CHAPTER 6 - Competitive strategies

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6.3 The generic competitive strategies

Active reading. Note the basic definitions of the main strategies and the techniques to achieve them. If you have studied Chapter 2 of this learning resource think about the discussion of how the provision of management accounting information can assist in sustaining the competitive strategy and whether the use of certain accounting techniques supports cost leadership rather than differentiation, or vice versa, or if indeed the techniques are useful for both.

Video link Competitive strategies

[https://www.youtube.com/watch?v=GUXmne7WUP8]

Porter (1985) identified the generic strategies for competitive advantage. These strategies help to determine the basis of competition, whether cost-driven or value-driven (differentiation), and the competitive scope, that is whether to target a broad market industry-wide, or whether to focus on a definable segment. It is about positioning the organization in the market; that is, it is a conscious choice.

6.3.1 Cost leadership

A cost leadership strategy seeks to achieve the position of the lowest-cost producer in the industry. By achieving the lowest production cost, a manufacturer can compete on price with every other producer in the market and earn the higher unit profits. Several strategies aid cost leadership which include:

Economies of scale

Economies of scale require high volumes of production and possibly a limited variation in the product offering, that is, standardization of products. Mature markets may become fragmented, as the focus moves toward products targeted at specific segments of the market, which can undermine the cost advantage as the cost base rises. Some of the economies of scale can be lost.

Technological advantage

The use of technology can help reduce costs and enhance productivity. Techniques include computer-aided design, computer-aided manufacturing, just-in-time purchasing, inventory management systems, and flexible manufacturing systems.

Exploiting the effects of the learning curve

Organizations become more efficient over time and, as the expertise increases, this can result in lower average unit costs. This wealth of experience makes it more difficult for new entrants who have less expertise in the production process to obtain the same degree of efficiency. It can create a barrier to entry and reduce the threat of new entrants to the industry. New technologies, however, can undermine this advantage, increasing the threat of new entrants, illustrating the need to monitor the environment continually.

Lean thinking

Adopting the principles of lean thinking can also help to support a strategy of cost leadership. Lean thinking involves always looking to eliminate inefficiencies in the systems and minimizing overheads wherever possible. Techniques such as total quality management can aid this process.

Low-cost suppliers

Using low-cost suppliers, perhaps from overseas suppliers where labor costs may be lower, can also not only keep costs low but provide a competitive advantage. It is, however, only an advantage to the extent that competitor organizations do not adopt the same policy. Movements in the exchange rates can undermine this advantage if it is not possible to pass on cost increases to customers.

Location

The choice of location can also be a source of a cost advantage. For example, locating the operations in a less expensive area such as an out-of-town site, or where government grants are available. If, however, the production is undertaken at a distance from the market, there could be a trade-off between the cost of production versus the cost of transportation. The most advantageous scenario is where low-cost production can be undertaken close to the markets served.

6.3.2 Differentiation

Differentiation is providing a product or service that is significantly different from the competitor offers, and the difference is valued by and effectively communicated to the customer.

Mintzberg (1988) suggested that there are several forms of differentiation. Image differentiation, in which the marketing strategy is used to create a distinct image or brand. Support differentiation that provides a distinctive service element during and after the sale. Quality differentiation, where high levels of reliability, durability, and performance are associated with the product. Design differentiation in which the product design includes unique features. Price differentiation in which a low-cost base enables the organization to compete on price. This last variation is the same as Porter’s cost leadership strategy, suggesting that an organization can differentiation its market offering by price. Finally, Mintzberg includes a category of undifferentiation in which none of the previous elements are emphasized.

There are other ways of differentiating the market offering that has been identified by researchers, for example, by location, positioning, technology, and innovation. The key, however, to any competitive advantage is gained through the characteristics of an organization’s products or services that satisfy customer needs more directly or better than the competitors. As with cost leadership, several techniques can be used to aid a strategy of differentiation.

