategy implementation is covered extensively, and based on the work of the psychologist Norman R. F. Maier.
2. Strategy formulation is divided into three bases for evaluation: facts, practicality, and mission/vision.

To simplify the narrative, the discussion herein refers only to profit-making entities, labeled firms, even though much of the material is applicable also to not-for-profit organizations. Additionally, the revenue-generating output of firms are referred to always as products, even when the product could be a service, such as transportation.

Precha Thavikulwat

14 October 2019

To Tipaporn, Alisa and Amalie.

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## 1: Introduction

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Strategic management is an area of study that examines the problems of maximizing organizational effectiveness from the perspective of executives at the highest command level of the organization's hierarchy. If the organization consists of a single firm, the problems are referred to as business-level problems. If the organization consists of a group of firms under common ownership, the problems are referred to as corporate-level problems. Solutions to these problems are called strategies. Strategic management is the study of how executives formulate and implement strategies (Learned, Christiansen, Andrew, & Guth, 1969).

In process, strategy implementation follows strategy formulation. In life, however, strategy implementation precedes strategy formulation, for executives learn to follow orders before they learn to give orders. For this reason, the narrative that follows begins with strategy implementation and ends with strategy formulation. In between, simulation games and cases are discussed.

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## CHAPTER OVERVIEW

### 2: Strategy Implementation

The goal of strategy implementation is to realize the organization's vision as articulated by its leaders. Executives implement strategies through subordinates. The strategy might be one that the executive is told to implement exactly as formulated, one that the executive has decided, or one that the executive seeks to develop in collaboration with subordinates. In all three instances, face-to-face meetings are necessary to reach a mutual understanding between executive and subordinates.

[2.1: Meeting With Subordinates](#)

[2.2: Quality and Acceptance](#)

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## 2.1: Meeting With Subordinates

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Meetings between executive and subordinates, individually and as a group, can be conducted using one of three basic methods: tell and sell, tell and listen, and problem solving (Maier, 1973). The objective that can be achieved and the skills needed for an effective meeting depend on the method.

The objective of tell-and-sell is to transmit information. This method is suitable when high acceptance by subordinates is assured or unnecessary, because the strategy involve issues about which subordinates are indifferent. A strategy involving product pricing, sourcing, and coding is of this kind.

The objective of tell-and-listen is to maintain control while encouraging subordinates to express themselves in a setting that is safe and therapeutic. This method is suitable for a strategy that is firm but unpleasing to subordinates, such as one involving termination of service, demotion, transfer, and undesirable working conditions.

The objective of problem solving is to arrive at the best strategy that the executive's team can devise based on the ideas and facts available to all team members. This general-purpose method is suitable for an executive skillful in leading problem-solving discussions. To be successful, the executive will have to work around subordinates' reluctance to admit to problems and to disagree with their superiors. The executive also will have to inhibit the executive's own tendency to make suggestions, because any suggestion made by a superior will be seen as a command by subordinates, and a signal that their views are not welcome. As such, the superior's suggestion will not be properly considered. The suggestion may be met with silence, or vehemently attacked.

High subordinate acceptance is assured when the strategy decided is one devised by the team. The quality of a team-devised strategy, however, depends on the skill of the executive conducting the meeting. Even so, a less-than-best strategy implemented by subordinates who believe in it can be more effective than the best strategy implemented by subordinates who do not believe in it.

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## 2.2: Quality and Acceptance

While a strategy is a solution to a problem, the implementation of strategy itself creates problems that must be resolved. The effective resolution of problems depends on applying the leadership method that fits each type of problem (Maier, 1963). Problems can be classified into types based on their requirements for objective quality and subjective acceptance.

Decision quality, dependent on knowledge and expertise, is factual. Decision acceptance, dependent on participation and involvement, is emotional. Effective decisions (ED) are the product of decision quality (Q) and its acceptance (A) by those who must work with the decision, thus,  $ED = Q \times A$ . The two dimensions, quality and acceptance, give rise to four types of problems: high quality low acceptance (Q/A), high acceptance low quality (A/Q), low quality and acceptance (/QA), and high acceptance and quality (QA/). A matrix showing the four types of problems and the leadership method that fits each type is shown in Figure 2.2.1.

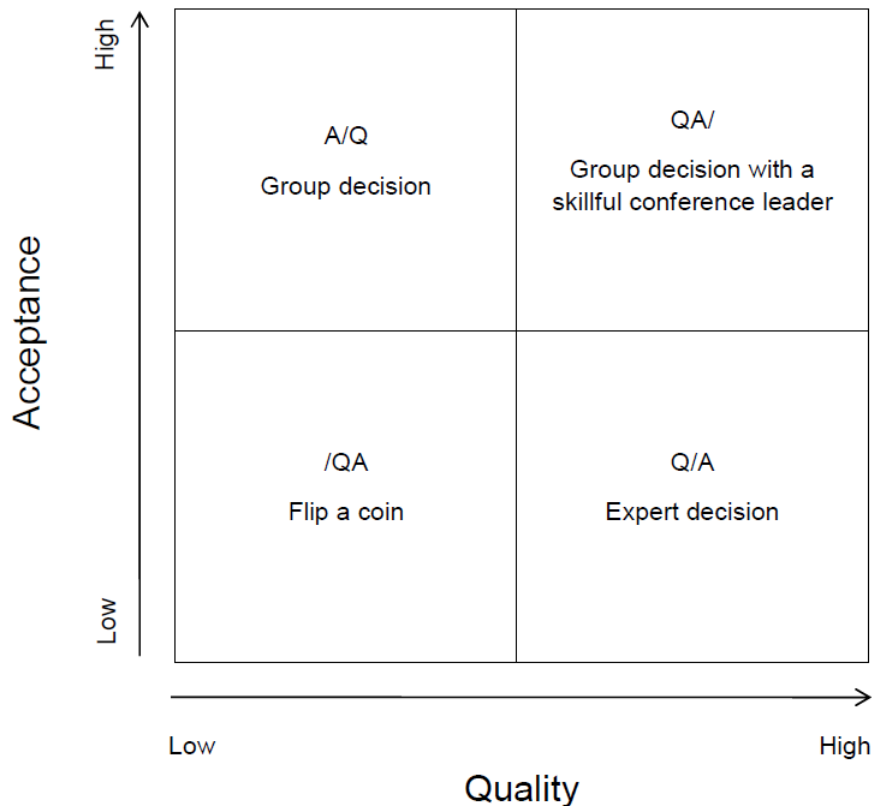


Figure 2.2.1: Quality and Acceptance Dimensions of Problems

Q/A problems are those concerning pricing, sourcing, and technical issues. The effective decision for these problems depends on facts, analysis, and expert judgment. Involving subordinates who do not know the facts and are not experts in the issue will be seen by subordinates as wasting their time. An expert should decide. If someone with more expertise than the executive is available, the executive should defer to the expert.

A/Q problems are those requiring a decision for which the choice is immaterial to its quality, but about which fairness is a concern. Who should work overtime, who should get the new office, what should be the penalty for breaking a rule, and what should be the reward for exceptional performance, are examples of problems of this kind. The executive should engage those involved in a group discussion, and accept the consensus of the group. The executive should expect that the group consensus will vary with the personalities involved, even when the objective facts are the same. This is not a problem, for fairness is not an immutable rule, but a feeling that a decision fits the concerns of the members of the group.

/QA problems are those requiring a decision for which neither quality nor acceptance will be lacking whatever the decision may be. Decisions on work direction are generally of this kind. Should work proceed from A to B or vice versa? Asking subordinates to make the decision as a group can give rise to an engaging but time-wasting debate over trivial concerns. The executive should settle the matter by the easiest means available, such as flipping a coin.

QA/ problems are those involving methods of work and standards for performance. Conflicts of interest between superiors and subordinates, fairness among subordinates, and expertise required to understand data might all be involved. Problems of this kind can be handled in one of two ways.

