# CHAPTER 1: COST MANAGEMENT AND STRATEGY

# QUESTIONS

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

1. Walmart: to keep costs low by streamlining restocking and sales

2. Hewlett-Packard or Dell Computer: 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 to identify key operations and to find those that add little or no value

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

5. Procter & Gamble or any similar large, diversified manufacturer: to assess the profitability of its different products

6. A small machine shop: to determine whether it should repair or replace a machine

7. 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 that will likely use somewhat different types of cost management information because of their unique competitive strategies include: :

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 Dell Computer 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 implement the strategy of 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. Other relevant certificates include the Certified Public Accountant (CPA) and the Chartered Global Management Accountant (CGMA).

**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, Walmart, and Target. 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 Samsung. 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 services 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 Boeing 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** For some firms, a popular web site can be an important differentiating factor. Firms such as [Amazon.com](https://www.amazon.com/), Etrade, eBay and many retailers have achieved powerful competitive advantage through their web sites, offering fast delivery and enhanced customer service. Other firms such as Walmart use the Internet to achieve cost advantage by using Internet based systems for transactions processing, production scheduling, purchasing, employee recruiting, etc.

**1-11** The management accountant is a full business partner with management in Stage 4 of cost system development. At this stage, the highest level, the management accountant has an integral role with management to implement the organization’s strategy.

**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; 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 and 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 which require 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

|  |  |  |
| --- | --- | --- |
|  | **Prior Business Environment** | **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)**

|  |  |  |
| --- | --- | --- |
|  | **Prior Business Environment** | **Contemporary Business Environment** |
| **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. 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 Analytics 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.

12. 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.

**1-15** Many students will answer Walmart 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 anyone 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 build strong relationships and reputations. 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. See for example the New York Times article on Johnson & Johnson: Katie Thomas, “Johnson & Johnson Praised for Taking Uterine Surgery Tools Off Market,” *The New York Times*, August 1, 2014, p B3.

**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, p B1), “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 1-50 which shows Coke as having one of the highest brand values 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. It is interesting to note that as many soft drink companies (in 2017) are facing competitive problems due to consumer concerns about the amount of sugar in these drinks, the companies are looking for ways to reduce the cost and caloric content of their drinks. Coke for example is developing new smaller portions and focusing consumer attention on “lite” snacks and its diet products, as well as its bottled water products. (See coca-colacompany.com/brands).

**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 whether there is 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. 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.

**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., technology) 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 computers as an example.

**It is also possible that a cost leadership firm could shift to differentiation. That could happen for example when the frim acquires or develops a patent that provides the firm access to a new market in which the patent provides a differentiated advantage.**

**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.

**BRIEF EXERCISES**

* 1. The IMA definition of management accounting states that:
  2. Management accounting is the process of gathering, reporting, and analyzing information for management decision making
  3. Management accounting is a profession that involves preparation and analysis of cost information, budgeting, performance measurement and analysis, to assist managers in decision making
  4. ***Management accounting*** is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization’s strategy.
  5. Management accounting is a set of practices in which accountants, working within companies, help managers to make better decisions based on accurate financial information

Answer c

Learning Objective: 01-01

Feedback: The IMA definition: “Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization’s strategy.” Answer c) is the best fit.

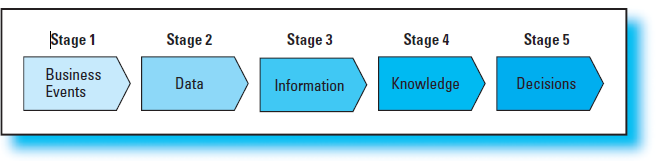
**1-25** Which of the following is the correct sequence in which cost management information is developed and used?

* 1. Business events, data, information, analysis, decisions
  2. Business events, data, analysis, information, decisions
  3. Business events, information, analysis, knowledge, decisions
  4. Business events, data, information, knowledge, decisions

Answer d

Learning Objective: 01-01

Feedback: Business events, data, information, knowledge, and decisions is the correct sequence, as used by the IMA in the definition of management accounting



**1-26**. Management accounting, as defined by the IMA, uses the expertise of the management accountant to

1. Improve quality and reduce cost
2. Implement a strategy of cost leadership or differentiation
3. Implement a strategy of customer value and shareholder value
4. Improve business processes and lean operations

Answer b

Learning Objective: 01-01, 01-04

Feedback: This question requires an understanding of the definition of management accounting, that is, management accounting “assists management in the formulation and implementation of an organization’s strategy.” It also requires an understanding of the two types of competitive strategy (from Michael Porter) – cost leadership and differentiation. Answer b is the only answer that fits the definition of management accounting and of strategy.

