The Impact of Costs on Differentiation Strategies

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"The marketing strategy options available to organisations today are based on relative costs and differential alternatives."

The purpose of this essay is to provide a discussion of the above statement, based on a review of historical and contemporary approaches to business strategy. In addition, this essay will examine the role of accounting information in the evolution of business strategies.

Strategy is often a complexly defined term, however, at its simplest level it answers two questions: where does the organisation want to go *and* how can the organisation get there? Marketing strategy requires the planning and coordination of marketing resources and the integration of marketing mix to achieve the desired result, and may cover a broad range of issues such as pricing, promotion, positioning and segmentation (Kotler, Brown, Adam & Armstrong, 2004). Ultimately however, an organisation's marketing strategy is dependent on the business's general strategy direction (Note 1).

In the field of generic strategy there are few that had more influence than Michael Porter in the 1980s. First to establish the concept of competitive advantages, Porter asserts there are two generic strategies available for business: a cost leadership or differentiation strategy.

		Competitive Advantage	
		Lower Cost	Differentiation
Competitive Scope	Broad Target	1. Cost Leadership	2. Differentiation
	Narrow Target	3A. Cost Focus	3B. Differentiation Focus

Figure 1 Porter's Generic Strategies (source: Porter, 1985, p.12)

In the cost leadership strategy, a business aims to operate at a *lower relative cost* than its competitor, while preserving parity in product offering. In contrast, a differential position means occupying a *differentiated position* in the market, so that customers perceive the firm's offerings as delivering superior customer value than its competitors, and are prepared to pay a premium price for it. Porter believes that all firms can be "winners" in their industry if they pursue either one strategy, as long as the firm is "single-minded" and not "stuck-in-the-middle" of the two strategies.

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		Relative Costs	
		High	Low
Degree of Differentiation	High	1. Market Niche	2. High Differentiation
	Low	3. Disaster Area	4. Cost Leadership

Figure 2 Strategy Options based on relative costs and differential alternatives

Under Porter's views of generic strategy, the role of accounting information is to cost attributes of products/services provided by the enterprise (Bromwich, 1990). For example, in pursuing a cost leadership strategy, the accuracy and minimisation of cost is crucial to the sustainability of the enterprise's product strategies so that entry by competitors is unprofitable in the face of these strategies. Likewise, under a differentiation strategy, organisations must have accurate cost approximation of attribute that provide a differential value, and those costs must be carefully monitored against the value customers are willing to pay a premium price for.

Traditionally, Porter's strategies are carried over a long horizon (approximately a decade), and conventional accounting techniques are sufficient to cover the needs of managers.

Although highly contentious, Porter's ideas have found an abundance of supporters and have established the most commonly accepted dogmas of competition-based strategy: the value-cost trade-off. Strategy is conventionally believed to be a choice between differential alternatives, or lower relative cost.

In 1990s, business environments have changed and Moss-Kanter claimed in her *New Wisdom* that businesses are "shifting away from defining their strategies in terms of lower cost and differentiated features." Rather, they are the fundamental source of competitive advantage, and successful businesses are defining their strategies in terms of core competence, time compression, continuous improvement and relationships.

Further in 1998, Eisenhardt and Brown assert that Porter's strategies have become inadequate in the highly volatile and hotly competitive markets faced by managers. Simply, they argue that it is no longer possible for organisations to choose an attractive market, create a vision, build up core competencies and position themselves. In the contemporary environment, Eisenhardt and Brown argue three things:

- Strategy is temporary, complicated and unpredictable. Today's winning strategy may not be tomorrows.
- Organisation drives strategy. Too much is happening, too fast, for "strategy-first approach".
- Timing is essential – not just speed, but rhythm and pacing, reacting and anticipating.

Essentially, there is no room for businesses that operate a long-term, singular generic strategy. Businesses are forced to compete "on the edge of chaos", and often strategies are both cost effective and offer a differential benefit, or will switch frequently between the two generic objectives in a relatively short time horizon.

Finally, in 2005, Kim and Mauborgne argued in *Blue Ocean Strategy* that in order to succeed, an organisation must simultaneously pursue both low cost and differentiation strategy. Instead of using generic strategies to "beat the competition" (Red Sea strategy), organisations can "make competition irrelevant" by creating a leap in value for customers and thereby opening up new and uncontested market space (Blue Sea strategy).

Red Ocean Strategy	**Blue Ocean Strategy**
Compete in existing market space	Create uncontested market space
Beat the competition	Make the competition irrelevant
Exploit existing demand	Create and capture new demand
Make the value-cost trade-off	Break the value-cost trade-off
Align the whole system of a firm's activities with its strategic choice of differentiation *or* low cost	Align the whole system of a firm's activities in pursuit of differentiation *and* low cost

Figure 3: Red Ocean Versus Blue Ocean Strategy (source: Kim and Mauborgne, 2005, p.18)

The cornerstone of blue ocean strategy is value innovation, which is created in the region where a company's actions favourably affect both its cost structure and its value proposition to buyers.

