# CHAPTER 1: COST MANAGEMENT AND STRATEGY

# QUESTIONS

**1-1** Firms Using Cost Management. Here are some examples; there are many possible answers.

1. Wal-Mart: to keep costs low by streamlining restocking and sales

2. Dell: to keep costs low by improving manufacturing performance and by using target costing and other management techniques

3. Citicorp: to keep costs low by using activity analysis (see exercise1-31) to identify key operations and to find those that add little or no value

4. A local school district or public agency: to keep costs low in order to provide the best possible service given available funds

5. Procter & Gamble: to assess the profitability of its different products

6. Any other large, diversified manufacturer, like Procter & Gamble: which needs to be able to analyze the relative profitability of its different products, using cost management

7. A small machine shop: which needs cost management to determine whether it should repair or replace a machine

8. A dance studio: to analyze and choose between different compensation plans for its teachers; and to determine whether it should open a new studio

**1-2** Firms not expected to be significant users of cost management information:

1. Microsoft: here the focus is on forming strategic alliances, innovation and competition; cost management is more important for other firms in the information technology business, such as Hewlett-Packard, and IBM that compete in part on innovation but also on price

2. Versace: a high fashion firm competes on innovation and product leadership; the development and communication of attractive new ideas is the key to competitive success rather than cost management

3. Other firms in the fashion industry, such as Chanel, Coach, Gucci, and Armani: for reasons similar to Versace

4. Major league sports: dependent primarily on the development of fan support, good coaching and player acquisition

**1-3** Cost management information is a broad concept. It is the information the manager needs to effectively manage the firm or not-for-profit organization -- both financial information about costs and revenues and relevant non-financial information about productivity, quality, and other key success factors for the firm. Typically, cost management is the responsibility of the Chief Financial Officer (CFO) who often delegates much of this responsibility to the Controller.

**1-4** In the private sector, the Financial Accounting Standards Board, an independent organization, and the American Institute of Certified Public Accountants (AICPA) supply guidance regarding financial reporting practices. The Sarbanes-Oxley Act of 2002 also created the Public Company Accounting Oversight Board which reports to the SEC to oversee auditing standards and practices. The AICPA also provides educational opportunities. In the public sector, The Cost Accounting Standards Board (CASB) sets cost accounting standards for those doing business with the federal government, especially defense contractors. The Institute of Management Accountants (IMA) is the principal organization devoted primarily to management accountants in the United States. The IMA has magazines, newsletters, research reports, management accounting practice reports, professional development seminars, and monthly technical meetings that serve the broad purpose of providing continuing educational opportunities for management accountants. In Canada, the Society of Management Accountants provides a similar role. Similar organizations are present in most other countries around the world. The Financial Executives International (FEI) organization provides services much like the IMA for financial managers, including controllers and treasurers. Because of the nature of its membership, the FEI tends to focus on management and operational control issues, and less on the product costing, planning, and decision-making functions.

**1-5** The Certificate in Management Accounting (CMA) is the most relevant certification program for management accountants since it focuses on the types of skills that are most in demand for management accountants: economics, finance, and management, financial accounting and reporting, management analysis and reporting, and decision analysis and information systems. Another relevant certification is the Certified Public Accountant (CPA).

**1-6** The four functions of management are:

1. Strategic Management -- information is needed by management to make sound strategic decisions regarding choice of products, manufacturing methods, marketing techniques and channels, and other long term issues.

2. Planning and Decision Making -- information is needed to support recurring decisions regarding replacement of equipment, managing cash flow, budgeting raw materials purchases, scheduling production, and pricing.

3. Management and Operational Control -- information is needed to provide a fair and effective basis for identifying inefficient operations, and to reward and support the most effective managers.

4. Preparation of Financial Statements -- information is needed to provide accurate accounting for inventory and other assets, in compliance with reporting requirements, for the preparation of financial reports and for use in the three other management functions.

**1-7** Strategic management is the most important management function since it most directly relates to the overall success of the firm. In strategic management, top managers determine how the firm is to compete and what specific goals it must set and achieve to be successful. The determination of these strategies and goals drives all other activities in the firm.

**1-8** Merchandising firms purchase goods for resale. Merchandisers that sell to other merchandisers are called wholesalers, while those selling directly to consumers are called retailers. Examples of merchandising firms include the large retailers, such as Sears, Wal-Mart, and Radio Shack. Merchandisers use cost management information to control stocking, distribution, and customer service.

Manufacturing firms use raw materials, labor, and manufacturing facilities and equipment to produce products. These products are sold to merchandising firms or to other manufacturers as raw materials for additional products. Examples of manufacturers include General Motors, IBM, and Sony. These firms use cost management information to control production costs.

Service firms provide a service to customers that offers convenience, freedom, safety, or comfort. Common services include transportation, financial services (banking, insurance, accounting), personal services (physical training, hair styling), medical services, and legal services. These firms use cost management information to identify profitable services and to control costs incurred in providing services.

Governmental and not-for-profit organizations provide services, much like the firms in service industries. However, the service provided by these organizations is such that there is often no direct relationship between the amount paid and the services provided. Instead, both the nature of the services to be provided and the customers who receive the service are determined by government or philanthropic organizations. These organizations use cost management information to determine and control the costs of the services they provide.

**1-9** The answers here can vary from large manufacturers such as Hewlett-Packard (HP) to small retail stores. If the class has trouble getting started, the instructor might use some of the firms mentioned in question 1-1, or from the instructor’s own experience and understanding. Again, if the students have a hard time, the instructor might ask them to think of firms close to their homes, or to think of firms in a given industry, etc.

**1-10** As firms move to the Internet for sales and customer service it is likely that strategies will change. For some firms, a popular web site can be an important differentiating factor. Firms such as Amazon.com, Etrade and eBay have achieved powerful competitive advantage through the strength of their web sites. Other firms might use the Internet to achieve cost advantage, by using Internet based systems for transactions processing, production scheduling, purchasing, employee recruiting, etc. It seems that the Internet could be effectively used to enhance either a cost leadership or product leadership strategy.

