

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. COMPAQ: 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 problem 1-31) 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 COMPAQ, 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, Givency, 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 Executive Institute (FEI) 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 COMPAQ 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. Changes in manufacturing and information technologies, and thus the need for cost management information to facilitate the introduction of new manufacturing and product technologies (e.g., determining which technologies will most contribute to profitability), and to incorporate in cost management reports the information needed to manage the new technologies effectively; the importance of life cycle costing -- considering the total costs of the product or service over its entire cost life cycle, from raw materials to sales and service;
 3. A focus on the customer, which requires cost management reports to include critical information about customer satisfaction, changing customer preferences, etc.;
 4. 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;
 5. 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: customer satisfaction, financial performance, internal business processes, and innovation and learning (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, 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, 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, a management technique used to monitor the costs of a product throughout its life cycle.

7. Benchmarking, 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, 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, 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, a strategic technique to help firms to 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 managing the risks that could negatively or positively affect the company's competitiveness and success.

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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 McDonalds. 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** 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 builds strong relationships and reputations. The study also reported that nearly half of financial leaders survey said that strong corporate social and environmental values effect financial performance in the short run. The article notes, as do many other surveys, that the firm Johnson & Johnson is perhaps the best know 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 recent Wall Street Journal article (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, 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 $\frac{1}{2}$ 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; Wachovia was recently rated as number one in customer service (for larger banks).
- 1-21** Here 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 (biotech,..) which 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, then 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 for 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)

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 Contemporary Management Techniques (40 min)

1. There are two SMAs 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.

2. 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.

3. 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.

PROBLEMS

1-26 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). 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 carefully 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 (see answer to exercise 1-25), would be appropriate. Also, 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 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 Institute, 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.

1-28 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 business 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. innovation and learning (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 to:

- process deposits
- process withdrawals
- answer customer inquiries
- sell traveler 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 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.

1-33 Strategy; Selling Electronics (20 min)

Since the new TV is clearly a high-end item, it is unlikely that most shoppers at Best Buy or Wal-Mart will be able to afford the product. On the other hand, the appearance of the new 80" TV in their stores could be an advantage to Best Buy and Wal-Mart, or similar retailer, because it would attract traffic into the store, and perhaps help the store to draw a new type of customer, one expecting very high end merchandise such as the Samsung TV. However, on balance, the product is clearly intended for the unique customer, and in fact, Samsung chose to market it through a single store, the Chicago-area Abt Electronics. The Danish manufacturer of high-end sound systems, Bang & Olufsen has also chosen to market its products in the Abt store. The reason? Abt creates special "boutiques" within the store that are designed to highlight the features of a given class of electronic merchandise. Only very high-end merchandise is available, so that the shopper's experience is focused on the uniqueness and attractiveness of the merchandise.

The message: if you have a differentiated product, you also need a differentiated means to market and sell it.

Source: Gwendolyn Bounds, "A Way to Fight Big Rivals, Play Up Style and Service," *The Wall Street Journal*, March 27, 2007.

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 2001 and Warnaco was allowed to retain the lucrative Calvin Klein contract.

See: "Behind a Bitter Suit Filed by Calvin Klein Lies Grit of Licensing," *The Wall Street Journal*, June 1, 2000, p 1.

Note: Calvin Klein products are also made by Kellwood Corp of St. Louis, Missouri.
(Ellen Byron: "101 Brands, 1 manufacturer," *The Wall Street Journal*, May 9, 2007, p B1.

1-35 Strategy, BMW (15 min)

The critical question for BMW is how the use of another manufacturer might affect customers' confidence in the BMW brand. Most would say that BMW is a differentiated firm, and its customers expect quality and features over cost. The X3 has been a great success for BMW (both in sales and reviews), so it is apparent that customers have accepted the contract manufacturing of the vehicle

Perhaps more interesting is BMW's plan to "protect its brand by not entering the minivan market." According to BMW's CEO, "We do not have a van because a van as it is in the market today does not fulfill any of the BMW group brand values." On balance, BMW has succeeded in the luxury, high-end of the SUV market, but has determined that the luxury, high-end market currently has no place for a minivan.

Source: "BMW's CEO Just Says No to Protect Brand," *The Wall Street Journal*, November 26, 2003, p B1; "Ah, That Excellent German Engineering – Straight from Southern Austria," *The Wall Street Journal*, September 10, 2003, p B1

1-36 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 will compete on cost leadership. These are the products we buy in Wal-Mart, Kmart, Best Buy and Home Depot, all cost-conscious retailers. The automobile industry has some firms that are more innovative than others (see BMW in problem 1-35 above) while others are less innovative. Note however, that William Ford, the CEO of Ford Motor has stressed in recent months the importance of innovation to that firm's strategy going forward.