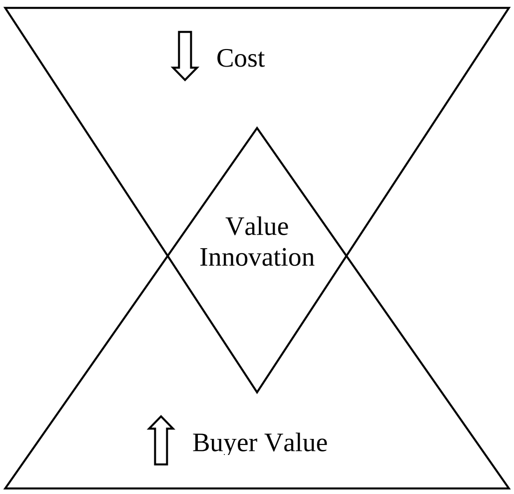

Figure 4: The simultaneous pursuit of Differentiation and Low Cost (source: Kim and Mauborgne, 2005, p.16)

Kim and Mauborgne (2005) argue that organisations can drive costs down by eliminating and reducing factors an industry competes on, while simultaneously driving value up for buyers by raising and creating elements the industry has never offered. For example, Cirque du Soleil is a blue ocean strategist who "reinvented the circus" by combining traditional "fun and thrill" circus performance with the intellectual sophistication and artistic richness of modern theatre. While the major circus players such as Ringling Bros. and Barnum & Bailey were busily benchmarking each other and raising its cost structure in a shrinking market (getting famous clowns, more lions), Cirque du Soleil created a blue ocean by creating uncontested new market space of circus-theatre experience to adult and corporate clients. In less than twenty years, Cir que du Soleil achieved the same level of profitability it took the global circus champions over one century to attain.

Contemporary business strategies, whether it's *New Wisdom*, *Competing on Structured Chaos* or *Blue Ocean Strategy*, all bring empirical evidences which clearly suggest that businesses today no longer compete solely on a lower cost or differential alternative strategy. Rather, they may compete on those fundamentals, or a combination of both strategies. So what are the implication for cost accountants and the role of accounting information?

The transition of the business environment means that accounting subsystem must shift from production-oriented accounting techniques such as absorption or marginal costing to customer-oriented techniques (Ratnatunga, 1999). Manufacturers can no longer produce and market large volumes of standard products with a relatively stable market and technological climate, as was in the days of Porter. Today the rapidly changing markets and technologies require market-driven management, and new accounting techniques must start with the customer.

For example, Ratnatunga (1999) suggests that for accounting information to be relevant to marketing strategy, conventional arbitrary bases of allocation must be abandoned. Instead, he argues the assignment of natural expenses to functional expenses, where a cost or expense is attached to a segment level only if it is expensed fully for that level (see attachment 1). Allocating expenses among functions and products would give relevant and useful product costing information to marketers and managers.

However, management accountants have recognized that traditional cost methods, despite a change in focus, are becoming irrelevant in the modern competitive environment (Hiromoto, 1991). Firms now compete in a contemporary setting characterised by intense global competition, rapid technological changes and the development of new management approaches such as Total Quality Management, Just-In-Time production and flexible manufacturing systems. Accounting systems must not only reinforce customer-oriented behaviour, but shift from a transactional processing informational mode to a decision support strategic mode.

A range of recently developed techniques, including Activity-Based Costing (ABC), Value Chain analysis, Target Costing, Product Life Cycle analysis, shareholder value analysis and Benchmarking have been proposed as ways of linking operations to the company's strategy and objectives. In their study of adoption of management accounting practices in Australia, Chenhall and Langfield-Smith (1998) found of all recently-developed accounting practices, ABC systems was the most widely promoted and adopted technique worldwide.

ABC is implemented as a supplement to traditional costing systems. Where traditional costing methods adequately measures the direct costs of products and services, the implementation of ABC can classify indirect costs to their functional levels, so that the accuracy of costs and accounting information is increased for the use of managers for strategy decisions.

Target costing represents another important management accounting tool where business strategy, marketing and accounting overlap (Gagne and Discenza, 1995). As contemporary strategies often call for lower costs combined with differential benefits, a pre-set strategic pricing is important. Instead of a cost-add approach, target pricing is a price-minus costing approach, where organisations start with the strategic price, then deducts its desired profit margin from the price to arrive at the target cost. Organisational activities are then controlled by using a target, or a market-based allowable cost, that has to be realized if the firm is to be profitable. All members of the organization must subsequently work to design and manufacture the product at the target cost.