**1-11** As firms move to the Internet for sales and customer service it is likely that their demand for cost management information will change. For example, order processing costs are likely to change dramatically. In the web-based environment, costs are likely to increase rapidly at first as new investments are made, but unit (per transaction) costs are likely to rise until the technology is in place and functioning, and then unit costs will come down as volume builds. From a strategic standpoint, the key issues may be customer service, speed of response and reliability which can be achieved through the web-site. Whether and how soon the firm can achieve these benefits is a critical question.

**1-12** The factors in the contemporary business environment that affect business firms and cost management are:

1. Increased global competition, which means an increasingly competitive environment for all firms and thus the need for cost management information to become more competitive; the need for competitive non-financial information in addition to financial information in cost management reports;
2. Lean manufacturing, in which companies reduce costs by using flexible manufacturing methods, statistical quality control, and many of the techniques developed by Japanese manufacturers; lean manufacturers adopt lean accounting to measure and sustain the improvements made from lean manufacturing.
3. Use of information technology, the Internet, and enterprise resource management; cost management information is used to facilitate the introduction of new manufacturing and product technologies (e.g., determining which technologies will most contribute to profitability), to develop new ways to manage customer and supplier relationships using the Internet; and to use enterprise resource management to develop an report cost management information in a lower cost, more comprehensive, and timely way;
4. A focus on the customer, which requires cost management reports to include critical information about customer satisfaction, changing customer preferences, etc.;
5. Changes in management organizations, new reporting practices to recognize the new focus on cross-functional teams in which employees from all areas of the firm work together to make the firm successful;
6. Changes in the social, political, and cultural environment of business, which requires an expansion of cost management reporting to include critical success factors related to the expectations of those beyond the ownership of the firm including employees, local government officials, and community leaders.

**1-13** Refer to Exhibit 1-3 in the text, reproduced here.

Comparison of Prior and Contemporary Business Environments

|  |  |  |
| --- | --- | --- |
|  | **The Prior Business Environment** | **The Contemporary Business Environment** |
| **MANUFACTURING** |  |  |
| Basis of Competition | economies of scale, standardization | quality, functionality, customer satisfaction |
| Manufacturing Process | high volume, long production runs, significant levels of in-process and finished inventory | low volume, short production run, focus on reducing inventory levels and other non-value-added activities and costs |
| Manufacturing Technology | assembly line automation, isolated technology applications | robotics, flexible manufacturing systems, integrated technology applications connected by network |
| Required Labor Skills | machine paced, low-level skills | individual and team paced, high-level skills |
| Emphasis on Quality | acceptance of a normal or usual amount of waste | strive for zero defects |

**Question 1-13 (continued)**

|  |  |  |
| --- | --- | --- |
| **MARKETING** |  |  |
| Products | relatively few variations, long product life cycles | large number of variations, short product life cycles |
| Markets | largely domestic | global |
| **MANAGEMENT ORGANIZATION** |  |  |
| Types of Cost Management Information Needed | almost exclusively financial data | financial and operating data, the firm's strategic success factors |
| Management Organizational Structure | hierarchical; command and control | network-based organization forms; teamwork focus -- employee has more responsibility and control; coaching rather than command and control |
| Management Focus | short term: short term performance measures and compensation; concern for sustaining stock price; short tenure and high mobility of top managers | long term; focus on critical success factors, commitment to the long term success of the firm, including adding shareholder value |

**1-14** The thirteen contemporary management techniques are:

1. The Balanced Scorecard (BSC) and the Strategy Map. The BSC is an accounting report that includes the firm’s critical success factors in four areas: financial performance, customer satisfaction, internal processes, and learning and growth (human resources). The Strategy Map is a method, based on the balanced scorecard, which links the four perspectives in a cause-and-effect diagram.

2. Value-Chain Analysis is a tool that helps the firm identify the specific steps required to provide a product or service.

3. Activity-based Costing and Management: Activity-based costing is used to improve the tracing of manufacturing costs to products and therefore the accuracy of product costs. Activity-based management (ABM) uses activity analysis to help managers improve the value of products and services and to increase the firm’s competitiveness.

4. Business Intelligence is an approach to strategy implementation in which the management accountant uses data to understand and analyze business performance.

5. Target Costing is a management method that determines the desired cost for a product upon the basis of a given competitive price, such that the product will earn a desired profit.

6. Life-Cycle Costing is a management method used to monitor the costs of a product throughout its life cycle.

7. Benchmarking is a process by which a firm identifies its critical success factors, studies the best practices of other firms (or other units within a firm) for these critical success factors, and then implements improvements in the firm's processes to match or beat the performance of its competitors.

8. Business Process Improvement is a management technique in which managers and workers commit to a program of continuous improvement in quality and other critical success factors.

9. Total Quality Management is a technique in which management develops policies and practices to ensure that the firm's products and services exceed the customer's expectations.

10. Lean Accounting uses value streams to measure the financial benefits of a firm’s progress in implementing lean manufacturing.

11. The Theory of Constraints is a strategic technique to help firms effectively improve the rate at which raw materials are converted to finished product.

**1-14 (continued)**

12. Enterprise Sustainability means the balancing of the company’s short- and long-term goals in all three dimensions of performance – social, environmental, and financial.

13. Enterprise Risk Management is a framework and process that firms use to manage the risks that could negatively or positively affect the company’s competitiveness and success.

**BRIEF EXERCISES**

**1-15** Many students will answer Wal-Mart or Target since these are mentioned in the text. A variety of answers are possible and sometimes students will disagree , as for example, in discussing a fast food restaurant such as McDonald’s. Some will argue that it is a cost-leader because the prices in fast food restaurants are typically low. But other students will argue that McDonald’s is different than other fast food restaurants, and thus, differentiation. I ask them to focus on what brings in the customer: Is it price or some quality of feature? Then many of the students will say that for the most part fast food restaurants are differentiators. I’ll ask if any one could name a fast food restaurant they would go to just for price and price only, and I will get a few examples there, but not many.