Strong brand image

The development of a strong brand image can help to create a barrier to entry as it takes time and money to develop the brand. New products and product variations can be generated from a strong corporate or product brand. In today’s environment, taking care not to damage the corporate brand is a significant factor in maintaining the corporate image, especially in the context of corporate scandals or celebrity endorsements. Indeed, accounting scandals of late, such as accounting fraud or tax avoidance, can impact on an organization’s brand. Thus, the accountant has a role to play in maintaining the corporate image.

Features and functionality

Developing features and functionality that provide the differentiating factor can provide a competitive advantage. A key element here is that the differentiating factor must be valued by the customer to support a higher price. Techniques such as value engineering and target costing (see section 7.8) can be used to help develop viable products that have distinctive features to the competition. There is a danger that in weak economic conditions, such as a recession, demand for differentiated products may reduce as consumers switch to low-cost products.

Product augmentation

A strategy that is followed by many organizations in today’s customer service-led economy is to augment the product offering to provide additional elements such as after-sales support. Techniques such as the analysis of the value creation system (see section 4.9) can be used to help determine where value can be added to the customer.

Value system

Elements of the value system such as information technology development or human resource management can be used to create new products or service elements, for example, enhanced customer service, flexibility to customer demand to create the ability to customize products. As with cost leadership, new technologies available can provide competitors with the ability to erode this advantage.

Effective marketing campaigns

The consumer markets are becoming more sophisticated, and the differentiating features of a product need to be communicated to consumers. Hence, the product needs to be backed up by effective marketing, but equally, the product must back up the marketing. Consumers are quick to spot that the product does not live up to the marketing claims with a resultant reduction in the credibility of the brand.

6.3.3 Focus (or niche) strategy

In a focus strategy, an organization concentrates its attention on one or more segments or niche markets and does not try to serve the entire market with a single product. Information technology can be useful in establishing the exact determining characteristics of the chosen niche, using existing customer records. For example, an analysis of the customer base using customer profitability analysis (see section 4.7) may indicate a highly profitable segment in which the organization has a competitive advantage. Therefore, the adoption of a focus strategy may be beneficial.

A focus strategy is often said to be adopted by organizations that lack the resources to service the total market. It can, however, be a conscious decision to focus on a segment, or segments, of the market regardless of resources available, if this is a more profitable strategy. The focus of the strategy can be on cost or differentiation.

(a) A cost-focus strategy aims to be a cost leader for a segment(s) of the chosen market
(b) A differentiation-focus strategy pursues differentiation for a chosen segment(s).

There are several advantages to adopting a focus strategy.

Focus on customer type

The organization can focus its resources on satisfying the needs of a specific customer type and thus does not necessarily spread itself too thinly by trying to fulfill a range of customer needs. A difficulty here is that the organization is limited somewhat by the growth in the market segment. It emphasizes the need to monitor changes in the environment.

The following example illustrates how a change in the business environment can affect a focus strategy. An accountancy trainer in the U.K. decided to focus its business on providing training to large accountancy firms and only provided training towards the Institute of Chartered Accountants in England and Wales (ICAEW) professional body’s qualifications. It did not offer, as did its competitors, training for other more globally oriented professional organizations such as the Association of Chartered Certified Accountants (ACCA) and Chartered Institute of Management Accountants (CIMA) qualifications. Shortly after the decision had been taken and implemented, the U.K. went into recession, and the large accountancy firms, who typically put their trainee accountants through the ICAEW professional qualification route, began to reduce their graduate intake, reducing the number of trainees that required training. The training organization got into trouble and was eventually taken over by a competitor organization offering training for the full range of professional qualifications.

Niche market operation

An organization that dominates a niche market can reduce the amount of competition to which it is exposed. Technology changes can undermine this advantage by enabling the production of small volumes at a lower cost or providing the service more speedily. For example, on-demand printing made low-volume and specialist books a viable option for both large and small organizations.

6.3.4 Example of competitive strategies

Table 6.1 provides examples of competitive strategies and the techniques employed to support them.