One way is for the executive to address first the quality aspect of the problem by making the decision or delegating the decision to an expert. Having decided on the solution, the executive applies persuasion to gain acceptance. The persuasion might include a quid pro quo, sufficient to gain acceptance but not so much as to undermine the solution. The acceptance that comes from persuasion, however, is rarely enthusiastic.

A better way is for the executive to address first the acceptance aspect of the problem by applying the method of group decision. The method assures acceptance, but a quality outcome depends on discussion leadership skills. These include skills in stating the problem, clarifying the facts, encouraging new contributions, discouraging repetition, keeping discussion on track, separating solution generation from solution evaluation, and assuring that alternatives are rigorously screened.

The skills do not include subterfuge, for the objective is not to guide group discussion to the solution that the discussion leader prefers, but to work with the group to reach the best decision possible. In fact, the process is hindered when the discussion leader has a preference, because a leader who has a preference feels compelled to state the preference. Preference stated, the group has more difficulty in reaching the highest quality decision, because the members must work on two objectives simultaneously, solving the problem and pleasing the leader. If after stating the preference, the leader proceeds to promote the preference and defend it against criticism, group members, suspecting deceit, will respond defensively, effectively ending the collaborative state of mind.

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### 3: Simulation Games

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Simulation games give practice in strategy implementation, for practice requires action that games demand. In a game, as in life, no action is an action and no strategy is a strategy.

A game involves both fictitious elements and real elements. The fictitious elements of a strategic-management simulation game are the attributes of the simulated business environment. The real elements are the players, their thoughts, feelings, and actions. To learn principles and skills that can be useful in everyday life, the player should accept the game's fictitious elements as given, and work with the real elements to win in the game. Winning, the objective of every game, should not be overlooked, for the game is not worth playing when players do not try to win. Yet the reward of winning is incidental to its true purpose, which is for the players to learn strategy-implementation skills. Learning strategy-implementation skills means learning how to take care of yourself and your associates whatever executive or ownership role you and they might play in a firm, for the challenge of strategy implementation is in reconciling each executive's personal interests with the personal interests of others on whom the executive depends.

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## CHAPTER OVERVIEW

### 4: Cases

Cases give practice in strategy formulation. A case may be fictional or real. When real, the case may be set or live.

When a case is fictional, all the facts for strategy formulation are contained within the write-up of the case. The student is expected to formulate the strategy that best addresses the facts as given. Generally, no research beyond what is supplied in the write-up is required. The only information outside of the case write-up that would be useful is information that is common knowledge among the students enrolled in the course.

A case that is real and set is about a firm at a set time, as given in the write-up of the case. The student is expected to formulate the strategy that best addresses the facts known at that time. Generally, searching for information going beyond what is contained in the write-up of the case and what is asked by the instructor is unnecessary. Moreover, information found about opinions or events that occurred after the time of the case can hinder good work, because a strategy based on the opinion of others is vacuous, and a strategy based on events occurring after the time of the case is illogical.

A case that is real and live is about an ongoing, generally local, firm. The student is expected to formulate a strategy that best accomplishes the goals of the assignment. While the case is being studied, important aspects of the case may change, including the goals sought and the limitations of the assignment. Adapting to the changes is part of the challenge of the live case.

Casework generally involves a writing assignment or a presentation-participation assignment, or both. The writing assignment may be an individual assignment or a group assignment. The presentation-participation assignment is generally structured such that a group of students present the case to the rest of the class or to a panel of judges.

[4.1: Writing Assignment](#)

[4.2: Presentation-Participation Assignment](#)

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## 4.1: Writing Assignment

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The purpose of a case writing assignment is to give practice in the kind of writing that is valued in the workplace. If after you have completed your assignment, you would not yourself pay money for what you have written, then what you have written is not good enough.

In the workplace, you would not pay for writing that tells you facts you already know. The writer might mention what you already know here and there in the piece, but if the piece is substantially about facts you already know, the piece would have no value to you.

You would not pay for writing that is unclear, especially when you know the author could be clearer. If the author writes that the company should focus on something, you would want the author to clarify. How is the company supposed to focus? What action must be taken to constitute focus?

You would not pay for writing that tells you to research or analyze the problem. The assignment requires analyze for which research might be useful. Admonishing the reader to do research and analysis, however, is condescending and useless.

Generally, the assignment will ask that the case be written from the viewpoint of a consultant, an outsider of the firm. From this viewpoint, the firm is identified by name. Do not use first- and second-person pronouns, we and you, to refer to the firm.

Generally, the assignment will require a narrative. If so, write in complete sentences organized into paragraphs, with attention to topic sentences and transitions between paragraphs. Do not submit a list when a narrative is required. Whereas a narrative shows how the writer thinks, a list only shows that the writer knows some words.

The following is a checklist of additional pointers on case writing:

1. Respond directly to the assignment. If the assignment is to submit research findings, do the research, submit the findings, and explain how you got the findings. If the assignment is to make a recommendation, analyze the facts, make a recommendation, and explain why the recommended course of action is best.
2. Answer the question before explaining the answer. If the requirement is to answer in one paragraph, the answer should be the first sentence of the paragraph. If the requirement is to answer in a short essay, the answer should be the last sentence of the first paragraph. In this instance, the first one or two sentences of the first paragraph should lead to the answer, the middle paragraphs should explain the answer, and the last paragraph should re-iterate the answer.
3. Cons before pros. Address reasonable arguments against your position before addressing the arguments for your position. The best argument for your position should be the last argument.
4. Write about what you know. Write especially about what you know that others may not know, because they have not studied the case as well as you have studied it. The mind needs time to work, so study the case several days before you write about it.
5. Do not question yourself or undermine your own position by apologizing, equivocating, or otherwise suggesting ineptitude. Do not write “In my opinion” (suggesting it is not worth much), “I think” (suggesting you do not know), or “I feel” (suggesting you do not think).
6. Do not complain about insufficient information, or call for further study or research. The task of strategic management is to identify the best course of immediate action given available information.
7. Write with grace and dignity. Do not disparage, patronize, preach, use slang, or make frivolous comments.
8. Be specific. Business is a numbers game, so use numbers whenever possible. When describing a course of action, give enough detail for the action to be visualized, as in a skit. Action that cannot be visualized cannot be executed.
9. Be assertive, neither wishy-washy nor dogmatic. Avoid *mights* (wishy-washy) and *musts* (dogmatic).
10. Economize on words. Do not merely restate the facts of the case. Either use the facts, to support an argument or introduce a topic, or do not mention them at all. Do not write a long introduction—get quickly to the point.

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## 4.2: Presentation-Participation Assignment

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The presentation-participation assignment is a role-playing assignment where every participant benefits through practice. Generally, a group of presenters assumes the role of consultants, while the audience assume the role of firm executives, other consultants, or both.

Before the presentation, the presenting group should agree on the positions to take and on each member's part in the group presentation. Every member should have a substantive part that involves a position and an argument for or against the position. No one should be assigned solely to introduce or to conclude the presentation. Every member should speak only once.

Presenters should dress in a way that does not detract from the presentation. To assure that the audience knows each presenter's name and can therefore address each one by name in the discussion that follows, the group should either plan for each speaker to be introduced by the immediately preceding speaker, or for each to begin with a self-introduction. To aid memory, the introduction should highlight a distinctive attribute of the speaker.

Speakers should be respectful of the audience. The speaker should refer to the firm by name, not as we or you. The former is wrong because the presenting group does not speak for the firm. The latter is condescending even when the presentation is to executives of the firm in a live case.

Be mindful of the context. Unlike a sales presentation, whereby the sales team makes a pitch to the firm that if successful will result in a sale, the consultant's presentation is delivery of a product that the client has already purchased. While the executives may be interested in arguments supporting the consultant's recommendation, they also will be interested in the limitations of the recommendation, for much of the value that executives gain from consultant's work comes from understanding limitations.