**1-16 (a)** This question is set to get a positive response and that is usually what I get. Then I try to spend some time getting some examples of why a strong ethical climate would be beneficial, and note the increasing importance of an ethical climate since the Sarbanes-Oxley Act. Also, a helpful resource is the article in the July 2005 Strategic Finance, “Is There Value in Corporate Values?” Reporting on a survey done by the Aspen Institute and the consulting firm Booz Allen Hamilton, the article notes that most respondents believe that strong corporate values build strong relationships and reputations. The study also reported that nearly half of financial leaders surveyed said that strong corporate social and environmental values affect financial performance in the short run. The article notes, as do many other surveys, that the firm Johnson& Johnson is perhaps the best known example of a company that has high corporate values.

**1-17** Again this question is posed for a positive response, and the main goal I have for the question is to have the class think through the decision as both a business and an ethical issue. According to a Wall Street Journal article at the time of this VIOXX issue (October 1, 2004, pB1), “Experts Praise How Merck Broke the News,” the announcement brought in positive publicity for the company. Interestingly, some of the firms hurt the most by the announcement were the media companies that were counting on Merck’s spending for VIOXX advertising.

**1-18** Like most beverage companies, there is a strong differentiation. Refer the students to the information in Problem 1-41 which shows Coke as having the highest brand value of any company. There is at least a perceived difference between a Coke and Sam’s Club Cola, for example. Ask the class if they can come up with an example of a cost leader beverage, and some will mention low priced brands of cola or beer.

**1-19** A commodity is a product or service that is difficult to differentiate from competitors: gasoline and paper products are some examples. You can ask the class to provide additional examples. The crucial point for a commodity: is there any reason you would pay more for this item? As such, commodities are natural cost leadership products or services.

**1-20** Most students will argue that they chose their bank because of service and location, thus differentiation. Others will say the rates are better, and then perhaps cost leadership. It is useful to distinguish the banking needs of say, a student, versus a small business like a car dealership which will rely more heavily on a variety of customer services and will likely see banks as more differentiated entities. In a July 4, 2007 article in the Raleigh News & Observer, David Ranii reports that most banks view customer relationships as the differentiator that helps them to succeed. One regional bank did a study and found that approximately ½ of its customers were “rate shoppers” while the other half were “relationship-oriented.” The bank had adopted customer-focused strategies to grow the customer-relationship side of its business. Smaller banks, in particular, focus on customer service to attract and retain customers. As Ranii notes, “Community banks routinely tout their (small) size as an advantage. They boast that they can afford to offer more personal service than the industry behemoths.” The large banks are not ignoring customer service, however; at that time, Wachovia was the fourth largest bank in the U.S. (acquired by Wells Fargo in 2008) and number one in customer service (for larger banks).

**1-21** There are a number of possible answers here. The main point of the question is that the cost leadership or differentiation classification applies across different types of firms in different industries. There are some industries (particularly those with commodities) which tend to be characterized by cost leaders and others (e.g. biotech) that tend to be characterized by differentiators. Other industries may have a mix of different types of competitors. I ask them to consider the automobile industry and to identify cost leaders and differentiators.

**1-22** It is certainly likely that a new product, with technologically advanced features, may begin as a differentiator and then as the market for the product matures and competitors enter the market for the product, the industry as a whole moves to more of a cost leadership type of competition. Consider cell phones as an example.

**1-23** Often people think of strategy as simply planning, or “long term” planning. In the broadest sense, this is correct, though the planning in strategy formulation and execution is somewhat more complex, including developing an understanding of the business environment in which the firm operates and of the resources available within and outside the firm to help it compete effectively. The steps in executing a strategic plan are considered in chapter 2.

**EXERCISES**

**1-24 Strategy; Real Estate Services (15 min)**

This exercise can be used to provide a good perspective for the students to see the role of cost management in solving business issues, and in placing the management accountant in more of a leadership role in the firm. It also provides an early motivation for the cost behavior issues to be discussed later in chapter 3 and chapter 8.

The management accountant has a hunch that the company is about to take on a potentially damaging strategic initiative. This is a great opportunity to begin to play more of a strategic role in the company. The first step should be to obtain the relevant information about projected revenues and costs and do a careful analysis of the likely profitability of developing the new, smaller customers.

Here’s how the case might be used in a class discussion. First, ask the class to identify the types of costs likely to be incurred by this company in providing its service. The answers are likely to include labor costs and materials for cleaning and maintenance, in addition to costs for maintaining the firm’s office. As these examples are given, put them on the chalkboard and collect 6 or 8 of them. Then, ask how each of these costs might differ between large and small customers. For example, the cost of cleaning labor and materials will likely be somewhat proportional to the square feet of space each customer occupies, so that cost projections based on current customer experience is likely to be useful in estimating the costs/profits of the smaller customers. However, security costs are likely to not vary greatly based on the size of the customer. How does this affect the pricing and the potential profitability of the smaller customers? Similarly, how will the office-related costs of managing the customer account differ between large and small customers – probably not much at all. Overall, the fact that some costs will not be proportional to customer size (as measured by square feet of office space) means the smaller customers will be more costly, per unit of floor space, than the larger customers. This should be taken into account in pricing the smaller jobs and in projecting profits from the smaller customers.

**1-24 (continued-1)**

An important issue this case brings out is the need for the management accountant to take a proactive role in business decision making. The discussion here should focus on what steps the accountant should take to become a more integral part of business decision making. A number of possible answers are likely to be proposed.

**1-25 Impact of the Recession on the Role of Cost Management (15 min)**

This question is intended for a brief class discussion, with a number of possible answers. Some students will note that the financial crisis has increased the importance of finance generally, as companies (especially smaller ones) work hard to manage cash flow and to reduce costs in the face of declining revenues. Others will argue that the financial crisis has turned management’s focus to operational efficiency, or to renewed efforts at retaining customers, etc. All of these responses are part of a good overall solution.

Two important points can be made in the discussion. One is the effect of the financial crisis on the continuing change of the types of skills required of management accountants, and the second is the increased importance of the management accountant’s role in strategy.

The impact of the recession on finance and cost management, as for other areas of business, is to motivate a drive for efficiency. Many finance staffs have reduced their numbers significantly. On the other hand, the important development is that the demand for finance skills has shifted. Automation of the finance function and some outsourcing has reduced the number of finance-related tasks that are easy to automate. However, demand has increased for financial planning and analysis skills; the analytical and strategic aspects of cost management have become more important to companies as they look for new ways to compete in the difficult economic times.