**1-27**. The management accountants in an organization probably report directly to the:

1. Controller
2. Treasurer
3. Chief executive officer (CEO)
4. Chief financial officer (CFO)

Answer a

Learning Objective: 01-01

Feedback: See Ex. 1-1; cost management experts report to the controller who in turn reports to the CFO; the CFO reports then to the CEO

**1-28** Walmart, Costco, and Dollar General are retailers that probably compete on the basis of

1. Quality and customer service
2. Product differentiation
3. Low prices
4. Desirable locations

Answer c

Learning Objective: 01-04

Feedback: While answers a, b, and d are competitive features for any company, the key competitive success factor for cost leadership companies like Walmart, Costco, and Dollar General are low cost and low prices.

**1-29.** Cost management has evolved from a focus on measurement to one of identifying those measures that are critical to the organization’s success. This means that cost managers are striving for this type of cost management system:

1. Basic transaction reporting systems
2. A system that focuses on reliable external financial reports
3. A system that tracks key operating data and develops accurate cost information
4. A system in which strategically relevant cost management information is an integral part of the system

Answer d

Learning Objective: 01-2

Feedback: This exercise considers Robert Kaplan’s four-stage model of cost management system development: 1) basic transactions, 2) focus on reliable external reporting, 3) track key operating data for decision making, and 4) strategically relevant cost management information is integral to the system. Stage 4, integral strategically relevant information, is the goal.

**1-30**. A management method in which managers and employees commit to a process of continuous improvement is best described as:

1. Total quality management
2. Business process improvement
3. Lean accounting
4. The theory of constraints

Answer: b

Learning Objective: 01-03

Feedback: Answers (a), (c), and (d) are incorrect because: total quality management focuses on meeting customer expectations; lean accounting supports lean manufacturing, a method that uses value streams and a focus on inventory reduction and increasing the speed of manufacturing operations. Like lean manufacturing, the theory of constraints focuses on the speed of the flow of product through the manufacturing process. Business process improvement is the correct answer as it is a management method in which managers and workers commit to a process of continuous improvement.

**1-31** Professional certifications are issued by the American Institute of Certified Public Accountants (AICPA), the Institute of Management Accountants (IMA), The Chartered Institute of Management Accountants (CIMA) and the Society of Management Accountants in Canada (CMA-Canada), among other professional accounting organizations. The Certificate in Management Accounting (CMA) is issued by:

1. CIMA
2. IMA
3. CPA Canada
4. AICPA

Answer: b

Learning Objective: 01-05

Feedback: The CMA certificate is issued by the IMA, Institute of Management Accountants

**1-32.** To determine whether a particular action is professionally ethical or not, using the Institute of Management Accountants Statement of Ethical Professional Practice, it is necessary to know:

1. Whether the act is legal in your jurisdiction
2. The intent and the business context of the act
3. The amount of the fraud or theft that is involved
4. Whether the management accountant is certified or not

Answer: b

Learning Objective: 01-6

Feedback: (b) is correct. (a) an act can be legal but not ethical; (c) the amount of the fraud or theft might influence the consequences to the perpetrator, but will not determine whether it is ethical or not; and (d) determining whether the act is ethical does not depend on whether or not the accountant is certified, though the consequences could be more significant for a certified management accountant.

**1-33.** Firms that want to grow quickly in the global marketplace often employ the cost leadership strategy because:

1. This produces favorable customs rates and import duties
2. Manufacturers around the world adopt lean manufacturing methods to bring their costs down
3. This allows them to employ and benefit from enterprise management systems
4. There are relatively few product variations across different countries

Answer: b

Learning Objective: 01-02,01-04

Feedback: Answer b is correct. (a) the cost leadership strategy is not likely to have any effect on customs rates or import duties, which are determined from product cost and other factors, (c) many global companies use enterprise management systems, but the motivations are related to the nature of their value chain, both upstream and downstream, and not their strategy (d) a number of products have significant variations across countries

**1-34.** The strategy map can be compared to the balanced scorecard (BSC) in that:

1. The strategy map is a subset of the BSC
2. The strategy map deals with the strategy component of the BSC
3. The strategy map provides a guide to implementing the BSC by linking the critical success factors
4. The strategy map and the BSC are unrelated

Answer: c

Learning Objective: 01-3

Feedback: Answer c is correct. (a) the BSC has perspectives which could be called subsets, but the strategy map is not a perspective or subset; (b) and (d) the strategy map provides a linkage of the critical success factors for **all** of the perspectives of the BSC,