During the presentation, members of the audience should note points of interest that should be clarified. When the floor is open for discussion, members of the audience should bring up the points of interest, taking care not to repeat points already stated. Each member should look for an opportunity to make one contribution to the discussion, and generally not more than three contributions, depending on the number of participants and the time allotted for the discussion.

The quality of the contribution is important. One contribution is better than none, for one attempt shows that one tries. But more than one is not necessarily better than one, because the later attempts may show that one does not listen.

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## CHAPTER OVERVIEW

### 5: Strategy Formulation

The process of strategy formulation is the process of solving problems. The goal is to arrive at the best strategy, which is one that is (a) supported by the facts of the problem situation, (b) practical, and (c) aligned with the mission of the organization and the vision of its leaders.

#### 5.1: Facts

##### 5.1.1: Financial Statements

##### 5.1.2: Porter's Five Forces

#### 5.2: Practicality

#### 5.3: Mission

##### 5.3.1: Mission/Vision

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## SECTION OVERVIEW

### 5.1: Facts

When faced with a problem, people often overgeneralize from their previous experience and fail to use known facts of the problem situation. People overgeneralize when they see similarities between the current problem and one of a past experience, while overlooking the differences. Although basic principles from a past experience can be effectively applied to similar problems, learning the wrong lesson is common, for every experience is unique in some way. The effort required to draw useful findings from facts can be tedious, so people tend to grasp at easy solutions that are not supported by the facts of the problem situation. Such solutions are gambles that are rarely effective.

To counter these psychological barriers to effective problem-solving, Maier (1963) has advanced four principles for screening solutions, two negative principles and two positive principles, as follows:

1. Solutions transferred from other situations should be rejected (Negative #1).
2. Solutions supported by facts or interpretations of facts that are challenged by other members of the group should be rejected (Negative #2).
3. Solutions founded either upon any of the unchallenged facts or unchallenged interpretations of facts taken from the problem situation should be selected for consideration and evaluation (Positive #1).
4. When exceptions to a trend in results can be satisfactorily explained, solutions based upon the trend should be selected for further consideration (Positive #2).

Maier envisioned that the leader of a problem-solving discussion group would apply these principles to screen out less desirable solutions and screen in more desirable ones *after* the group has arrived at a list of proposed solutions, for the overarching principle of problem solving is that the solution-generating process should be distinct from and precede the solution-evaluating process. Both processes are necessary, but whereas solution generation requires creativity, solution evaluation requires criticism. Criticism inhibits creativity. When the two processes are muddled, people limit their contributions to ideas that will not be criticized. The group does not get to the best solution, because discussion ends with the first solution that is acceptable.

#### Topic hierarchy

#### 5.1.1: Financial Statements

#### 5.1.2: Porter's Five Forces

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## 5.1.1: Financial Statements

This page is a draft and is under active development.

The facts of a business are summarized in financial statements that for public companies are included in annual reports to shareholders and filings with regulatory agencies (in the U.S., look especially for Form 10-K of the U.S. Securities and Exchange Commission). These reports and filings can usually be found in the investor area of the public firm's website. Beginners in the art of business analysis may see nothing interesting in the numbers. For professionals, however, those numbers are more interesting than what people say, for numbers can lie, but people are worse.

When reviewing financial statements, first, look for trends in the income statement and the balance sheet. Has revenue, gross margin, and net income been rising or falling? Has cash, receivables, inventory, and other items of the balance sheet been rising or falling? Next, look for exceptions to the trend. Exceptions may be caused by notable environmental effects, strategic actions, or both. Raise questions about the exceptions. Recall Screening Principle 4: When exceptions to a trend in results can be satisfactorily explained, solutions based upon the trend should be selected for further consideration.

Examine also the relationships among the items of the financial statement. Examine ratios. The formulas for computing common financial ratios are shown in Table 5.1.1.1.

Table 5.1.1.1: Common Financial Ratios

| Name                           | Formula   |
|--------------------------------|---|
| <b>Liquidity</b>               |   |
| Current Ratio*                 | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$  |
| Quick Ratio                    | $\frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$                   |
| <b>Leverage</b>                |   |
| Long Term Debt to Total Assets | $\frac{\text{Long Term Debt}}{\text{Total Assets}}$   |
| Long Term Debt to Equity*      | $\frac{\text{Long Term Debt}}{\text{Total Shareholder's Equity}}$                                 |
| Non-Current Debt to Equity     | $\frac{\text{Total Liabilities} - \text{Current Liabilities}}{\text{Total Shareholder's Equity}}$ |
| <b>Activity</b>                |   |
| Inventory Turnover*            | $\frac{\text{Cost of Sales}}{\text{Average Inventory}}$   |
| Accounts Receivable Turnover   | $\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$                                  |
| <b>Profitability</b>           |   |
| Gross Profit Margin            | $\frac{\text{Gross Income}}{\text{Sales}}$  |

| Name                     | Formula  |
|--------------------------|--|
| Operating Profit Margin  | $\frac{\text{Operating Income}}{\text{Sales}}$   |
| Net Profit Margin        | $\frac{\text{Net Income After Taxes}}{\text{Sales}}$   |
| Return on Assets (ROA)   | $\frac{\text{Net Income After Taxes}}{\text{Average Total Assets}}$  |
| Return on Equity (ROE)*  | $\frac{\text{Net Income After Taxes}}{\text{Average Total Shareholder's Equity}}$  |
| Earnings per Share (EPS) | $\frac{\text{Net Income After Taxes}}{\text{Average Number of Shares Outstanding}}$  |
| Price-Earnings Ratio     | $\frac{\text{Net Income After Taxes}}{\text{Average Market Capitalization Value}} = \frac{\text{Net Income After Taxes per Share}}{\text{Average Market Price per Share}}$ |

\* Key Ratios

Examine the firm's financial ratios over time, especially the key ratios asterisked in Table 5.1.1.1. At the first pass, precision is unnecessary. The objective is to get a quick feel for the numbers and to locate exceptions for further investigation. Compute ratios mentally, to develop a useful top-executive skill that improves with practice. Write down results. They say you can tell a person's rank in an organization by how she gets numerical results. If she uses a computer, she's an administrative aide; if she uses a hand calculator, she's a middle manager; but if she uses the back of an envelope, she heads the firm.

Finally, the most informative ratio is the one nobody expected, for the informative value of facts is the difference between actual and expected facts. For this reason, always go beyond the common ratios to look for relationships that others may have missed. A missed relationship can be the basis of a strategy that has not occurred to others. The best strategy is usually among those that have not occurred to others, because if it had, it would likely have already been adopted, and the problem would already have been solved.

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## 5.1.2: Porter's Five Forces

Whereas financial statements are a standard method of organizing facts about a firm of interest to owners, regulators, tax collectors, and other stakeholders, no equivalently standard method of organizing facts about the environment of a firm is available. The closest to a standard method may be Michael Porter's (1980) Five Forces. Porter groups the reasons for the relative successes of industries into five categories that he calls forces. These forces include two powers of closely related industries, two threats from unrelated parties, and relationships among competitors in the industry. The forces are (a) bargaining power of buyers, (b) bargaining power of sellers, (c) threat of new entrants, (d) threat of substitute products or services, and (e) rivalry among competitors. Porter's adapted schematic drawing of the five forces is shown in Figure 5.1.2.2

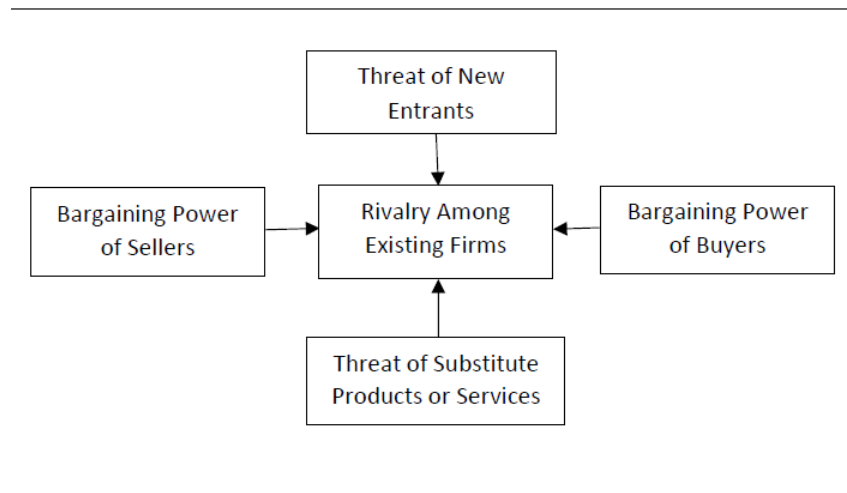


Figure 5.1.2.2 Porter's Five Forces

### 5.1.2.1: Bargaining Power of Buyers

The bargaining power of buyers refer to the bargaining power of a firm's customers. This force favors the industry when the buyers of its products are many, for the intensity of the competition among buyers rises with their number, which reduces their bargaining power in dealings with their suppliers.