For example, cost management can also be used in target costing and strategic planning to identify opportunities for success in the currently weak economic conditions in the U.S. and Europe. To illustrate, some manufacturers of parts for construction equipment have targeted high-end products that are in demand in the emerging markets such as China and India. Timken and Parker Hamilton, for example, have targeted specific high-end, high-demand niche products which are difficult for competitors to produce at a competitive price.

**1-25 (continued -1)**

Another important finding, based on a survey of CFOs, shows:

* + 46% of the CFOs surveyed report that the crisis has enhanced the demand for their skills
  + 57% report that their role “has become more important and respectful”
  + 87 % report that they feel they “havea voice in business issues beyond finance, including corporate strategy.”

A broad take-away of the discussion should be the enhanced role of the finance function, the management accountant, and particularly the role of the management accountant in the organization’s strategy development and implementation.

Source: Alix Stuart, “The Incredible Shrinking Finance Department,” CFO, November 2010, pp 46-52; “Recession Impressions,” CFO, November 2009, pp 42-43; John Helyar and Phil Kuntz, “A Mini-Revival for the Rust Belt,” *Bloomberg Businessweek*, August 29, 2011, pp 20-21.

**1-26 Risk Management, Enterprise Sustainability, and Lean Accounting (40 min)**

1. There are two IMA Statements on Management Accounting (SMA) on Enterprise Risk Management. “Enterprise Risk Management: Frameworks, Elements and Integration” (2006), and “Enterprise Risk Management: Tools and Techniques for Effective Implementation” (2007).

The definition in the text notes that enterprise risk management is a framework and process that firms use to managing the risks that could negatively or positively affect the company’s competitiveness and success. Risk is considered broadly, to include (1) hazards such as fire or flood, (2) financial risks due to foreign currency fluctuations, commodity price fluctuations, and changes in interest rates, (3) operating risk related to customers, products, or employees, and (4) strategic risk related to top management decisions about the firm’s strategy and implementation thereof.

1. There are three SMAs on enterprise sustainability. “Implementing Corporate Environmental Strategies” (1995), “Tools and Techniques of Environmental Accounting for Business Decisions” (1996), and “The Evolution of Accountability – Sustainability Reporting for Accountants” (2008). The definition in the text notes that enterprise sustainability means the balancing of the company’s short and long term goals in all three dimensions of performance – social, environmental, and financial.
2. There are two SMAs on lean accounting. “Lean Enterprise Fundamentals” (2006), and “Accounting for the Lean Enterprise: Major Changes in the Accounting Paradigm” (2006). The definition in the text notes that lean accounting uses value streams to measure the financial benefits of a firm’s progress in implementing lean manufacturing.

**1-27 Contemporary Management Techniques (30 min)**

1. For an article on target costing, Tim should consider the types of firms which would demand this type of strategic costing. These would be firms that are in very competitive industries, where cost/price competition is critical, such as consumer products. Examples of firms that might use target costing also include those that have short product life cycles (the time from introduction of the product into the market until its withdrawal from the market). Many consumer products firms are in this category: cameras, TVs, and many entertainment products. The firm must be very deliberate in planning about costs when there are short life cycles, since there is a short time to recover the development costs -- the product must be careful designed, using target costing, so that it is profitable in its short life cycle.

2. For an article on life-cycle costing, Tim’s search for appropriate firms would lead him to many of the same types of firms as for target costing in (1) above. Intense competition on price/cost and short product life cycles are indicators of firms that are likely to use life-cycle costing. The reason is that in both cases, the focus is on the management of design and therefore the management of downstream costs, so as to achieve profitability for the product over its life cycle. Some Japanese firms, for example, will introduce a product that is not profitable at the first phase of its life cycle, but as costs are expected to come down in the manufacturing process through continuous improvement efforts, the product will become profitable later in its life cycle.

3. For an article on the theory of constraints, a wide variety of firms, including both manufacturing firms and service firms, would be appropriate. Manufacturing firms would be good examples to use for the article since the manufacturing process is intuitive -- the reader can easily see how the different operations in the manufacturing process must be managed to speed up the flow of product through the plant. In addition, it is easy to visualize the flow of product and the build-up of inventory which is an indication of bottlenecks in the production process.

**1-27 (continued -1)**

4. Business intelligence (BI) is becoming a critical management tool for many companies, so a variety of industries and companies could be chosen. Some examples provided in Chapter 8 include EHarmony and Gallo. BI allows these companies to become more competitive by better understanding their customers. An additional example is the use of BI in universities. A recent Wall Street Journal article explains how more than 200 universities, including the University of Indiana and the University of Virginia, use BI to find qualified candidates and to better prepare their students for work after graduation.

Source: Melissa Korn and Shana Tibken, “Schools Plan Leap Into Data,” *The Wall Street Journal*, August 4, 2011 p B12.

**1-28 Balanced Scorecard (15 min)**

1. The balanced scorecard can help a firm by explicitly drawing managers’ attention to critical success factors in four key areas: customer satisfaction, financial performance, internal business processes, and innovation and learning (human resources). The balanced scorecard helps managers to focus on the strategically important, critical success factors, and to take a long-term perspective to the firm’s performance. In effect, it helps managers to focus on the broad set of critical factors that the firm must attend to in order to compete successfully.

2. The Balanced Scorecard: Some example factors that might be included in JIC’s Balanced Scorecard are as follows:

a. customer satisfaction

quality

on-time delivery

features and functionality, relative to competition

responsiveness of sales and service staff

perceived innovativeness

sales growth

number of new customers

number of lost customers and why

b. financial performance

earnings

earnings per share

liquidity measures: current ratio, quick ratio

return on equity

return on assets

cash flow

unit cost, trend in costs

c. internal processes

cycle time

inventory levels: finished goods, work in process, and

raw materials

product quality

waste, scrap, and re-work

materials and labor usage relative to standard

**1-28 (continued -1)**

number of engineering improvements

productivity

warranty returns

vendor quality

scheduling errors and adjustments

d. learning and growth (human resources)

turnover

training hours

number of accidents

number of useful employee suggestions

number of employee complaints

number of relevant educational certificates earned

**1-29 Banking; Strategy; Skills (20 min)**

The purpose of this exercise, and 1-30 which is an alternate, is to have the student consider the role of the cost management professional in an actual company. What are the job skills required to be an effective employee, and thereby, help the company to be successful?