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

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 at the time of publication it is too early to tell.

Source: "A Memory Card You Won't Forget," *Business Week*, August 15, 2005, p 62.

1-38 Ethics: The WorldCom Scandal (15 min)

The WorldCom scandal is one of the most significant and extensive frauds in U.S. history. The important part of this story is that the survivor organization, MCI, is doing well under new leadership and has begun an ethical compliance program. The question is intended primarily as a basis for class discussion, and there are likely to be a wide range of views. I begin by noting that the announcement of a Chief Ethics Officer is a good strategic move for MCI, given the recent history of the company. It is important for the firm to make a clear statement about the importance of ethical behavior in the years ahead.

It is difficult to determine the precise role for an ethics officer; the concept is new and there is not much experience to provide guidance. The functions set out in the MCI announcement make sense – employee training, hotline, pledge, and code of ethics. It is clear in the MCI case that the officer has the strong support of top management. So the role and responsibilities of the chief ethics officer should be watched closely at the top management level -- both CEO and CFO. From the experience with WorldCom and other frauds, where both the CEO and CFO were culpable, it is probably also important that the chief ethics officer report not only to the CEO and CFO, but also to the firm's audit committee (a subset of the firm's board of directors with responsibility for managing the audit function and providing oversight of internal control procedures within the firm).

Source: "WorldCom Staffer Ordered to Commit Fraud Balked, then Caved," *The Wall Street Journal*, June 23, 2003, p1.; MCI web site; www.mci.com

1-39 Ethics: Who, What, and Where?

The answers to each question, from the survey, follow:

1. Are first time offenders more likely or less likely to commit fraud?
First time offenders are more likely to commit fraud; only 12% had a previous conviction.
2. Most frauds are detected by audit, are revealed by the perpetrated, or are they the result of a tip by another employee? Most fraud are detected by a tip, and 60% of those tips are from a fellow employee, and another 20% from a customer, and 15% from a vendor.
3. A fraud hot line which employees can use to report suspected fraud does or does not help in reducing the cost of fraud? Organizations that had the anonymous hot line had median fraud losses of \$56,500 while those without the hot line had median losses of more than twice that amount. The hot lines helped reduced the cost of fraud losses.
4. Is the cost of fraud higher in small companies or larger companies? The median cost of fraud for smaller companies was \$98,000 which was higher than the median cost for any but the largest companies. So smaller companies seem to suffer larger median losses than larger companies.
5. Is age or gender the of perpetrator associated with the cost of fraud? The median cost of fraud for males is \$160,000 and for females is \$60,000. Older employees were more likely to be involved in fraud, perhaps because they were more likely to be involved in a position of significant responsibility and therefore had a greater opportunity.
6. What do these results tell you about the incidence of fraud and how a company can best protect itself from occupational fraud?
Overall, the results suggest that the problem of occupational fraud is very important and very costly to organizations. It also seems that while audit and control procedures are important, anonymous hot lines can play a crucial role in detecting occupational fraud.

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.

Source: "Michelin Rolls," Business Week, September 30, 2002, pp58-62

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 2008 *Business Week* article.

As an aside, the list of top 10 brands has 9 of the same 10 firms as the 2007 list. Also, Google replaced Mercedes-Benz in the 2007 list, while Mercedes-Benz replaced Marlboro on the 2006 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 six years.

Note however, that as the recession in the fall of 2008 changes consumer buying behaviors, some suggest that the strength of brands is weakening, and that cost conscious consumer 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* 2009 most-innovative list? Note that Toyota, IBM, Microsoft, and Nokia are on both lists. Note also that none of the ten on this list are clear cost leaders, except Wal-mart. These firms succeed by providing new and attractive products, such as Apple’s iPod. So they are arguably all differentiators (except for Wal-Mart) as well.

1-41 (continued -1)

A recent issue of *Business Week* (March 23&30, 2009), p 12, shows 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.

1-41 (continued -2)

For an additional class exercise, you can ask the class if they can name the 10 top brands of cars (based on 2008 resale value):

1. VW
2. BMW
3. Acura
4. Honda
5. Porsche
6. Subaru
7. Lexus
8. Infiniti
9. Audi
10. Toyota

Source: *The Wall Street Journal*, November 14, 2007, p d7B.