Importantly, target costing supports product innovation, which is central to contemporary strategies and company's strategic success. In pursuing product innovation, accounting and cost management methods must assist the minimisation of existing product cost, as well as introduce new products at the lowest cost to meet customer demands.

A classic example of innovation forced by target-costing was Swatch. Setting the strategic price of Swatch at $40 to combat the $75 Japanese quartz watch, the Swiss company worked backwards to arrive at a target cost which Swatch must be produced. Given the high cost of Swiss labour and material, target pricing forced Swatch to make radical changes in its product and the production methods. By innovation in production line restructuring (simplified assembly lines), simpler designs (cutting inner-parts from 150 to 51), and cost-effective materials (plastic and cloth) Swatch arrived at a new cost structure 30% cheaper than any other watch company in the world (Gagne and Discenza, 1995).

Finally, Yasin, Bayes and Czuchry (2005) argue that for accounting systems to be effective from a strategic perspective, they must transit from the traditional closed system to an open system. A closed system (appendix 2) allows only a limited exchange of information between external parties, between each subsystem and the accounting subsystem itself. As information is not fully captured nor reported throughout the organization, a closed system is said to serve only a “scorecard function”.

An open system (appendix 3), in contrast to closed system, can capture, measure and share information among all internal and external entities. With a strategic focus, an open system must react in real time in capturing and reporting information to decision makers. This requires substantial improvements in the chart of accounts and a customer-oriented focus, as well as modifications in information systems. However, the end result is information have a real-time focus, and can be shared by all constituents to support strategic decision making.

With the changes in business environment and the emergence of contemporary strategies, Mia and Clarke (1999) found that managers are increasingly reliant upon management accounting information for decision-making. Their research work also provide empirical evidence that increasing managerial use of relevant accounting information is associated with improved business performances.

In conclusion, businesses today no longer operate solely on a lower relative cost or differential alternative strategies. Contemporary approaches to business strategy show that the conventional cost-value tradeoff is no longer applicable, and businesses may offer lower cost and differential value simultaneously or may switch between the two alternatives in short time horizon. The role of accounting information in the evolution of business strategies is that accounting information must have a strategic focus and become an integral part of the business organization, rather than operate as a separate transaction recording subsystem. By fully utilizing accounting information to make strategic decisions, managers can improve business performances.

NOTES

Four product-marketing strategy options include:
- Market penetration (existing products in existing markets);
- Market development (existing products in new markets);
- New product development (new products in existing markets)
- Related diversification (new products in new markets).

But are ultimately dependent upon the generic business strategy.

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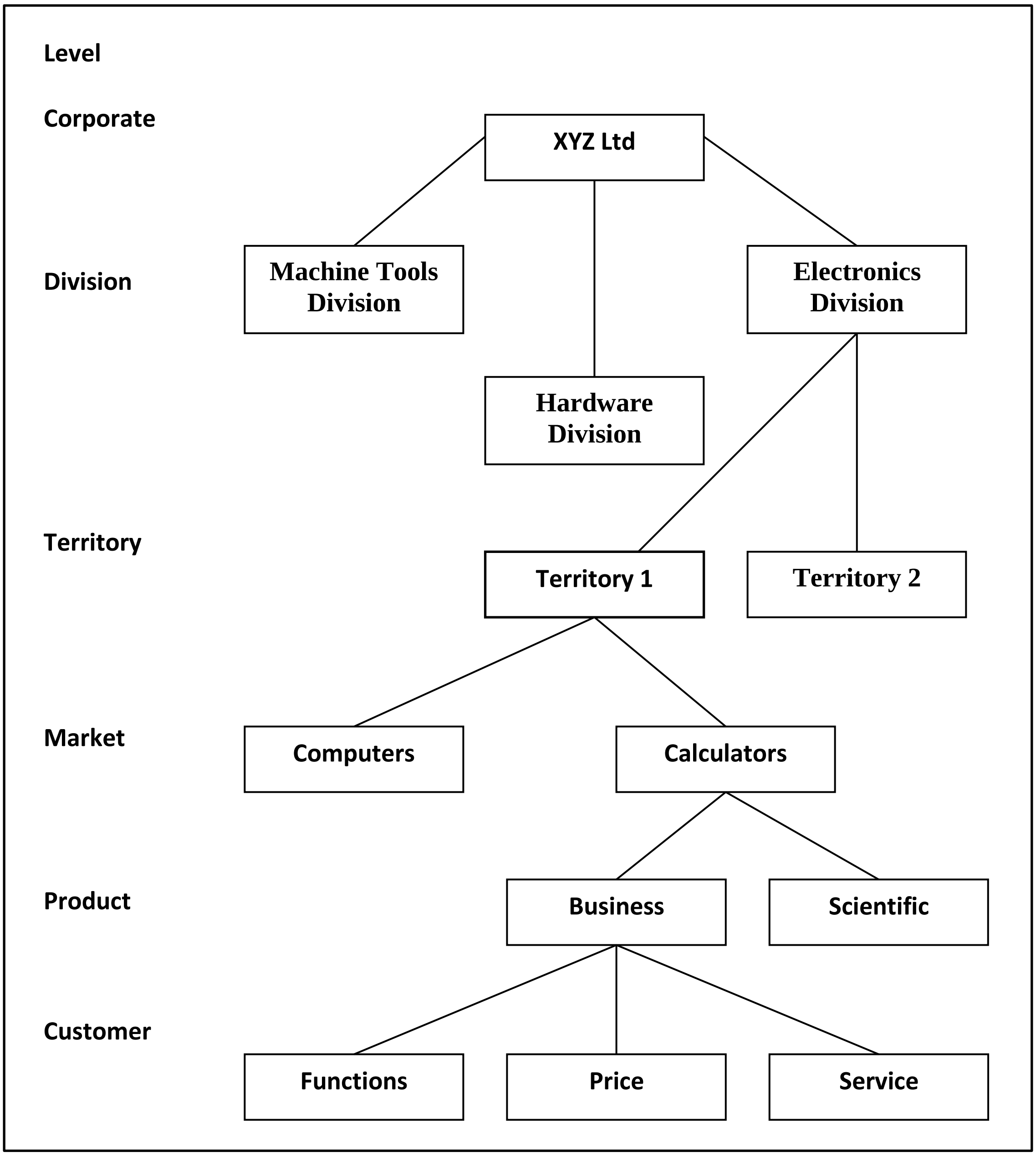
APENDIX 1