**1-35.** The IMA ethical standard that requires the management accountant to act with integrity:

1. Requires the management accountant to mitigate conflicts of interest
2. Is not a part of the IMA Statement of Ethical Professional Practice
3. Is necessary to ensure that the management accountant’s credibility is not impaired
4. Is necessary to ensure that the management accountant does not violate confidentiality

Answer: a

Learning Objective: 01-6

Feedback: The three aspects of integrity in the IMA statement are:

1. Mitigate actual conflict of interest. Regularly communicate with business associates to avoid apparent conflicts of interest.
2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically
3. Abstain from engaging in our supporting any activity that might discredit the profession

Answer (a) correctly matches the ethical standard of integrity to mitigating conflicts of interest

**EXERCISES**

**1-36 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.

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.

**1-37 Strategy; Food Producer (15 min)**

1. The strategy is differentiation due to the use of unique ingredients. While many food producers are cost leaders, Yee-Haw, which competes on the basis of its unique products, is best described as a differentiator.
2. No. The reason is that the sale of its differentiated, premium product in discount stores would undermine the differentiated competitive advantage that the company now enjoys. In other words, the new customers would undermine the pool of existing customers.
3. The key factors are noted above. The company is an actual company and the owner, Allison Yeary, says she is struggling with the decision, “We could really, really use the revenue, but we’re a premium company.” Having the company associated with a discounter would likely damage their premium brand.

Source: “When Turning Away Customers Will Help the Bottom Line,” Caitlin Kelly, *The New York Times*, August 27, 2015, p B4.

**1-38 Risk Management, Enterprise Sustainability, and Lean Accounting (40 min)**

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

The IMA SMAs are at the following site:

<https://www.imanet.org/insights-and-trends/statements-on-management-accounting?ssopc=1>

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 five SMAs on sustainability. “Implementing Corporate Environmental Strategies” (1995), “Tools and Techniques of Environmental Accounting for Business Decisions” (1996), “The Evolution of Accountability – Sustainability Reporting for Accountants” (2008), “Increasing Employee Engagement in Organizational Sustainability Efforts,” and “Flexible Budgeting Applied to Sustainability Measurements” (2014)
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.

**1-39 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 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, 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.

4. Business analytics (BA) 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. Other examples include banks such as Capital One, and manufacturers such as John Deere. BA allows these companies to become more competitive by better understanding their customers. An additional example is the use of BA 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 BA 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.

**1-40 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. 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. 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

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

**1-40 (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

Turnover

Training hours

Number of accidents

Number of useful employee suggestions

Number of employee complaints

Number of relevant educational certificates earned

**1-41 Banking; Strategy; Skills (20 min)**

The purpose of this exercise, and 1-42 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

**1-41 (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; 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

**1-42 Consulting; Skills (20 min)**

This exercise can be used as an alternative to 1-41. Generally, the personal attributes will be the same as for banking. What skill areas might be especially important in consulting? Perhaps consulting skills might also include creativity and problem solving, the ability to follow a logical thought process, to develop and analyze alternatives.

**1-43 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 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. An additional alternative, for those who have the CPA, would be to pursue the Chartered Global Management Accountant (CGMA) certificate offered by the AICPA and Chartered Institute of Management Accountants (CIMA, UK).

**1-44 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 cause 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.

The story of the Intel chip scandal is at: <https://ggwash.org/view/30949/how-is-the-dc-cheating-scandal-like-a-1990s-intel-chip>

**PROBLEMS**

**1-45 Strategy; Downsizing Luxury (15 min)**

BMW, Tiffany, Audi and Mercedes-Benz are-well known luxury brands and their products are know to be among the most highly-regarded and expensive in their respective product markets. So it is clear that their competitive strategy is differentiation.

Does the the move into downmarket products mean the firms are moving to a cost leadership strategy? Not likely, as the reason for the popularity of the new, less expensive products is the attachment to the luxury brand. So the question arises, can this new strategy lead to what Michael Porter calls ”getting stuck in the middle.” As explained in the text, Porter’s view is that a company cannot succed at both cost leadership and differentiation. That is, the customer is attracted to the products becuase of the low price or the differentiation, and a mixing of the two will lead to confusion in the market and loss of the differentiation. Will the less expensive products dilute the luxury brand?

The expansion of these companies to the downmarket creates a risk for these companies that the brand can be dilulted and of less value. However, as Mark Del Rosso (former chief operating officer of Audi of America) notes in a recent *BloombergBusinessweek* article (“The Downside of Low-End Luxury Cars”), “Consumers ultimately choose the products that best suit their lifestyle, and what we are seeing is that the (Audi) A4 has not faced any lost volume, and that A3 sales have provided incremental gains.” Whether the more expensive products of the Audi brand will continue to be unaffected is a question that will be answered in the coming years.