### 5.1.2.2: Bargaining Power of Sellers

The bargaining power of sellers refer to the bargaining power of a firm's suppliers. This force favors the industry when sellers of the resources it needs are many, for like buyers, the intensity of the competition among sellers rises with their number, which reduces their bargaining power in dealings with their customers.

### 5.1.2.3: Threat of New Entrants

The threat of new entrants is the ease by which new companies can join the industry. The new entrants may initially expand the market for a new industry by helping to publicize the benefits of the industry's products, but as the market approaches saturation, new entrants cut into the market share of the established companies. In the long-term, costly entry bolsters the profitability of the industry. Thus, this force favors the industry when the cost of entry, comprising required fees and necessary investments, is high.

### 5.1.2.4: Threat of Substitute Products or Services

Even when the power of buyers is weak, the availability of substitutes for the products of an industry limits the prices that can be charged for the products. Threat of substitution favors the industry when good substitutes are not available or available at high prices only.

### 5.1.2.5: Rivalry Among Existing Firms

Besides industry structure and culture, the extent to which existing firms of an industry try to outcompete each other depends upon their numbers. Rivalry increases with the number of competitors, so this force favors the industry when the number of competitors

is small.

### 5.1.2.6: Applying the Five Forces

In the absence of numbers, Porter's Five Forces is applied by using judgment to interpret available facts. Judgments differ, so one person might conclude that a force is favorable to the industry, whereas another person examining the same facts might reach a different conclusion. The disagreements should be explored to see if they arise from resolvable differences in knowledge or understanding. Unresolved disagreements at the solution-evaluation stage call for applying Screening Principle #2: Solutions supported by facts or interpretations of facts that are challenged by other members of the group should be rejected.

Essentially, Porter's Five Forces is a checklist of items to study about the environment of a business. The checklist assures that all bases are covered. The primary value of the checklist is in the learning that occurs as the items of the list are discussed and debated, with the completed list itself having only a modest value in assisting memory of issues considered. What truly matters is the quality of the strategy, not the quality of the list. In other words, participants in a five-force discussion should see it as an opportunity to learn more about the firm, rather than an assignment to develop a quality list.

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## 5.2: Practicality

The practicality of a strategy is the extent to which the strategy serves the purpose intended. Whereas facts are either true or false, practicality is a matter of degree. Tools for assessing practicality include SWOT, VRIO, breakeven analysis, projected financial statements, EPS-EBIT analysis, and matrices.

### 5.2.1: SWOT

The classic tool for assessing the practicality of a strategy is a list of considerations known as SWOT, standing for Strengths, Weaknesses, Opportunities, and Threats (Learned, Christiansen, Andrews, and Guth, 1969). Strengths and weaknesses are nominally factors internal to the organization, so the examination of an organization's strengths and weaknesses is known as internal factor analysis. Opportunities and threats are nominally factors external to the organization, so the examination of these factors is known as external factor analysis. In fact, strengths do not exist without opportunities, and weaknesses do not exist without threats. An airline may employ many pilots who are excellent musicians, but musical talent is not the airline's strength in the absence of an opportunity for the airline to apply its pilot-musicians to advance its business.

Accordingly, a listing of an organization's strengths tends to overlap a listing of its opportunities. Likewise, a listing of its weaknesses tends to overlap a listing of its threats. To confound matters even more, a fact that one person considers a strength another may consider a weakness. If a firm has more employees than its competitor, for example, the firm has more resources at its disposal, apparently a strength. Yet, more employees also mean more difficulties in coordinating activities, apparently a weakness.

To address the overlap and varied interpretations, a four-part SWOT analysis can be reduced to a two-part ST analysis, that is, list only strengths and threats. Even better, reduce plurals to singulars, from strengths to strength, and threats to threat. The longer the list, the more the strongest item of each list becomes indistinct, reducing its value in strategy assessment. When only the best is good enough, the best strategy must be the one that builds on the firm's primary strength and forestalls the firm's most immediate threat.

### 5.2.2: VRIO

VRIO, standing for Value, Rare, costly to Imitate, and exploited by Organization (Barney, 2002), is a systematic means of identifying a firm's core competencies that expands on strengths. The idea is to list the resources and capabilities of the firm that are valuable, which is to say that without them the firm would be less profitable or more vulnerable to threats. Then to cull the list to arrive at a shorter list of items that are rare, which is to say that few other firms have them. Then, to cull the second list to arrive at a final list of items that are costly for other firms to imitate. The items of the final list are the firm's core competencies. Practical strategies are the ones that exploit core competencies. Strategies directed at unexploited core competencies are especially desirable.

In practice, each executive's VRIO listing is likely to differ from the list of every other executive, and attempts to reconcile the lists can be divisive. If some executive's area of responsibility should be missing from the core-competency list, the implication on the standing of the executive whose area of responsibility is missing from the list is ominous.

### 5.2.3: Breakeven Analysis

The objective of breakeven analysis is to identify the point at which the firm's net income will be zero. The firm will be marginally sustainable at this point, for in business, a positive net income is necessary for long-term survival. A strategy is less desirable to the extent it moves a profitable firm closer to its breakeven point.

Breakeven analysis is based on a model of a firm with a single product with cost of production falling into two categories: fixed and variable. For the model, whereas fixed costs do not change with production volume, variable cost rises linearly with production volume. Thus, Total Cost ( $C$ ) equals Total Fixed Cost ( $F$ ) plus Unit Variable Cost ( $v$ ) multiplied by production volume ( $Q$ ), as shown in Equation 5.2.1.

$$C = F + vQ \quad (5.2.1)$$

When unit price ( $p$ ) is constant and the quantity produced is the quantity sold, total revenue ( $R$ ) is the product of price and quantity, as shown in Equation 5.2.2.

$$R = pQ \quad (5.2.2)$$

The breakeven quantity ( $Q^*$ ) is where  $C = R$ , as shown in Equation 5.2.3.

$$pQ^* = F + vQ^* \quad (5.2.3)$$

Applying algebra to Equation 5.2.3, the breakeven quantity is as shown in Equation 5.2.4.

$$Q^* = \frac{F}{p - v} \quad (5.2.4)$$

Thus, if Lucy's lemonade stand is built with \$20 worth of lumber, the fixed cost; if making lemonade requires \$0.10 worth of lemons per cup, the variable cost; then if Lucy sells lemonade for \$0.50 a cup, Lucy's lemonade business will break even after she has sold  $\$20 / (\$0.50 - \$0.10) = 50$  cups of lemonade.