1. There are a number of possible answers here. Here are some ideas:

Customer satisfaction

Customer retention

Employee satisfaction

Employee turnover

Transaction processing error rate

Time: customer wait time – at cashier, for opening an

account, for getting loan approval, etc.

Number of new branches

Number of ATMs

The bank remains competitive and successful by attending to these critical success factors.

2. Again, there are a variety of ways the materials might be developed. The key idea is that the recruiting materials and the job description should follow from the critical success factors noted above. Here is an example:

Business Knowledge/Understanding strategy

Has a good understanding of business fundamentals; cost and revenue drivers, the regulatory environment in banking, etc.

Understands the strategy and business environment of bank customers he or she works with.

Customer Focus

Employee works well with customers and other employees

Efforts are customer-focused

Creative Problem Solving

Thinks creatively

Understand complexities

**1-29 (continued -1)**

Persuasive

Is able to present ideas concisely and clearly

Understands who “owns” a problem, and who can solve it

Flexibility

Not easily disappointed; handles conflict well

Is able to see multiple viewpoints while asserting a position

Can be a business partner, customer advocate, as well as loyal employee and friend

Embraces change

Good supervisor

# Creates a positive climate

Provides opportunities for development, learning and promotion

Can make tough personnel decisions

Is able to delegate, and teaches others how to do the same

Looks for new ideas and rewards suggestions

Builds commitment

Performance

Shows enthusiasm

Has high standards

Willing to work extra hours when necessary

Is willing to take risks

Keeps supervisors informed

Works well on a team

Effectively manages time

## Communication Skills

Communication is clear and focused

Good sense of confidentiality where appropriate

Technology Skills

Fully versatile in using computer applications that apply in the banking industry

Develops new skills where appropriate

Professional Ethics

Displays high standard for ethical behavior

**1-30 Consulting; Skills (20 min)**

This exercise can be used as an alternative to 1-29. Generally, the personal attributes will be the same as for banking. What skill areas might be especially important in consulting? Perhaps creativity and problem solving, the ability to follow a logical thought process, to develop and analyze alternatives.

**1-31 Activity Analysis in a Bank (20 min)**

1. Activity analysis is used to identify a detailed description of the specific activities performed in the operations of the bank. The activity analysis is used in two ways: activity-based costing and activity-based management. Activity-based costing (ABC) could be used to improve the tracing of the bank’s costs to its products and services, therefore improving the accuracy of decisions based on the cost information. Activity-based management (ABM) uses activity analysis to improve operational control and management control.

2. Example activities might be:

process deposits

process withdrawals

answer customer inquiries

sell travelers checks

balance cash drawer (at the end of the day)

receive an installment loan application

process an installment loan application

provide advice regarding investments, including an explanation of investment services provided by the bank

receive a mortgage loan application

process a mortgage loan application

mail out monthly statements: checking customers, savings customers, loan customers

The activity analysis for processing deposits, for example, would include a detailed description of the number of different ways the activity is initiated and performed, the time required, the skills required, resources required (e.g. labor, technology, facilities), etc.

**1-32 Professional Organizations and Certifications (15 min)**

Ian should consider joining one or more professional organizations. This would be helpful for developing relationships with other cost management professionals. Relationships of this type, and the continuing professional education programs of these organizations, offer an excellent way to develop professional skills and to identify career opportunities. Ian should consider joining the Institute of Management Accountants (IMA) right away, and then later to consider the Financial Executives International, or equivalent, as he progresses in his career.

Ian should also consider taking one of the certification exams. The IMA’s Certified Management Accountant (CMA) program will be the most relevant at the start. Also, Ian should consider certification as a Certified Public Accountant (CPA), as it is widely recognized not only within management accounting, but also in public accounting and financial management.

**1-33 Ethics, Product Quality (15 min)**

Some will recognize this as similar to the case of the Intel Pentium chip reported in the news in the mid 1990s. Even if the fault will occur in very rare and unusual circumstances, if the consequence could be some damage to a user, the firm should advise users of the fault and the potential implications. On the other hand, there should be no need to advise users if the fault is not likely to have any noticeable consequence on the use of the chip, as for example, if the chip simply takes much longer for a very rare type of processing, but returns the proper result. The effect of the delay is not likely to have a damaging effect on any known user.

**PROBLEMS**

**1-34 Strategy; Calvin Klein (20 min)**

Calvin Klein products are clearly differentiated on the basis of high fashion and cost. What remains at issue is whether some differentiated products can be sold in discount retail stores. Thinking that the presence of so much of his products in discount retail stores could hurt his brand, Calvin Klein sued Warnaco to stop this practice. The suit was settled out of court in January 2001and Warnaco was allowed to retain the lucrative Calvin Klein contract.

See: Ellen Byron: “101 Brands, 1 manufacturer,” *The Wall Street Journal*, May 9, 2007, p B1

Note: Calvin Klein products are also made by Kellwood Corp of St. Louis, Missouri.

**1-35 Current Economic Information; Use of the Internet (30 min)**

Information obtained from the Federal Reserve Board site, in July 2011:

<http://www.federalreserve.gov/apps/fof/FOFTables.aspx>

Gross Domestic Product (Table F6)

Gross domestic product remained relatively flat from the period 2007 to 2010, rising slightly from $14,061 billion in 2007 to $14,369 billion in 2008 then falling to $14,119 in 2009 and rising again to $14,660 in 2010. While economists have said the Great Recession ended in June 2009, there has not been much improvement since that time. Overall this is a sign of a very slow economic recovery. Looking to components of GDP, in line 7, private domestic investment fell from $2,266 billion in 2007 to $1,755 billion in 2010; GDP is an important measure of economic activity, so this is clearly a negative sign for the recovery. Similarly, in line 15, household and nonprofit investments fell from $542 billion in 2007 to $283 in 2010, falling each year during that period.