Table 6.1 Examples of competitive strategies

Cost leadership	
Walmart	Everyday low prices to attract customers Large-scale and efficient supply chains High volumes and economies of scale
McDonald’s	Standard processes Division of labor Centralized purchasing
IKEA	Sourcing of products in low-wage countries Basic level of service, little after-sales service provision
Low-cost airlines such as TWA, Jetstar	No-frills travel Quick turnaround
Differentiation	
Apple	Technology advantage User interface
Mercedes-Benz	Prestige vehicle Quality image Precision engineering
Nike	Association with successful sports personalities Range of specialist shoes and clothing High-profile brand

Focus	
Oscar Health Insurance	Focuses on the New York market only Uses a slogan of "No more referrals." Allows customers to talk to a doctor to tailor the quote
Whole Foods	Focuses on local stores taking away the feeling of big store image Promotes a "greener" lifestyle

Learning activity. Think of other examples relevant to your home country where you could classify the strategy being adopted by the organization as cost-led or differentiated. What, if any, is the basis of differentiation?

6.3.5 The danger of being stuck in the middle

Active reading. Think about the organizations that you identified in the learning activity. How easy was it to determine their strategy? It is becoming more difficult in some markets to identify the specific strategy being followed with any degree of precision. Note the danger where managers are not clear about following the strategy they are adopting or paying due attention to the nature of the competitive market. Also, note the use of marketing by organizations to differentiate their offering from competitors.

During the 1980s, when Porter developed his model of generic competitive strategies, it could be said that there were organizations that were definite cost leaders and those that were differentiators. Porter argued that it is dangerous to be "stuck in the middle." Figure 6.1 illustrates an organization that is attempting to occupy the middle ground.

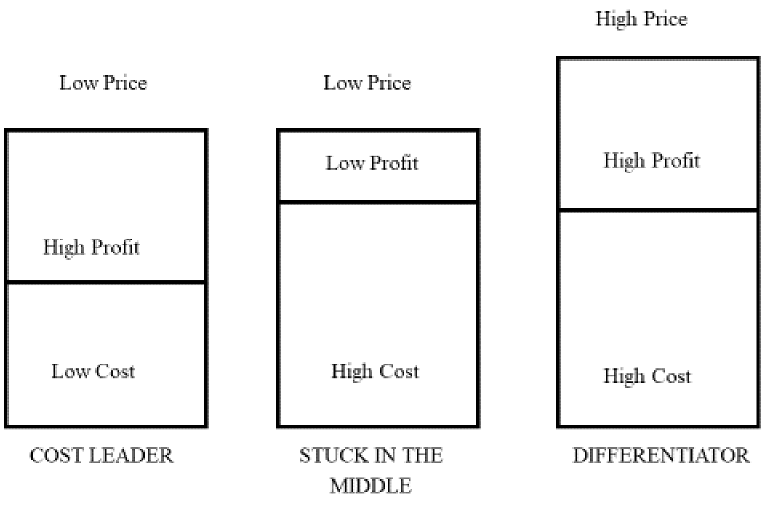

Figure 6.1 The danger of being stuck in the middle

The cost leader offers a basic product at a low cost and charges a price that provides a reasonable and sustainable profit. The differentiator has a higher cost base due to providing additional features or service elements but, as the customer values these, the differentiator can charge a higher price to produce a sustainable profit level. Now, suppose a competitor enters the market offering the same product or service as the differentiator, and therefore has the same cost base. The strategy of the new entrant is to match the price of the low-cost provider, thus providing a lower profit. This strategy could be successful in the short term as the competitor in the middle will attract customers from both the cost leader and the differentiator. In the long run, however, both the cost leader and the differentiator will react and reduce prices, as shown in Figure 6.2.