Although the particulars of Lucy's lemonade stand may not apply to any sizeable everyday-world business, the basic principle is the same, but some adaptation usually is necessary. Many firms have more than one product and more than one model of each product. If sales of the products and models tend to rise and fall together, the firm's breakeven can still be found even when an aggregated unit of output of the firm's products and models is unavailable by applying Equation 5.2.5, derived by dividing both sides of Equation 5.2.4 by current production volume ( $Q'$ ).

$$\frac{Q^*}{Q'} = \frac{F}{pQ' - vQ'} \quad (5.2.5)$$

The left side of Equation 5.2.5 is the breakeven point relative to current production volume. On the right side,  $pQ'$  is current total revenue and  $vQ'$  is current total variable cost. The figure for current total revenue appears on the firm's current income statement. The figure for current total variable cost can be estimated from the same statement. If the firm's policy is to adapt quickly to changes in sales by changing production-employment levels, then all of the firm's current total cost of sales may be considered a reasonable estimate of current total variable cost. Otherwise, current total variable cost will be a fraction of current total cost of sales. The remaining current cost of sales, expenses, and interest charges sum to the firm's current total fixed cost.

Graphing the relationships in the form of a breakeven chart, with quantity on the horizontal axis and the dollar amount on the vertical axis as illustrated in Figure 5.2.3 for Equation 5.2.3, and Figure 5.2.4, for Equation 5.2.5, can be helpful in a presentation. On both charts, the breakeven point is at the intersection between  $R$ , the total-revenue line, and  $F + vQ$ , the total-cost line. Breakeven charts can show the effect on profitability and the breakeven point of changing prices, marketing expenditures, and other contemplated actions.

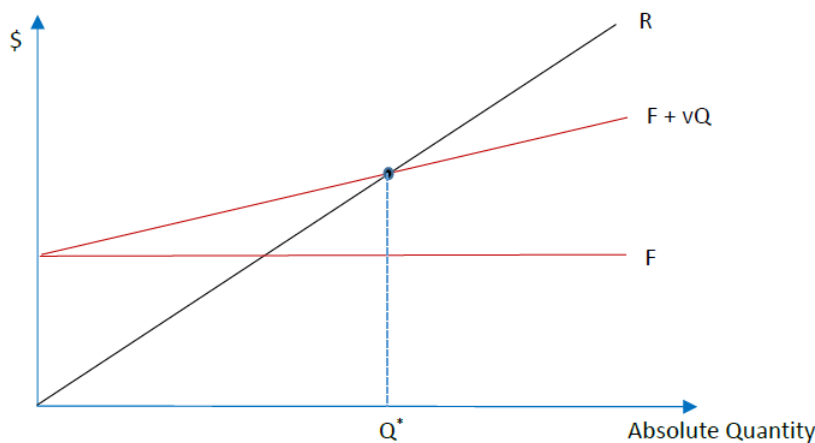


Figure 5.2.3: Absolute-Quantity Breakeven Chart. Total Revenue ( $R$ ), Total Fixed and Variable Costs ( $F + vQ$ ), and Total Fixed Cost ( $F$ ) vs. absolute quantity produced and sold. The crossing point is the breakeven quantity ( $Q^*$ ).

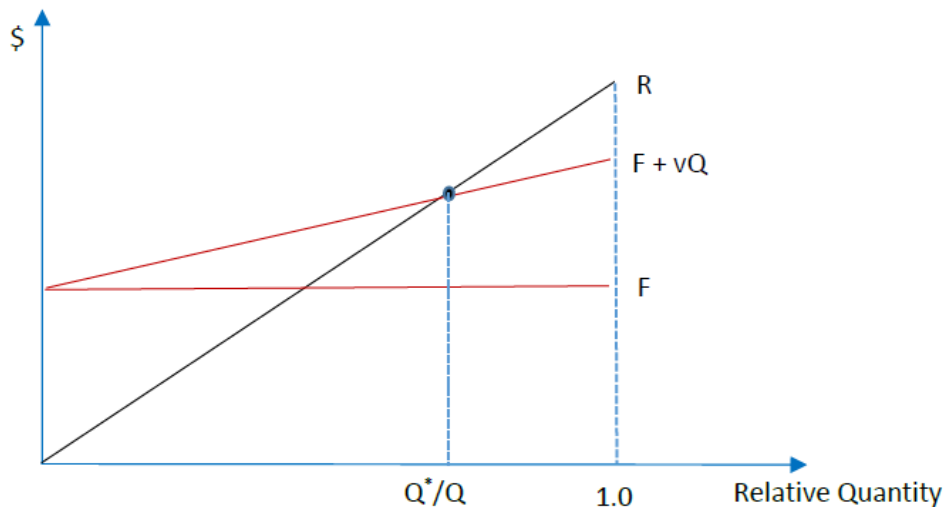


Figure 5.2.4: Relative-Quantity Breakeven Chart. Total Revenue ( $R$ ), Total Fixed and Variable Costs ( $F + vQ$ ), and Total Fixed Cost ( $F$ ) vs. relative quantity produced and sold. The crossing point is the breakeven quantity relative to current quantity produced and sold ( $Q^* / Q$ ).

### 5.2.4: Projected Financial Statement

Projected, also known as pro forma, financial statements are especially useful for assessing the practicality of a strategy that includes several elements that must be coordinated. Launching a new product epitomizes a strategy of this kind. Expenses must be incurred to finalize development of the product, followed by manufacturing, advertising, and delivery of the product to customers. Financing through borrowing or sales of shares might be necessary. In general, projecting the financial statements is necessary to ascertain how much financing is needed and when it is needed.

A complete set of project financial statements includes three scenarios: pessimistic, optimistic, and likely. To proceed, begin with the likely scenario. Project first the items of the income statement, followed by those of the balance sheet.

On a spreadsheet, assign a column to each year, starting with the first year of the strategy and ending with the third year after the product reaches its market. Starting with revenue, enter on the spreadsheet the likely annual revenue of the strategy for each of the five years. Follow by projecting the cost of the goods or services over the same periods, and then the expenses from the most recent year to the last year projected. You can simplify your work on some items by entering formulas rather than numbers. For example, enter cost of goods or services as a ratio of revenue, gross margin as revenue minus cost of goods or services, and so forth.

Enter zeros for interest expenses beyond those of existing debt. You will return to interest expense later, if after completing the projections you find that borrowing is needed. When you reach net income after taxes, enter dividends or withdrawals, as the case may be, following existing policy on the payment. The item following dividends or withdrawals will be the contribution to retained earnings. Add this amount to the firm's retained earnings of the previous year to arrive at the retained earnings of the income-statement-ending year.

After projecting retained earnings over all the years of the projected income statement, project the remaining items of the balance sheet, excepting cash. Account receivables may be reasonably projected as a fraction of revenue. Likewise, inventory and accounts payable may be reasonably projected as fractions of cost of goods or services. Use a summative formula to compute Total Liabilities and Equity. Use a reference formula to assure that the figure for Total Assets is the same as the one for Total Liabilities and Equity. Use a subtractive formula to compute Cash. Thus, Cash is the plug account that assure that the balance sheet balances, so that Total Assets = Total Liabilities and Equity, as it must.

Examine the cash account. If it is low or negative, enter the combination of long-term debt and capital sufficient for positive cash, reasonable current and quick ratios, and acceptable long-term debt to equity ratios. A model for choosing between debt and equity financing is discussed in Part 5.2.5.



To finalize the projection, replace the zero-interest-expense items of the projected income statement with formulas that compute interest expense as a percentage of long-term and other debt that may be in the projected balance sheet. Tweak dividends or withdrawals, long-term debt, and capital until the liquidity ratios are about right for every year projected.

Having projected the likely scenario, proceed to projecting the pessimistic and optimistic scenarios, using the spreadsheet of the likely scenario as the template. For presentations, apply the graphic features of the spreadsheet to show charts of revenue, net income after taxes, long-term debt, and other items that might be of interest.

### 5.2.5: EPS-EBIT Analysis

The viability of a strategy must be assured before its financing is addressed, for a wager that is not a good bet is not a good bet irrespective of who fronts the money for the bet. Viability assured, the analysis of earnings per share (EPS) relative to earnings before interest and taxes (EBIT) addresses the question of whether the financing of a corporation's strategy should be by debt or equity. Two examples highlight the issue.