Source: “The Downside of Low-End Luxury Cars,” Mark Clothier, *BloombergBusinessweek,* July 21, 2014; “Tiffany Moves Down Market and Makes a Mint,” Kyle Stock, *Bloomberg Businessweek*, May 21, 2014.

See also, U.S. News “Cheap Luxury Cars,” Will Maley, August 3, 2016, <https://cars.usnews.com/cars-trucks/cheap-luxury-cars>

Additional Note: In a similar manner, the motorcycle maker Buell which is known as one of the best and most expensive bikes in the world, and having a proud racing tradition, is now testing the waters of entering the market for low-price motorcycles.

Source: “High-End Motorcycles Meet India’s Mopeds,” *Bloomberg Businessweek*, August 25, 2014, pp 52-53.

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

The solution is based on information obtained from the Federal Reserve Board site, in May 2017. At that time data was available for the four years, 2013 to 2016.

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

Gross Domestic Product (Table F2, line1)

Gross domestic product gained 11% from the period 2013 to 2016, rising from $16,692 billion in 2013 to $18,869 billion in 2016. Overall this is a sign of a continuing economic recovery. There was a 13% increase from 2011 to 2014. This can be compared to the 2007-2009 period of the recession in which there was virtually no gain in GDP. GDP is an important measure of economic activity, so this is clearly a positive sign for the economy.

Home Mortgages (Table D3, line 3)

Mortgage debt rose to $9,754 in 2016 from $9,467 in 2013, a 3% increase.

In contrast, home mortgage assets fell 5% from 2011 to 2014, continuing the pattern of 2007 to 2010. Media reports during this time have explained that the housing bust was a key factor in the slow economic recovery of 2009-2014, and this data is consistent with that.

Overall, these figures reflect an economy very much recovered from the Great Recession of 2007-2009.

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

The rate of innovation is higher in software and services, semiconductors, pharmaceuticals, 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.

**1-48 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 parts 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.

For a broad example of the risks that CFOs from many industries are concerned about, the following reports a 2012 survey by CFO magazine; in that survey CFOs found the following to be the most important risks in their firms (and percentage of CFOs indicating the risk is important to their firm):

Customer demand/profitability (66%)

Workforce capabilities/talent management (41%)

Recent or pending regulatory requirement (35%)

Commodity costs (27%)

Technology/data security(22%)

Risks in markets overseas (14%)

Availability of credit/bank relationships (13%)

Inflation (9%)

Natural disasters (7%)

Tax policies (5%)

Source: Patrick H. Stroh, “Enterprise Risk Management at United Health Group (UHG),” *Strategic Finance*, July 2005, pp 27-35; Kate O. Sullivan, “Keeping Cool in the Hot Seat,” CFO Magazine, March 2012, pp 39-424

A January 2017 survey in *Business Insurance* shows that at this time CFOs are most concerned about data breaches and cyber attacks.

<http://www.businessinsurance.com/article/20170119/NEWS06/912311495/Top-operational-risks-equipment-failure-cyber-attack-natural-diaster>

**1-49 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 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 is consistent with the company’s strategy. However, the incentive might be more fair and effective if it could be targeted to each employee; also, there might be difficulty in measuring performance at the individual employee level.

**1-50 Strategy: Brand Value (15 min)**

1. The best answer is differentiation for each of the 20 companies.   
The reason is that these firms are the top twenty brands. Having brand recognition is an important way to succeed for a differentiator.

2. 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 its analysis.

As an aside, the list of top 10 brands for 2016 has 9 of the 10 companies in both the 2014 and the 2016 list, with Toyota and Samsung entering the list in 2012, Mercedes-Benz entering the list in 2014 and Amazon.com entering the list in 2016. Many of these firms have been on the list for several years.

For a discussion of how brand value relates to the firm’s book value and the firm’s market value, see Gary Cokins and Nick Shepherd, “The Power of Intangibles,” *Strategic Finance*, May 2017, pp 32-39, and the article by Alfred King and Una Newman, “Brand Value: Hidden Asset in Plain View,” *Strategic Finance*, July 2015, pp 23-29.

Analysis of Innovation Ranking:

Note that Apple, Toyota, IBM, Google, Toyota, Microsoft, Tesla, Amazon.com and Samsung 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.

