# CHAPTER 1: COST MANAGEMENT AND STRATEGY

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# 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.

**1-26 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.

**1-28 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

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

materials and labor usage relative to standard

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

**1-30 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.

**1-32 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.

**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. **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/>.

**1-38 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. **(continued -1)**

A recent survey by CFO Magazine reports that 72% of the CFOs responding to the survey indicated that their responsibility for risk management has increased over the recent few years. These CFOs also indicate that they are the executive in their firm that is chiefly responsible for risk management. An ongoing problem, the CFOs indicate that their chief worry is the lack of resources for risk management.

Source: Kate O’Sullivan, “Keeping Cool in the Hot Seat,” CFO, March 2012, pp. 39-42.

**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.

**1-42 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.

**1-44 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:

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| **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.”

**1-46 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.