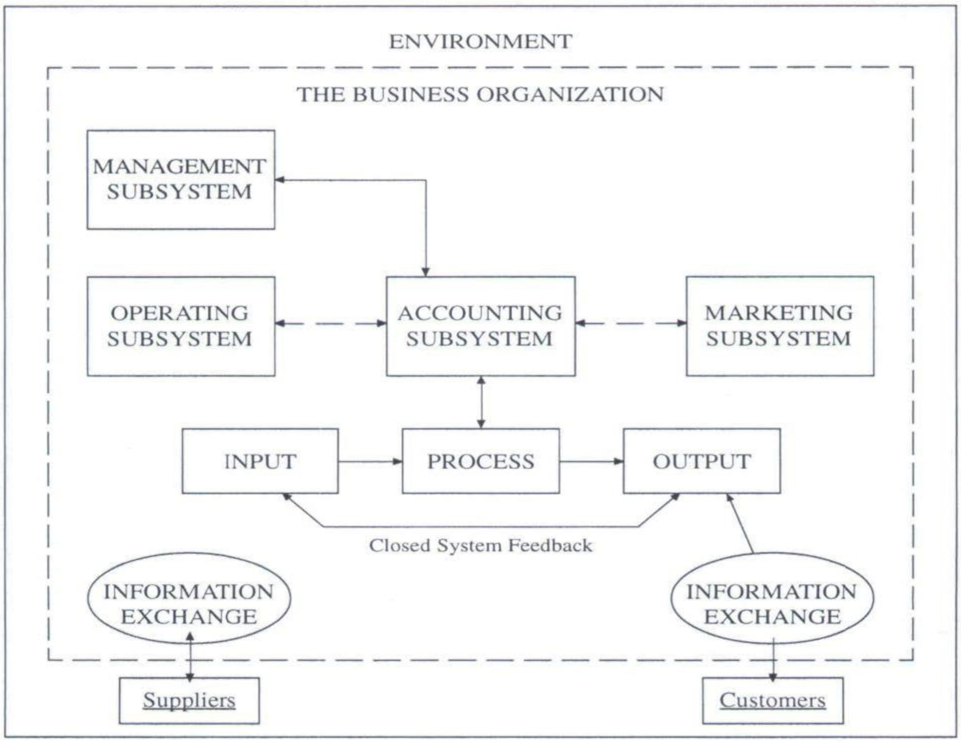
The segment levels of a company (source: Ratnatunga, 1999, p.46)



APENDIX 2

A closed system view of accounting subsystem

Figure 1. A Closed System View of the Traditional Role of the Accounting Subsystem in the Quality Orientation



APENDIX 3

An open system view of accounting subsystem

Figure 2. An Open System View of the Emerging Role of the Accounting Subsystem in the Quality Orientation