Bob has a safe investment that will surely earn more than the interest that Bob must pay to borrow the needed money from his bank. The investment might be to buy materials for renovating a house for which Bob has a signed contract from the homeowner. Should Bob ask his bank for a loan, or ask an investor he knows to invest in the project for a share of the outcome, a likely profit and an unlikely investment loss?

Sue has a risky investment that will lose money if she fails, but win her a lucrative prize if she succeeds. The investment might be to employ an assistant to help her develop artificial-intelligence software for a national competition. Should Sue ask her bank for a loan, or ask an investor she knows to invest in the competition for a share of the outcome, an unlikely profit and a likely investment loss?

The answer might seem obvious. Bob should ask his bank (debt financing), and Sue should ask her investor (equity financing). In principle, whereas debt financing is more practical when the risk is low, equity financing is more practical when the risk is high. Between the extremes, the answer will depend on the interest rate of the debt relative to the share of the project that must be given up for the equity, moderated by tax, legal, and personal concerns. These considerations can be clarified with algebra and a graph.

Consider an EPS-maximizing linear model (David & David, 2017) whereby debt to finance strategic investments incurs an interest payment ( $I$ ). Consider also that a constant corporate income tax rate ( $r$ ) applies to earnings net of all interest payments, so that the firm's projected income-tax payment is  $(EBIT - I)r$  and its projected after-tax earnings is therefore  $(EBIT - I) - (EBIT - I)r$ . EPS is the firm's after-tax earnings divided by its number of shares outstanding ( $n$ ). Accordingly, if the firm's strategy should be financed with debt only, then its projected EPS is derived by applying Equation 5.2.6.

$$EPS = \frac{(EBIT - I) - (EBIT - I)(1 - r)}{n} = \frac{(EBIT - I)(1 - r)}{n} \quad (5.2.6)$$

On the other hand, if the strategy is financed with equity only, a number of new shares ( $m$ ) will have to be issued in lieu of debt, but with no debt, no interest payment will have to be made, so  $I = 0$ . In this case, the firm's projected EPS is derived by applying Equation 5.2.7.

$$EPS = \frac{EBIT(1 - r)}{n + m} \quad (5.2.7)$$

Thus, for the general case of necessary payments of interest on debt ( $I > 0$ ) and of reasonable taxes on corporate income ( $1 > r > 0$ ), when  $EBIT = 0$ , EPS for debt-only financing (Equation 5.2.6) must be negative and EPS for equity-only financing must be zero (Equation 5.2.7). These two points are shown in Figure 5.2.3, a graph of EPS relative to EBIT.

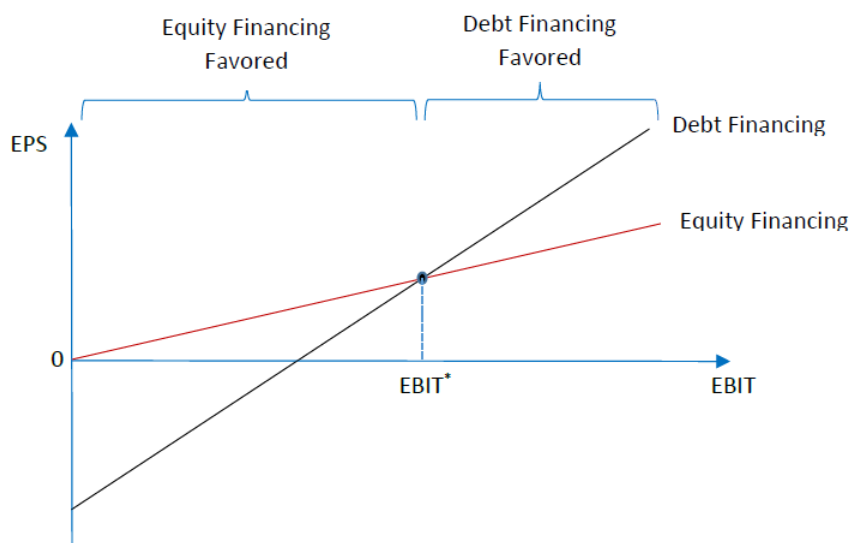


Figure 5.2.3: EPS-EBIT Chart.

For both debt-only and equity-only financing, EPS rises linearly with EBIT, but the slope of the curve (actually a straight line) is greater for debt-only financing. To see this, Equation 5.2.8 rearranges Equation 5.2.6 in slope-intercept form to show that the slope of the curve for debt-only financing,  $(1 - r) / n$ , differs only from the slope for equity-only financing (Equation 5.2.7),  $(1 - r) / (n + m)$ , in that the equity-only denominator is greater by  $m$ . Since equity financing implies that  $m > 0$ , the equity-only slope must be smaller.

$$\text{EPS} = \frac{\text{EBIT} (1 - r)}{n} - \frac{I (1 - r)}{n} \quad (5.2.8)$$

The critical point is at the intersection of the two curves. Debt-only financing is favored for EBIT above this point, whereas equity-only financing is favored below it.

Algebraically, the critical point (EBIT\*) is when the equity-only EPS (Equation 5.2.7) equals the debt-only EPS (Equation 5.2.8). At that point, Equation 5.2.9 holds. Isolating EBIT\* on the left gives rise to Equation 5.2.10

$$\text{EPS} = \frac{\text{EBIT}^* (1 - r)}{n + m} = \frac{\text{EBIT}^* (1 - r)}{n} - \frac{I (1 - r)}{n} \quad (5.2.9)$$

$$\text{EBIT}^* = I \left( \frac{n}{m} + 1 \right) \quad (5.2.10)$$

Confirming intuition, Equation 5.2.10 shows that debt financing is preferred over equity financing (EBIT\* is smaller) when the interest payment ( $I$ ) is lower and more shares must be issued relative to those outstanding ( $n/m$  is smaller). Math sharpens intuition.

## 5.2.6: Matrices

Matrices, useful for showing the practicality of a strategy along two or more dimensions, add precision to qualitative arguments. That the axes and associated numbers of a matrix are usually imprecise is limitation of data, rather than a fault in the technique itself.

### 5.2.6.1: Product positioning matrix

Matrices are especially useful in marketing, by breaking down the often-ambiguous idea of product desirability into more tangible attributes. A washing machine, for example, can have two attributes: capacity and energy efficiency. A matrix of available washing machines in a market can show the relative placement of a proposed new machine among those already available. A matrix of this kind is a product-positioning matrix, also known as a perceptual map, as illustrated in Figure 5.2.4. On the figure, each washing-machine model is represented by a circle whose size corresponds to its share of the market. The practicality of a new model is assessed by visually observing its place on the matrix. Generally, a new model should be positioned high on the attribute that customers uniformly desire (e.g., energy efficiency) and away from other models on the attribute that vary in desirability among customers (e.g., capacity).

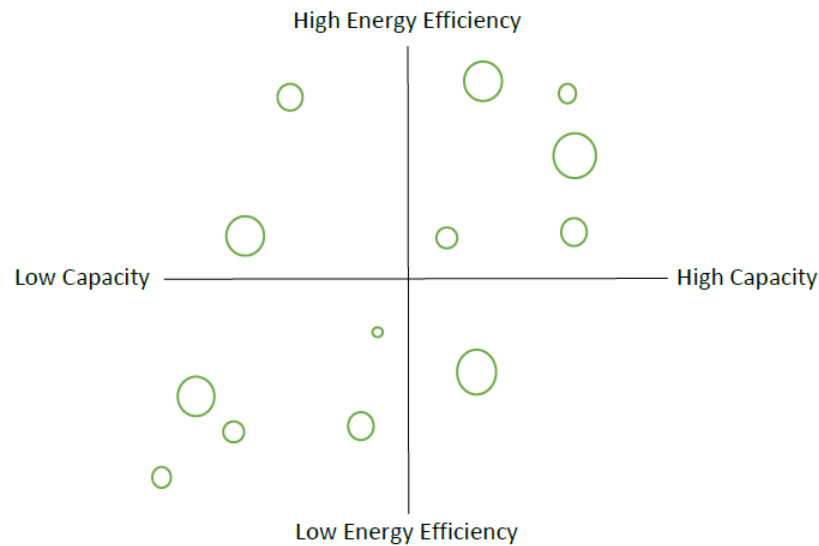


Figure 5.2.4: Product Positioning Matrix of Washing Machines.