Further Related Information: Countries can also be ranked on innovation. *Bloomberg Businessweek’s* 2014 rankings, in order, are: 1. South Korea, 2. Japan, 3. Germany, 4. Finland, 5. Israel, 6. United States, 7. Sweden, 8. Singapore, 9. France, and 10. United Kingdom.

Source: “What’s in the Innovation Sandwich,” *Bloomberg Businessweek,* January 19, 2015, pp 49-51.

**1-51 Strategy; Customer Service (15 min)**

Note:

The USA Today report is at:

<https://www.usatoday.com/story/money/business/2014/07/19/customer-service-hall-of-fame/12690983/>

* + - 1. All 10 of the listed companies are best described as differentiators, based on customer service.
      2. Most of the companies in the USA Today report 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 recognition. The web site above goes into some detail for each company as to why it was selected. Note again the overlap between the lists of companies with top brands, for innovation, and for customer service. Apple and Amazon.com are on all three lists.

**1-52 Strategy: Cost-Cutting in the Pharmaceutical Industry, Ethics (15 min)**

The point of this question was to examine a company that operated in a differentiation-oriented industry, pharmaceuticals, but was behaving in some ways like a cost leader. So the answer to the required question requires some discussion, and the problem is best used for class discussion.

Background:

In 2014 Valeant was in the midst of a number of acquisitions of other pharmaceutical companies (see below for more information on Valeant in 2014). It was apparent that a strategy emerged in which Valent reduced expenditures on research and development and raised prices on drugs obtained in these acquisitions, sometimes as much as 10 times the original price. In September 2105, the U.S. House oversight committee began an investigation and Valeant’s stock began a steep slide from a high of approximately $250 in August to a low of approximately $30 in March 2016. There were additional charges of false sales and anti-competitive practices causing investigations by the Food and Drug Administration (FDA) and also the SEC. While it is not clear that Valeant’s pricing strategy was illegal, it is clear that the strategy was not sustainable in the face of furious consumers, regulators, and legislators. In March 2016, Valeant’s board fired the CEO and began selling some businesses to pay off the high debt from the purchases in 2014 and 2015.

In 2017 the stock price of Valeant continued to fall and there is on-going discussion of whether the firm will now fail. Instead of a $41 B market capitalization in 2014, the market capitalization for Valeant was $5.5B in June 2107. The Motley Fool web site advises caution about any further investment in Valeant. <https://www.fool.com/investing/2017/05/05/what-to-expect-from-valeant-pharmaceuticals-q1-res.aspx>

Answer:

It seems clear now that, apart from generic drug manufacturers, successful pharmaceuticals are likely to compete on the basis of differentiation, that is, new and improved drugs that are safe and appropriately priced to cover research and development costs. Valeant’s attempt to succeed by cutting research and development costs (a cost leader strategy) and increasing price was not sustainable.

**1-52 (continued -1)**

Additional Information on Valeant Operations in 2014 . Valeant operates in the pharmaceutical industry, an industry that is known for its reliance on innovation, attention to safety, and customer confidence rather than cost-reduction. This is true for manufacturers of generic drugs as well as companies the manufacturer patented medicines. Companies in the pharmaceutical industry are typically differentiators as a result. In contrast, it appears that Valeant has chosen a cost leadership strategy. What Valeant does is to purchase a pharmaceutical company with successful products, and then remove the research and development programs at these firms, to increase profits in the short term.

As a reporter for ProPublica (an independent newsroom) indicated in 2014, “Wall Street loves companies that live fast and run thin. Some flourish, but many die young. It’s not clear yet where Valeant will end up.”

Jesse Eisinger, “Valeant’s Cost-Cutting Ethos May Yet Give Wall Street Indigestion,” *The New York Times*, July 31, 2014, p B6; see also, David Geller, “Botox Maker Allergran Sues Valeant and Ackman, Claiming Insider Trading,” *The New York Times*, August 2, 2014, p B2.

**1-53 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.

The AICPA offers the CPA certificate in conjunction with the states’ Boards of Accountancy. In addition to the CPA certificate, the AICPA offers, in partnership with the Chartered Institute of Management Accountants (CIMA, UK), the Chartered Global Management Accountant (CGMA) certificate which is patterned in part after the CIMA’s Certificate in Business Accounting.

**Revision of the CPA Exam**: A revised CPA exam appeared in April 2017. The main effect of the revision was to reduce the number of multiple-choice questions and to increase the number of task-based simulations. The new exam places a greater emphasis on higher-order skills of analysis and evaluation.

For more information on the revised CPA exam, see: “Last-Minute Guide to the Updated CPA Exam,” by Ken Tysiac, *Journal of Accountancy*, April 2017, pp 40-43.