Home Mortgages (Table F218)

On almost every dimension, home mortgage assets fell from 2007 to 2010. All sectors were down $107 billion in 2008 and another $208 billion in 2009 and another $329 in 2010, an increasing decline each year. Media reports during this time have explained that the housing bust was a key factor in the slow recovery, and this data is consistent with that.

Overall, these figures reflect an economy very slowly recovering from recession at the time the data was obtained.

**1-35 (continued -1)**

The severe recession that began in December 2007 and ended in December 2009 has left a period of high unemployment, a depressed housing market, and has caused firms to review and in some case make significant changes to their competitive strategies. The introduction to the chapter noted how Wal-Mart has prospered in the lean times because of its core business strategy of low prices. Here are some other examples:

**In the apparel industry**

Abercrombie & Fitch has adopted the strategy of maintaining prices, and accepting lower sales in order to protect its reputation and differentiation. In contrast Saks has drastically lowered its prices to maintain sales volume. Fashion designers who supply these retailers are also responding, some with an attempt to provide simultaneously innovative design and great value.

Source: Christina Binkley, “Lean Times Beget Fresh Fashion Ideas,” *The Wall Street Journal,* February 18, 2009, p D1; Nicholas Casey, “Abercrombie Fights Discount Tide,” *The Wall Street Journal*, December 8, 2008, p B1.

**In the food industry**

McDonald’s, together with Wal-Mart, was the only firm in the DJIA average to experience stock appreciation in the latter part of 2008. McDonald’s is doing well in the lean economic times. Other firms have experienced success: Hershey, the candy maker, has benefited from consumers moving from the higher-priced chocolates to the lower priced Hershey products.

Source: Julie Jargon and Anjali Cordeiro, “Recession Puts Hershey in Sweet Spot,” *The Wall Street Journal*, January 28, 2009, p B1.

* 1. **Strategy; Innovation (15 min)**

1. The rate of innovation is higher in software and services, semiconductors, drugs, biotech, and technology hardware because the firms in these industries compete largely on innovation. For example, a drug firm is successful to the extent it is able to develop new drugs; cost efficiency is not a key to its success, and it is unlikely to be a cost leader. The only exception to this might be a manufacturer of generic drugs, where quality as well as cost leadership would be important.

2. Somewhat lower levels of innovation are seen in the food and beverage, consumer goods, and household products, because a larger portion of these products and firms compete on cost leadership. These are the products we buy in Wal-Mart, Kmart, Best Buy and Home Depot, all cost-conscious retailers.

Source: Peter Coy, “The Search for Tomorrow,” *Business Week*, October 11, 2004, pp 216-220.

A more recent follow-up to Peter Coy’s study is the survey done by *Business Week* and the Boston Consulting Group. The survey of 1,000 senior managers validated the earlier study: software and technology companies such as IBM, Samsung and Apple were most highly ranked.

Source: Jena McGregor, Michael Arndt, Robert Berner, Ian Rowley, Kenji Hall, Gail Edmonduson, Steve Hamm, Moon Ihlwan, and Andy Reinhardt, “The World’s Most Innovative Companies,” *Business Week*, April 24, 2006.

For a current update on innovation in business see the *Bloomberg Businessweek* site, <http://www.businessweek.com/innovation/>.

**1-37 Strategy; Commodity Business (15 min)**

SanDisk is apparently trying to move from a cost leadership strategy that fits well the commodity business to a differentiated strategy. This approach has been successful for other tech firms, such as Intel, which has established itself as a differentiated brand in a commodity market. The innovations described in the article are significant and point to success, but after the introduction of SanDisk’s product (April 2009) other firms entered the waterproof USB flash drive market and the product’s price has decreased significantly, showing the need for continuous strategy review.

**1-38 Enterprise Risk Management (20 min)**

The risk factors in the UHG (United Health Group) ERM appear to be relatively comprehensive. A manufacturer will have different risk factors than a service firm such as UHG, so the ERM of the auto parts manufacturer would recognize these differences. For example, while the auto manufacturer will likely have a risk category for the external environment, under this category it would have a risk factor of, for example, trend in input prices or in auto demand instead of trend in medical loss/utilization.

Also, an auto manufacturer will likely place much more emphasis on risk factors in the category, business process execution. As a manufacturer, most of the cost and risk lies in this category – manufacturing costs, warranty liability, raw materials costs and availability, etc, will be important risk factors in this category.

Another difference is in the analysis and reporting category. It is much more likely that a manufacturer will also have a sustainability report as part of its reporting process. Investors and regulators are likely to expect this. UHG’s operations do not have the environmental impact of an auto manufacturer.

The risk category, business strategies and policies, is likely to look somewhat similar for a manufacturer. While the strategies and policies will be different, the types of risks listed by UHG are likely to be similar to those faced by a manufacturer.

The risk category, people, will likely differ somewhat for a manufacturer. Rather than a focus on fraud and abuse and leadership, the manufacturer will likely be more focused on productivity and people who are able to adapt and perform in a very cost leadership type of competition that is common to this type of manufacturing.

The category, technology and data, is also likely to be different for a manufacturer. While data management is critical for a health insurance and health services company like UHG that has many customers, the data management issues will likely be less challenging for the manufacturer. The manufacturer needs effective systems to track production costs, operating performance, sustainability measures, and financial performance; this is likely to be a simpler technology than for UHG.

Source: Patrick H. Stroh, “Enterprise Risk Management at United Health Group,” *Strategic Finance*, July 2005, pp 27-35.

**1-39 Strategy; Service Company (20 min)**

1. Full Frame employs the cost leadership strategy by focusing primarily on low price and profitability through growth. This is consistent with Clyde’s description of the business as one that is difficult to differentiate.
2. Clyde’s pricing and employee-incentive policies are consistent with the cost leadership strategy. The fact that the business has grown from one to five stores in the past seven years is an indication that the strategy is working.