To arrive at a single comprehensive score for products with several uniformly desirable attributes, assign each attribute a weight corresponding to its judged importance to the market (e.g., .40 for energy efficiency, .25 for water efficiency, and .35. for noise). Then ask a panel representative of the customers to score the attributes of each model on a fixed rating scale, say from 1 to 5. For each model, multiply the panel's average scores across the attributes (e.g., 4 for energy efficiency, 5 for water efficiency, and 2 for noise) by their weights and sum the weighted scores across all attributes to arrive at a single comprehensive score of the product's rated desirability for that market (e.g.,  $4 \times .4 + 5 \times .25 + 2 \times .35 = 3.55$ ). If the weights are set such that they sum to one ( $.40 + .25 + .35 = 1.0$ ), then the comprehensive score will fall conveniently within the range of the rating scale (e.g., 1 to 5).

#### 5.2.6.2: Product portfolio matrix

A conglomerate doing business in several markets may have market shares and market growth that differ by market. In this case, a market-share, market-growth matrix can highlight the practicality of a strategy that is more or less aggressive, a point made by Henderson (1970) of the Boston Consulting Group (BCG), whose product portfolio matrix is well known. Unlike the product-positioning matrix, which shows competing models of a single market, the product portfolio matrix shows non-competing businesses in different markets.

The BCG product portfolio matrix is unusual in two respects. First, instead of absolute market shares, the matrix uses relative market share, computed by dividing the absolute market share of the business by the market share of the competitor with the highest market share. Thus, if the absolute market shares of the three competitors are 30%, 25%, and 15%, then the relative market shares of those competitors are  $30\% / 25\% = 1.2$ ,  $25\% / 30\% = 0.83$ , and  $15\% / 30\% = 0.50$ , respectively. Second, the matrix shows relative market share as falling, rather than rising, with distance from the origin. An example of a product portfolio matrix is shown in Figure 5.2.5.

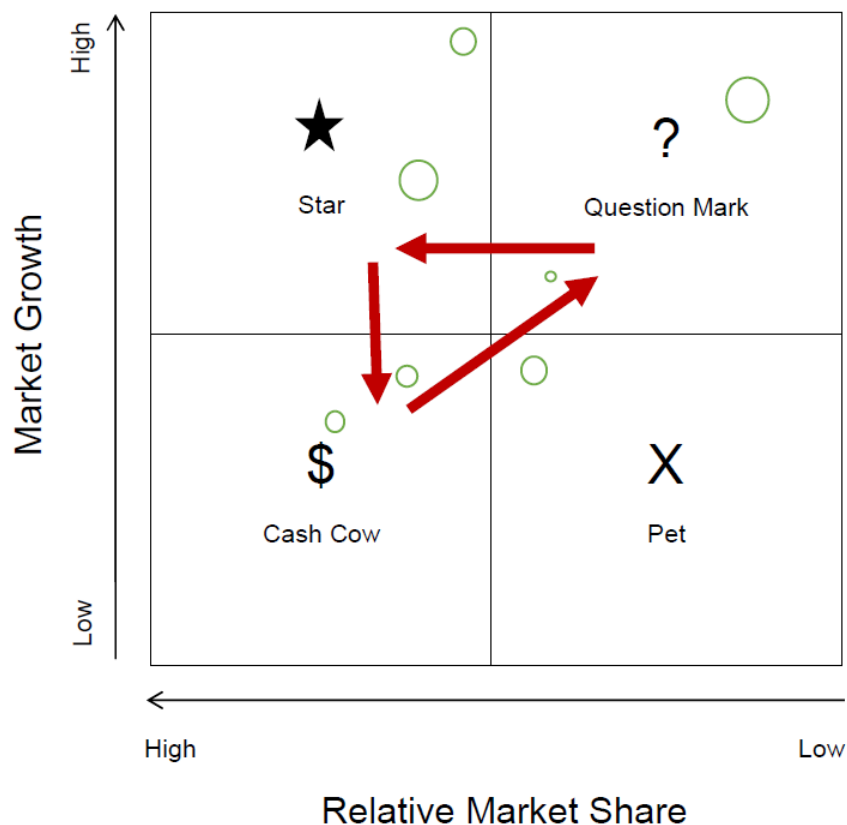


Figure 5.2.5: Product Portfolio Matrix.

In Figure 5.2.5, businesses appear as circles, the size of which corresponds to each business’s percentage of the firm’s total revenue. Henderson suggests that a strategy of investment is practical for question marks, businesses with low relative market share in an industry with high market growth. The investment objective is to turn question marks to stars, businesses with high relative market share in an industry with high market growth. To keep up with market growth, stars require continued investment, so they generally generate little cash. Eventually, however, market growth must diminish, in which case the stars become cash cows, businesses with high relative market share in a market with low growth. A strategy of maintenance is appropriate for cash cows, for their profitability would not rise with further investments. The cash they generate should be reinvested in question marks, completing the cycle of cash cows → question marks → stars → cash cows.

A disinvestment strategy is practical for pets, originally called dogs. These are businesses with low relative market share in a market with little to no market growth. Relative to the other businesses of the firm, they are failures.

The line dividing high and low relative market shares depends on how the markets of the various businesses are defined. The narrower the definition, the fewer the number of competing firms and therefore the higher the market share of each firm. The ambiguity makes the product portfolio matrix more of an illustrative technique than a theory of investment. One could start with 1.0 as the dividing line. If none of the firm’s businesses appears to the left of the line, which occurs when none has the highest absolute share of its market, then set the line to 0.5 or lower.

The line dividing high and low market growth depends on how the economy is defined. The definition of the economy should include all the areas in which the firm does business. The line of division could be set at 0% or at the long-term growth rate of the defined economy, which is about 5% a year globally, about 2% a year for the United States, and more or less elsewhere.

### 5.2.6.3: Porter’s generic strategies

Porter’s (1980) argument for the practicality of three so-called generic strategies and the impracticality of one is based on a matrix of strategic target vs. strategic advantage, as illustrated in Figure 5.2.6. Strategic target refers to the population that the firm’s product is intended to serve, and strategic advantage refers to the extent to which the product is, in the customer’s perception, either

superior (uniqueness) or inexpensive (low cost), the presumption being that firms maximize profit, so a firm with a superior product would not sell the product for a low price.

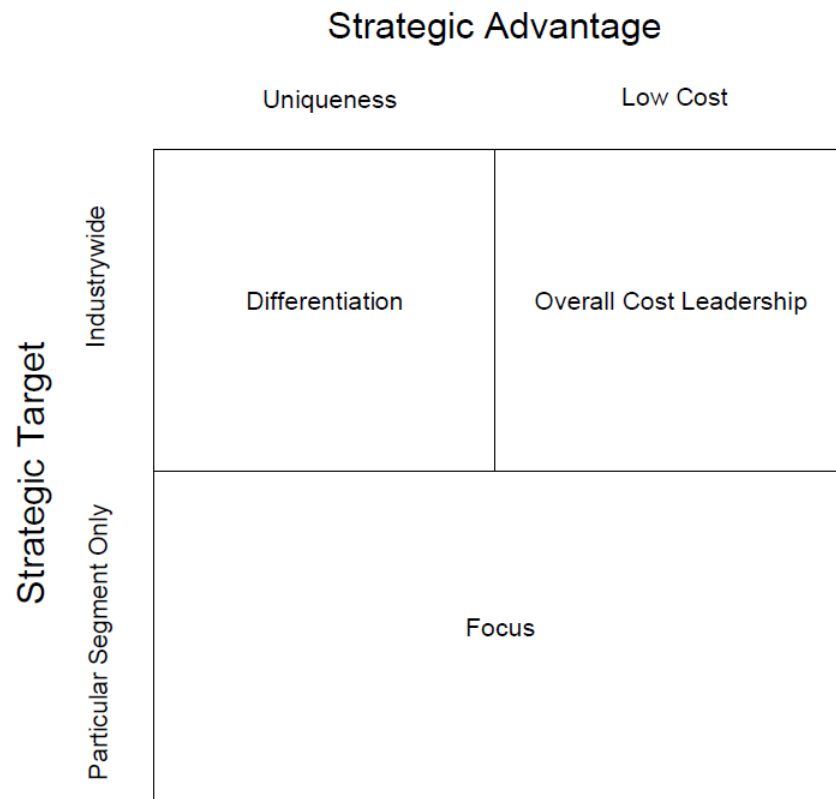


Figure 5.2.6: Porter's Generic Strategies.