**The CMA Exam has two parts**

(<http://www.imanet.org/cma-certification/become-a-cma/become-a-cma-overview>):

|  |  |  |
| --- | --- | --- |
|  | | |
| **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 is the globally recognized, advanced-level credential appropriate for accountants and financial professionals in business. Achieving the CMA demonstrates your professional expertise in financial planning, analysis, control, decision support, and professional ethics – skills that are in demand by organizations around the world.”

**New Certificate from the IMA**:

The IMA has also introduced a new (2017) certification program, Certified in Strategy and Competitive Analysis (CSCA). This certificate will help the management accountant to achieve the career success envisioned in the definition of management accounting by focusing on the strategic role of the management accountant:

**Management accounting** is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the ***formulation and implementation of an organization’s strategy.***

The CSCA exam will have three parts: (1) Strategic Analysis (25%), (2) Creating Competitive Advantage (40%), and (3) Strategy Implementation and Performance Evaluation (35%). One must be a CMA to be able to sit for the CSCA exam.

See: “Get the CSCA Credential to Accelerate Career Growth,” Dennis Whitney, *Strategic Finance*, April 2017, pp 29-31.

**1-54 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** |
| **Institute of Management Accounting** | * *Strategic Finance* magazine * *Management Accounting Quarterly* | * conferences * courses * technical committees | * CMA certificate * CFM program (certificate in financial management) * Strategy and Competitive Analysis (CSCA). |
| **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) |
| **Financial Executives International** | * *Financial Executive* magazine | * conferences, courses * technical committees | * research foundation   (FERF) |

**1-55 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. Since 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.

**1-56 Ethics; Who, What, and How?; Use of Internet (20 min)**

1. The three most common behavioral indicators are (see Executive Summary and Figure 96 of the Report):
   1. Living beyond ones means
   2. Financial difficulties
   3. Unusually close relationship with vendor or customer
2. Smaller companies are more vulnerable to fraud. This reason is likely that the smaller companies do not have the resources to provide the needed controls to detect and prevent fraud (see Figures 40,41,and 42)
3. $150,000 (see Executive Summary of Report)
4. The top three means by which occupational fraud is detected, in order (see Figure 21):
   1. Tip
   2. Internal audit
   3. Management review
5. Hotlines can be very helpful. In particular they dramatically increase the effectiveness of the most important detection device, the employee tip (see Figure 34).

**1-57 Most Ethical Companies (15 min)**

The Ethisphere annual report is likely to be interesting to all three, the business manager, the regulator, and the investor.

The business manager can use the information, together with information from other sources, to benchmark the manager’s own company in the status of the ethical environment in the manager’s company. If your company is not on the list, or not nominated, the CFO and other managers should consider if failing to be listed or nominated reflects deficiencies in the ethical environment. The assumption is that the company’s management is concerned to maintain an effective ethical climate. The Ethisphere report can be a catalyst for needed change.

The regulator who is concerned with accurate financial or other reports from the company may use the information to serve as a basis for better understanding of what a successful ethical climate looks like, to identify industries where ethical climates are more advanced, and to provide a starting point for assessing the reports and behaviors of a company that falls under that regulator’s jurisdiction.

Many investors use information such as the Ethisphere report in helping to determine whether to invest in a particular firm or industry. A positive report on ethical climate for a firm, together with other information, is often the basis for such decisions by the “ethical investor.”

**1-58 Changed Conditions and Ethical Behavior (10 min)**

This case is intended for class discussion. The goal is to have a discussion of the role of conditions that might affect the accountant’s ethical judgment. In this study, the researcher found that most accountants chose to approve the financial statement in case (b), where the misstatement is spread over three years. The researcher argued that “unethical acts can become an integral part of the day-to-day activities to such an extent that individuals may be unable to see the inappropriateness of their behaviors.” A short class discussion should uncover other arguments, such as a different impact on investors between the two cases. The discussion should include a recognition and discussion of at least three important factors:

* In each case, there is unethical behavior, the fact that it is spread over three periods does not affect that. There is an intent to deceive in both cases.
* Accountants and auditors use the concept of materiality to determine when a misstatement must be recognized in the financial statements; how does materiality work with unethical judgment in this case?
* The size of the misstatement will likely impact the ability of the accountant or auditor to detect the misstatement (assuming the accountant is not the perpetrator)

Source: Alina Tugend, “Doing the Ethical Thing May be Right, But It Isn’t Automatic,” *The New York Times*, November 19, 2011, p B5.

**1-59 GM Ignition Defect, Brand Value (20 min)**

This problem is best used for class discussion, as there are a likely to be a wide range of views expressed and an opportunity for useful dialogue within the class regarding the ethical issues in the case.