Potential problems:

1. While the growth strategy should work for a time, there is likely to be a limit to the total demand, within Clyde’s community for the framing type of service that Full Frame provides. Clyde may have to franchise the business or expand it beyond his current family – adding stores in other communities or perhaps other cities and states. This will require a professional level of management that Clyde will have to adopt if he wants the business to continue to grow.
2. Managing a company with the help of family members has its own set of rewards and potential problems. It may be more difficult to resolve disputes and to effectively employ performance management.
3. Clyde’s current incentive plan rewards all employees for stores where efficiency has improved. The incentive might be more fair and effective if it could be targeted to each employee; however, there might be difficulty in measuring performance at the individual employee level.

**1-40 Strategy: Auto Tire Manufacturing (15 min)**

Michelin’s continued success at selling high-end tires at premium prices is evidence that this firm is succeeding at differentiation in an industry that is largely characterized as a commodity business based on cost leadership. Michelin also effectively markets the importance of the quality it provides in advertisements that note the importance of safety in choosing an auto tire.

**1-41 Strategy: Brand Value (15 min)**

This question is intended for class discussion. Some students will be surprised by some of the firms on the two lists, and also by firms that are missing from the lists. The major point of the exercise is to discuss the nature of the differentiation strategy and how firms that have developed valuable brands have succeeded in making this differentiation. Ask the class if they themselves, or they expect others, would pay more for products of the firms on the top brands list. Those that say yes will be acknowledging the “earnings premium” that Interbrand Corp. refers to in the September 2009*Business Week* article.

As an aside, the list of top 10 brands for 2009 has the same 10 companies as the 2008 list, with McDonalds and Google moving up from 2008. Also, the 2008 list has 9 of the same 10 firms as the 2007 list. Google replaced Mercedes-Benz in the 2008 list, while Mercedes-Benz replaced Marlboro on the 2007 list; prior to that time, the list had the same 10 companies as for the prior three years. Thus, the same nine firms have been at the top of the list for seven years.

Note however, that as the recession changes consumer buying behaviors, some suggest that the strength of brands is weakening, and that cost-conscious consumers will look for savings and avoid the higher priced branded products. See Ellen Byron, “At the Supermarket Checkout, Frugality Trumps Brand Loyalty,” *The Wall Street Journal*, November 6, 2008, p D1.

Is there also an “earnings premium” for the firms on the *Business Week* 2010 most-innovative list? Note that Toyota, IBM, Microsoft, and General Electric are on both lists. Note also that none of the ten on this list are clear cost leaders. These firms succeed by providing new and attractive products, such as Apple’s iPad. So they are arguably all differentiators as well.

**1-41 (continued -1)**

Two issues of *Business Week* (March 23 & 30, 2009), p 12, show the top ten firms to receive patents in 2008:

|  |  |
| --- | --- |
| **Company** | **Patents in 2008** |
| IBM | 4,186 |
| Samsung Electronics | 3,515 |
| Canon | 2,114 |
| Microsoft | 2,030 |
| Intel | 1,776 |
| Panasonic | 1,745 |
| Toshiba | 1,609 |
| Fujitsu | 1,494 |
| Sony | 1,485 |
| Hewlett-Packard | 1,424 |

Notice that there is a significant difference between the list of innovative companies as measured by the number of patents and the list as measured by the survey of senior executives. In both cases, for both lists, an examination of the company’s products suggests that the firms on both lists are primarily differentiators. However, the survey by executives is probably a more reliable measure of innovation in a strategic sense because it reflects not just the *number* of patents, but also the company’s effectiveness at marketing and promoting its new products.

Some of the firms on the list are differentiated on innovation and style, such as Apple, which enjoys a 30% gross margin, far higher than other firms in its industry. See Arik Hesseldahl, “Why the Mac is Still a Rock Star for Apple,” *Bloomberg Business Week*, June 28-July 4, 2010, p 28.

**1-42 Strategy and the Balanced Scorecard; Customer Service (15 min)**

Most of these companies are well-known and the students will likely recognize them as differentiators based on customer service and a number of other factors including product quality and brand. The articles cited below explain for each firm how it goes about achieving world-class customer service. For some, like LL Bean, it is the attention toward satisfying employees so they are happier to provide better customer service. For USAA, it is employing military veterans and extensive training. For Ace Hardware, it is the use of technology.

The 2009 list shown below had five firms in common with the 2010 list: USAA, Lexus, The Ritz-Carlton, Publix Super Markets, and Ace Hardware:

1. Amazon.com
2. USAA
3. Jaguar
4. Lexus
5. The Ritz-Carlton
6. Publix Super Markets
7. Zappos.com, online retail
8. Hewlett-Packard
9. T. Rowe Price Brokerage

10.Ace Hardware

The 2007 list shown below had four firms in common with the 2010 list: USAA, Lexus, Four Seasons Hotels, and Nordstrom. Notice that USAA and Lexus are on all three lists: 2007, 2009, and 2010.

1. USAA
2. Four Seasons Hotels
3. Cadillac
4. Nordstrum
5. Wegmans Food Markets
6. Edward Jones, brokerage
7. Lexus
8. UPS
9. Enterprise Rent-a-Car

10.Starbucks

**1-42 (continued – 1)**

Source: Jena McGregor, “Customer Service Champs,” *Bloomberg Business Week*, March 1, 2010, p 44; Jena McGregor, “Customer Service Champs,” *Business Week*, March 5, 2009, pp 32-34.

An interesting contrast to the above rankings is reported in an article about the effects of cutting customer service. Cost-cutting of customer service items at airlines are now well-known and have had their effect on customer satisfaction and loyalty. The article also explains how Dell and Home Depot have struggled to retain customer loyalty after some unwise cost cutting. At Home Depot, full-time workers were replaced with part time workers who had less knowledge and incentive. And at Dell, call centers were not effectively supported so that customer call wait times of a half hour or more were common.

Source: Brian Hindo, “Satisfaction not Guaranteed,” *Business Week,* June 19, 2006, pp 32-36.