Porter argues that if a firm can keep cost below that of its competitors, an *overall cost leadership* strategy of pricing the product low to attract an industrywide market is practical. Also practical is a *differentiation* strategy of making the product appear superior in the eyes of the customer, either because of branding or desirable features or both, so that the product remains attractive industrywide even when priced higher than the prices of its competitors. Also practical is a *focus* strategy of reaching just a segment of the industry with an inexpensive product, cost focus; or a higher-priced unique product, differentiation focus. Porter disparages any strategy that is not among the three as stuck in the middle.

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## 5.3: Mission

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### 5.3.1: Mission/Vision

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A firm is an institution commanded by people with a common purpose. To the extent that the purpose is being met (Question: What business are we in?), that purpose is its mission. To the extent that the purpose is aspirational (Question: What business do we want to be in?), that purpose is its vision. From another perspective, the firm has a mission; its leaders have a vision.

The mission/vision statement may be narrow, specifying the product (e.g., electric car), or broad, specifying the function (e.g., mobility device). Some argue that the functional statement is best, because the functional statement specifies how the product satisfies the primary need of its primary customers, which is to say, is customer oriented. Who the primary customers are or should be, and what primary need is or should be satisfied by the firm's product are often uncertain, which is why coming up with a statement that fits can be challenging.

A statement that does not differentiate the firm from all other firms (e.g., maximize profit), however, should be avoided. At best, it would be unnoticed; at worst, it would suggest ineptitude.

The well-written mission/vision statement is short, truthful, and clear. It is a statement with which dedicated employees agree even when they disagree on many other issues. It inspires, and is itself the product of a certain inspiration.

A firm may have a formal statement that appears in its annual report to shareholders. The formal statement may be true or not. If true, the statement should show in what its executives do. If not true, the statement may have been written for appearance's sake, perhaps to satisfy some requirement, or may have lost its meaning as leaders and circumstances change over time.

Thus, a strategy aligned with the formally stated mission/vision of the firm may still be unacceptable to the firm's current executives, because their true love is not what is formally stated. Still, the formal statement is a guide. It meant something to those who wrote it. Some element of what they wrote might still be in play.

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## 6: Common Types of Strategies

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Many strategies fall readily into one of a small number of common types. A type is not a strategy, because a type is not a workable plan. For a plan to be workable, the plan must specify who is to act and when the action is to occur. When a strategy fits into a type, however, the strategy may be immediately assessed as better or worse because of its type.

### 6.1: Liquidation

A liquidation strategy, whereby the entire firm is offered for sale, is a case of strategic failure. Liquidation is an admission of defeat rather than a practical strategy. Firms do not need strategic managers to liquidate themselves. They need lawyers.

### 6.2: Continuous Improvement

Continuous improvement is philosophy, not strategy. It implies continuing to do what has been done, with efforts made towards small improvements in process and product from time to time. The philosophy can suffice for successful firms in stable environments. That is, in the absence of a decision to change directions, employees of well-managed firms look for ways to improve the work they do. They are usually aware of ways to improve the work by spending more money. The challenge of strategic management is to find ways to improve the work while spending less money, or spending the least amount of money. Meeting that challenge, however, requires a strategy.

### 6.3: Divestiture

Divestiture, when a firm sells part of itself but remains viable, is practical only when facts show that a buyer will pay an attractive price for the part of the firm that is divested. Absent a buyer, divestiture is hope, not strategy.

### 6.4: Partnership

Partnership, where a firm joint ventures or contracts with another, is similar to divestiture in that it requires the cooperation of another firm. If the facts do not show that another firm is a willing, able, and ready partner, partnering also is hope, not strategy.

### 6.5: Acquisition and Integration

Acquiring a supplier (backward integration), a customer (forward integration), a competitor (horizontal integration), or an unrelated business (conglomeration) requires a target firm and the ability to pay a premium price, usually 15% or more, for the acquisition. Unlike products, which may be more useful to the buyer than to the seller, firms are moneymaking entities for which the value of the monetary stream they deliver is generally the same for both parties. The seller bought into the firm because the seller viewed the firm positively, as the interested buyer does. The seller will only sell when the seller is offered payment distinctly more than the monetary stream that the seller expects with continued ownership. This is why the thought that a firm can be acquired without paying a substantial premium is fantasy, and why a strategy of acquisition is usually not practical.

### 6.6: Research

Research is a gamble. Unless the facts show that the gamble is likely to pay off, gambling with the firm's resources is not what top managers are paid to do.

### 6.7: Retrenchment

Retrenchment is cutting expenditures. The strategy is practical if the facts show that the savings would exceed the possible loss of revenue.

### 6.8: Organic Growth

Organic growth refers to growth in revenue attributable to regular business operations, which does not include acquisitions and mergers. This kind of growth can arise from four types of strategies, as illustrated by the Ansoff (1957) matrix of Figure 6.1.



|                 |                    |                     |
|-----------------|--------------------|---------------------|
| New Market      | Market Development | Diversification     |
|                 | Market Penetration | Product Development |
| Existing Market | Existing Product   | New Product         |

Figure 6.1: Ansoff Matrix of Organic Growth

#### 6.8.1: Market Penetration

Market penetration is lowering prices or raising promotional expenditures or both, with the objective of increasing sales volume. The strategy raises the firm's breakeven point, undermining the firm's financial position. The strategy must be justified by its coherence with the mission of the firm and vision of its leaders.

#### 6.8.2: Market Development

Market development is introducing an existing product to a new market. The method by which the product will be made available must be clear, together with the costs of building and maintaining the supply chain of product to market.

#### 6.8.3: Product Development

Product development is either modifying a product to make it more appealing to customers, or developing a new product. The strategy can result in expanding customer choice. If so, the cost of managing stock to assure availability whenever a customer places an order increases. The increased cost is difficult to estimate, so it tends to be overlooked. The compelling justification for the strategy is that the strategy identifies, using a method such as a product-position matrix, the key attributes of the product that is to be developed, together with price, cost, and profit estimates based on reasoning that is sound.

#### 6.8.4: Diversification

Diversification is introducing a modified or new product to a new market. The strategy involves both market development and product development, which makes it especially difficult to execute successfully.

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## 7: Conclusion

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Good ideas are not good because they are the same ideas that have been successful elsewhere. Good ideas are good because they are based on facts of the problem situation. Inasmuch as the task of strategic management is to formulate and implement good ideas, the search for good ideas should always start by studying the facts that are known. Theory can be helpful in organizing and clarifying the facts.

Sometimes, however, theory misleads either because the theory is either wrong or incorrectly applied. When the theory is incompatible with the facts, the facts must prevail. The strategy based on theory must give way to the strategy based on facts.

Thus, the first consideration in evaluating a strategy is the extent to which the strategy is based on facts of the problem situation. The final consideration is the extent to which the strategy is acceptable to those who must execute it. The former is a quality consideration; the latter is an acceptance consideration. The effective strategy satisfies both considerations: Effectiveness = Quality × Acceptance.

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