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 article cited below explains for each firm how it goes about achieving world-class customer service. For some, like Jaguar, it is the use of field teams for customer service. For USAA, it is employing military veterans and extensive training. For Ace Hardware, it is the use of technology, and for Hewlett-Packard, it was the opening of new customer service centers.

The 2007 list of 10 customer service champs had some firms in common:

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

Source: Jena McGregor, "Customer Service Champs," *Business Week*, March 5, 2007, pp 52-64. The article also lists firms ranking 11 through 25; "Customer Service Champs," *Business Week*, March 2, 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 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.

1-44 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 achieve the brand image they desire. As of October 2007, shareholders appeared to have supported the strategy by supporting an increase in the firms' stock price.
2. The problem for contract manufacturing 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 – that's the bottom line of the whole pet food scandal." 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, Vera 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 acknowledges she is nervous about the launch of the Kohl's line. How will the new line affect the overall Wang brand, and 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

1-45 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	<ul style="list-style-type: none"> • CMA Management magazine • Strategic Leadership news tabloid • Management Accounting Standards 	<ul style="list-style-type: none"> • Executive program for senior managers • conferences • technical committees 	<ul style="list-style-type: none"> • Certificate program -- the CMA (Canada) • Strategic Leadership Program (for CMAs)
Chartered Institute of Management Accountants	<ul style="list-style-type: none"> • Financial Management magazine 	<ul style="list-style-type: none"> • on-line courses and in-company courses • conferences • technical committees 	<ul style="list-style-type: none"> • Programs for colleges and universities – Learning through partnership; Accreditation through partnership • The Chartered Management Accountant program • recruitment mall
American Institute of CPAs	<ul style="list-style-type: none"> • Journal of Accountancy magazine • accounting and auditing standards • code of professional ethics 	<ul style="list-style-type: none"> • conferences • courses • technical committees 	<ul style="list-style-type: none"> • CPA certificate • affinity program • Center for Excellence in Financial Management • Web Trust • Classifieds
Institute of Management Accounting	<ul style="list-style-type: none"> • Strategic Finance magazine • Management Accounting Quarterly 	<ul style="list-style-type: none"> • conferences • courses • technical committees 	<ul style="list-style-type: none"> • CMA certificate • CFM program (certificate in financial management)
Financial Executives International	<ul style="list-style-type: none"> • Financial Executive magazine 	<ul style="list-style-type: none"> • conferences, courses • technical committees 	<ul style="list-style-type: none"> • research foundation • “ask an FEI researcher” program

1-46 Current Economic Information; Use of the Internet (30 min)

Information obtained from the White House site, in November 2008:

From the International Section:

1. In the second quarter of 2008, the U.S. current-account deficit on international transactions increased to \$180 billion.
2. The Nation's international deficit in goods and services was \$56.5 billion, as both exports and imports decreased.

From the Output Section

3. In the third quarter of 2008, real GDP decreased approximately .3 percent at a seasonally adjusted annual rate.
4. In the third quarter of 2008, real nonresidential fixed investment decreased approximately 1 percent at a seasonally adjusted annual rate.
5. In the third quarter of 2008, real residential investment increased almost 20 percent at a seasonally adjusted annual rate.
6. In the third quarter of 2008 corporate profits decreased 4 percent at a seasonally adjusted quarterly rate.
7. In September 2008, real personal consumption expenditures decreased 0.4 percent at a seasonally adjusted monthly rate

From the Production Section:

8. Housing starts for single and multiple family homes fell dramatically in the summer and fall of 2008 relative to the prior year.
9. New orders for manufactured durable goods, down in August, increased 0.8% in September 2008.

Overall, these figures reflect an economy in recession at the time the data was obtained.

1-46 (continued -1)

The severe recession that began in December 2007 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 maintain 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

McDonalds, 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 benefitted 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.

1-47 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.

1-47 (continued)

The CMA Exam has four parts:

Business Analysis

Business Economics
Global Business
Quantitative methods and Internal Control
Financial Statement Analysis

Management Accounting and Reporting

Budget preparation and Information Management
Cost management
Performance Measurement
External Financial Reporting

Strategic Management

Strategic Planning
Strategic Marketing
Corporate Finance and Decision Making
Capital Budgeting

Business Applications (cases are used to test the understanding of topics in the above three parts)

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

- To establish management accounting as a recognized profession by identifying the role of the management accountant and financial manager, the underlying body of knowledge, and a course of study by which such knowledge is acquired;
- To encourage higher educational standards in the management accounting field;
- To establish an objective measure of an individual's knowledge and competence in the field of management accounting; and
- To encourage continued professional development by management accountants.