**1-43 Strategy: Discounting, Differentiating, and Contract Manufacturing (25 min)**

1. Acer and HTC understand that they can increase margins and profits considerably by achieving brand recognition. As contract manufacturers only, their profits are limited to what can be negotiated with the manufacturer or retailer – a cost leadership competitive situation. But as a brand, they can differentiate their product (on quality, innovation, …) and sell for higher prices to the ultimate consumer. This seems to be a solid strategy for Acer and HTC if they can continue to achieve the brand image they desire.
2. The problem for contract manufacturing such as Menu Food, Inc. can be that different retailers and manufacturers who purchase the same product but who sell the product in different brands at different prices may find it harder to support the price differences. As noted by Jack Trout, president of a marketing strategy firm in Connecticut, “ If the public begins to get the perception that there’s not much difference , then you can’t hold your prices...” He added, “Commoditization is the real enemy of branding.”
3. Vera Wang started with one of the world’s best known bridal fashion producers, and now has branched out into a variety of high-end fashion clothing and accessories. In 2007 she branched out into a low cost line of dresses starting at $68 and handbags starting at $49 for the retailer, Kohl’s, under the name, “Simply Vera” by Vera Wang. Ms. Wang distinguishes her lines by noting that her high fashion line is very risky, “fashion-forward”, and intended for the very few who want and can afford that luxury. The Kohl’s line is intended to be comfortable, but also “edgy,” differentiated from the other Kohl’s lines in terms of fashion appeal, but also affordable. Ms. Wang acknowledged she was nervous about the launch of the Kohl’s line. As of January 2012, “Simply Vera” is still part of the Kohl’s line of clothing. It appears that the new line has not affected the overall Wang brand or her ability to differentiate.

Source: Bruce Einhorn, “What’s in a Name,” *Business Week,* November 12, 2007, pp 82-84. Ellen Byron, “101 Brands, 1 Manufacturer,” *The Wall Street Journal*, May 9, 2007, p B1. Vanessa O’Connell, “Is Discount a Good Fit for Vera Wang,” *The Wall Street Journal*, September 5, 2007, p B1.

**1-44 Different Professional Certification Programs (15 min)**

The answers will vary depending on the student’s career interests. Below is listed the summarized content of the two exams taken from the web sites.

The CPA Exam has four parts**:**

**Auditing and Attestation (AUD)**. This section covers knowledge of auditing procedures, generally accepted auditing standards and other standards related to attest engagements, and the skills needed to apply that knowledge.

**Business Environment and Concepts (BEC)**. This section covers knowledge of general business environment and business concepts that candidates need to know in order to understand the underlying business reasons for and accounting implications of business transactions, and the skills needed to apply that knowledge.

**Financial Accounting and Reporting (FAR)**. This section covers knowledge of generally accepted accounting principles for business enterprises, not-for-profit organizations, and governmental entities, and the skills needed to apply that knowledge.

**Regulation (REG)**. This section covers knowledge of federal taxation, ethics, professional and legal responsibilities, and business law, and the skills needed to apply that knowledge.

**1-44 (continued -1)**

The CMA Exam has two parts:

|  |
| --- |
|  |
| **Financial Planning, Performance and Control** |
| Planning, Budgeting, and Forecasting |
| Performance Management |
| Cost Management |
| Internal Controls |
| Professional Ethics |
| **Financial Decision Making** |
| Financial Statement Analysis |
| Corporate Finance |
| Decision Analysis and Risk Management |
| Investment Decisions |
| Professional Ethics |

The CMA Program has the following objectives, as explained on the IMA website:

“The CMA program has been designed to meet the evolving needs of business –today and tomorrow. We look forward to helping you achieve excellence as a professional. Certification will confirm your proficiency in your chosen field and your dedication to personal and professional growth.”

**1-45 Learning About Different Professional Organizations; Using the Internet (40 min)**

The following sets out a number of key aspects of the different organizations:

|  |  |  |  |
| --- | --- | --- | --- |
| **Organization** | **Publications** | **Training** | **Other** |
| Society of Management Accounts – Canada | * CMA Management magazine * Strategic Leadership news tabloid * Management Accounting Standards | * Executive program for senior managers * conferences * technical committees | * Certificate program -- the CMA (Canada) * Strategic Leadership Program (for CMAs) |
| Chartered Institute of Management Accountants | * Financial Management magazine | * on-line courses and in-company courses * conferences * technical committees | * Programs for colleges and universities – Learning through partnership; Accreditation through partnership * The Chartered Management Accountant program * recruitment mall |
| American Institute of Certified Public Accountants | * Journal of Accountancy magazine * accounting and auditing standards * code of professional ethics | * conferences * courses * technical committees | * CPA certificate * affinity program * Center for Excellence in Financial Management * Web Trust * Classifieds * CGMA Certification (partnership with   CIMA) |
| Institute of Management Accounting | * Strategic Finance magazine * Management Accounting Quarterly | * conferences * courses * technical committees | * CMA certificate * CFM program (certificate in financial management) |
| Financial Executives International | * Financial Executive magazine | * conferences, courses * technical committees | * research foundation * “ask an FEI researcher” program |

**1-46 Ethics, Product Quality (15 min)**

Though Green Acres is benefiting financially from its consumers’ misperception and has not purposely done anything misleading (since it has never labeled its products as “organic”), it cannot continue to allow consumers to think its products are organic. As it knows that its consumers perceive its products as “organic” and that many consumers buy Green Acres products specifically for this reason, Green Acres has a moral obligation to inform them about its true practices. Even if the health and environmental consequences of genetically modified organisms are yet unknown, the potential for harm to the consumer necessitates that Green Acres advise consumers of its use of genetically modified crops and notify them that risks might potentially exist from consuming its products.

**1-47 Ethics; Who, What, and How?; Use of Internet (20 min)**

1. The three most common behavioral indicators are:
   1. Living beyond ones means
   2. Financial difficulties
   3. Unwillingness to share duties
2. The three most common measures to detect and prevent fraud are:
   1. External auditor
   2. The company’s code of conduct
   3. Internal audit
3. Smaller companies are more vulnerable to fraud because the smaller companies do not have the resources to provide the needed controls to detect and prevent fraud
4. $160,000
5. The top three means by which occupational fraud is detected, in order:
   1. Tip
   2. Management review
   3. Internal audit
6. Hotlines can be very helpful. In particular they dramatically increase the effectiveness of the most important detection device, the employee tip.