1. In situations like this the management accountant should consider the IMA ethical standards of competence, confidentiality, and integrity.

The standard of competence requires the management accountant to perform their duties in accordance with “relevant laws, regulations, and technical standards.” This would include required reports to the National Highway Traffic Safety Administration (NHTSA) regarding product safety.

The standard of confidentiality is important in this situation because it requires the management accountant to keep information confidential unless legally required or otherwise authorized to disclose it. Note that the IMA guidance on application of ethical standards states that the disclosure should begin *within* the company and then proceed to an IMA Ethics Counselor and then to an independent attorney.

The standard of integrity is applicable because it guides the management accountant to refrain from conduct that would impair the accountant’s ability to act ethically and also to refrain from activities that might discredit the profession.

Overall, a key lesson from the GM defect case is that a company must have an open and ethical culture in which problems like this one are promptly identified, communicated internally (and externally when appropriate), and dealt with appropriately. To address GM’s internal issues on the matter and to increase transparency within the company after the February announcement, GM formed a program, “Speak Up for Safety,” to motivate employees to act in the desired manner.

2. There has been much controversy and speculation about the cause of the delay. Some of the reasons offered are as follows:

* Some would argue that cars cannot be perfectly safe and that safety issues will occur with all cars, that is, “buyer beware.” The counterpoint to this argument is that once detected, the defect should have been promptly disclosed.

**1-59 (continued -1)**

* Others would argue that the vehicles involved were low-cost vehicles and for this reason, as above, the company bears less responsibility for the safety risk. The counterpoint is the same as above.
* Some would say that GM was distracted during 2005-2010 in dealing with pending bankruptcy, then bankruptcy in 2009, and recovery thereafter. As a result, the defect problem was not given the attention it deserved.
* Individual employees who could have disclosed the matter likely feared that so doing would damage their careers at GM or in the industry. Note from the answer to part (1) above that management accountants’ responsibility for confidentiality affects their ability to disclose
* GM has noted at least in some cases unrelated to the ignition defect that the restructuring agreement of July 10, 2009 (following bankruptcy) created a “New GM” that was protected from claims arising from events prior to July 10, 2009. CEO Mary T. Barra has indicated that GM will not plan to use this argument in the defective switch case, but rather to rely instead on financial settlements through the company’s litigation compensation program headed by Kenneth R. Feinberg, a victim compensation expert.

1. While the sales of GM vehicles has not shown an effect immediately following the announcement of the ignition switch defect, it is unknown whether there will be a longer term effect on the GM brand. The financial news service, **24/7 Wall Street**, reports that GM is the most damaged of the “Nine Most Damaged Brands” (<http://247wallst.com/special-report/2014/05/13/americas-nine-most-damaged-brands-3/>).

In 2017 the potential longer term negative effect of the scandal on GM sales can be seen as modest at best. One possible reason for this is that most of GM’s sales in this period were in China.

<https://www.statista.com/statistics/304367/vehicle-sales-of-general-motors-by-country/>

Source: Curtis Vershoor, “Ethics Missteps Damage Brand Value,” *Strategic Finance*, July 2014, pp 11-13, “History Guides Other Cases of G.M.’s Behavior,” *The New York Times*, March 28, 2014, p B1; Hillary Stout, Bill Vlasic, Danielle Ivory, and Rebecca R. Ruiz, “G.M. Prepares to Count Cost of Suffering,” *The New York Times*, June 22, 2014. pB1.

**1-60 The European Union; Strategy; Globalization (15 min)**

Prime Minister May is restating the case for globalization and EU membership that has driven her country’s economic and political policies for decades. These policies have brought success to many sectors of the UK economy. The forecast however is that most industries will suffer as a result of Brexit, some more so than others. Some industries have a relatively high rate of exports to other EU countries, such as food and beverage. Others have a relatively high level of employment from other EU countries, such as business services. These are the industries that will be most affected. The amount of the effect will depend on the nature of the final agreement that the UK makes with the EU when it does exit the EU. For example, the final agreement might allow the UK to preserve some key elements of its trading advantages with the EU, or in contrast it might save some of the benefits of labor movement between the UK and the EU countries. Or, some balance of these two factors. The final determination of the agreement will determine which industries are most affected.

Management accountants working in those industries in the UK will have to refine their organization’s strategy to more effectively compete in the new circumstances of the global economy. This could mean a refocus on cost control for cost leadership firms and for some firms, an entirely new strategy might be needed. For example, a company that competes on the basis of cost leadership for its product might seek new ways to reduce cost, possibly by increasing the amount of automation that is used. Likely these firms will use target costing to a higher degree to help identify new ways to provide a competitive product at a competitive price.

On balance, it is fair to say that there is a lot of uncertainty about how the anti-globalization movement will affect firms around the world. The changes in business over the next few years should give us an idea.

Source: “Despite Brexit, May Says Britain will Lead New Era of Free Trade,” Steven Erlanger and Steven Castle, *The New York Times,* January 20, 2017, p A10; “Merkel Meets Trump, the Defender Versus the Great Disrupter,” Mark Landler, *The New York Times,* March 18, 2017, p A13.

“What Does Brexit Mean for the Key Parts of the UK Economy?” Christopher Williams, *The Telegraph*, July 2, 2016. “European Bank Aims for Control in London After ‘Brexit’,” Jack Ewing, *The New York Times,* June 24, 2017. “Something Else to Blame on Brexit,” Jack Sidders, *Bloomberg Businessweek*, September 11, 2017, pp 28-29.

**1-61 The North American Free Trade Agreement; Globalization; Strategy (20 min)**

There are a wide range of possible answers. The problem is designed for class discussion of the major points in the consideration of NAFTA. In covering the problem, I would make sure that the class considers:

* + Consideration of a recommendation that the trade agreement be amended to include e-commerce, labor protection, and environmental protection if possible.
  + Employ caution and allow plenty of lead time in making large changes, as the global supply chains of many companies (see example below) have been adapted to deal with the competitive situations they face.

An example of how NAFTA is used by automakers follows. Consider the life cycle of the electric control circuit board used in the manufacture of electric car seats:

First, electric components including resistors and capacitors are purchased from an Asian supplier.

Second, the components are used in the production of a circuit board in Mexico

Third, the circuit board is shipped to an El Paso, Texas warehouse to avoid paying Mexican value-added tax on the production of the board

Fourth, the circuit board returns to Mexico where a factory owned by a Norwegian company installs the board into an electric motor to complete the assembly of the part

Fifth, the completed part is shipped to the Lear Corp. auto seat manufacturing plants near Dallas, Texas and Ontario, Canada where Lear installs it into the car seats which are then shipped to the nearby auto assembly plants.

Note how many times the circuit board moves from country to country and occasionally over a long distance.

A question to be resolved in this process of reviewing NAFTA is the use of bilateral trade agreements (between two countries) as opposed to multilateral agreements (between three or more countries). Much of the trade agreement effort in recent decades has focused on multilateral agreements. NAFTA is a multilateral agreement. The two approaches differ in terms of how quickly and easily they are accomplished, how comprehensive they are, and other dimensions. A good discussion of the pros and cons is at:

<https://www.wto.org/english/news_e/sppl_e/sppl53_e.htm>

Another issue is the winners and losers that appear in any trade negotiation. Often the key winners are consumers, potentially a very large group, that benefit in terms of better access to a lower price and potentially higher quality products. The losers are often the producers in a given country that are no longer competitive with the producers in another country; the lack of competitiveness may be the result of unfair labor practices or poor environmental practices, as well as manufacturing efficiency, that make a country’s products cheaper to produce. It is the goal of trade policy to achieve an appropriate balance between those individuals and values involved.

It is interesting to note that while China and other Asian countries have been the locus of many of the manufacturing jobs that have left the U.S., the growth of the Asian markets and the increased living standards of the people in those countries has resulted in demands by the Asian workers for better pay and work conditions. This in turn has meant a shift in some manufacturing from the Asian countries to Africa and other countries where labor is plentiful and inexpensive.

How this impacts the management accountant: Management accountants are likely to be faced with a need to refocus or change strategy and to develop new cost management systems that are appropriate to the new competitive environment. Suppose that a link in the company’s supply chain is removed as a result of changes in the trade agreement. The supply chain will then need to be rebuilt to accomplish the manufacturing objective with competitive quality and cost. Also, a company that succeeds on the basis of cost leadership might need to seek new ways to reduce cost, perhaps by automation or by sourcing of other domestic suppliers. Other techniques can also be helpful, especially target costing which can be used to redesign the product for greater production efficiency. Additional techniques will be covered later in the text, especially chapters 5, 13, and 17.

Source: “A Supply Chain in the Crosshairs,” Thomas Black, *Bloomberg Businessweek*, February 6, 2107, p 13. “On Trade, a Politically Feisty Trump Risks Economic Damage,” Peter S. Goodman, *The New York Times*, April 30, 2017. “Made in China? Not Forever,” Keith Bradsher, *The New York Times*, June 1, 2017, p B1.