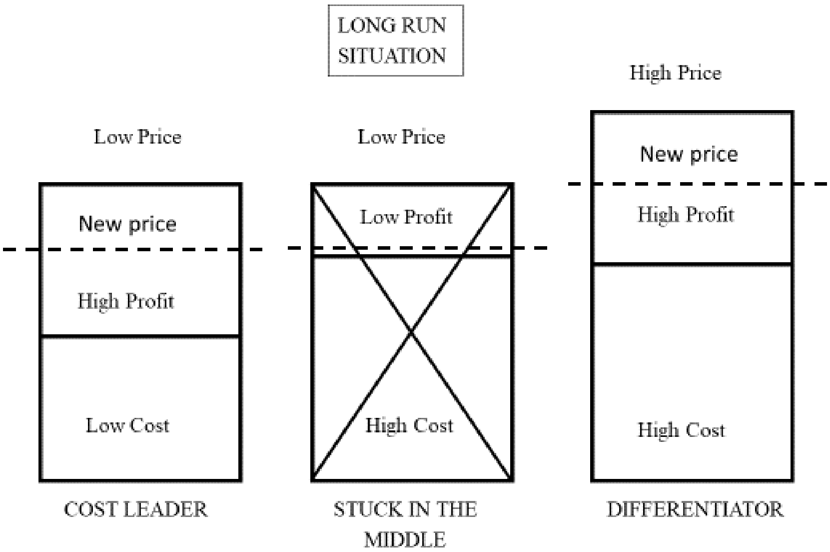

Figure 6.2 Long-run situation with price reduction

The horizontal dotted lines represent the new price due to increased competition. The customers of the differentiator will revert to the original, probably due to the established nature of the brand name. The stuck in the middle competitor will need to respond by reducing its price to the cost leader to which it had aligned its pricing strategy on entry to the market. The profitability of the stuck in the middle is now not sustainable, and the organization will likely fail. Therefore, in a competitive market, being stuck in the middle is not a sustainable strategy in the long term.

This explanation works for the markets in the 1980s when it was clear that there were cost-led and quality-led producers. However, it could be argued that today's consumer is more sophisticated and expects even the value for money products to be of good quality, which makes it more challenging to differentiate purely on the grounds of quality. The differentiating factor needs to add value to the customer. Most organizations today use marketing techniques to try and convince the consumer that their product or service is better or different than the competition, and it is probably true that all organizations are trying to keep costs to a minimum.

Therefore, to the casual observer, it often becomes blurred as to whether the company is competing based on cost or differentiation.

A former CEO of the Heinz company is reported to have said that the strategy of Heinz is to put products in cans for as little money as possible, but they use marketing to convince the consumer that "Beans means Heinz." Porter's message in the 1980s was that organizations need to be clear about what their strategy is, and not to become side-tracked to find themselves stuck in the middle with no clear strategy. It could be said that organizations that provide good quality products at low cost are stuck in the middle but, if this is the conscious decision and management are clear about the strategy, then, in essence, there is nothing wrong with this approach. Organizations in this situation may be, as some well-known supermarkets profess, striving to be a cost leader in a quality, value-added market. These markets, such as food retailing, are characterized as being highly competitive with a range of organizations that span low-cost budget providers at one end of the market to organizations that are targeting a more discerning customer prepared to pay a high price for high quality, and those in the middle. These markets can support a range of competitor organizations but are often low-margin businesses reliant on market share for their profitability.

Consumers today have high expectations when buying products or services (Ireland et al., 2011), and there is an expectation of a certain degree of quality, although it may still be true that you get what you pay for. There is, however, a growing trend for companies to adopt what might be called a hybrid strategy, that is, keeping costs low, enabling the price to be highly competitive, while offering an element of differentiation either to the product or service elements.

6.3.6 The strategy continuum

Active reading. There is a saying that the best strategy is to offer a quality product at a reasonable price. Is this stuck in the middle or taking advantage of the best of both worlds?

It could be argued that there is, in fact, a continuum between cost-leadership and differentiation, and it is finding a combination that works in the chosen markets. It is about positing the company within the market. In Chapter 3 of this learning resource, a positioning grid was introduced to undertake a cluster analysis of competitors mapped against different criteria (section 3.11). The grid for price versus quality is shown in Figure 6.3.

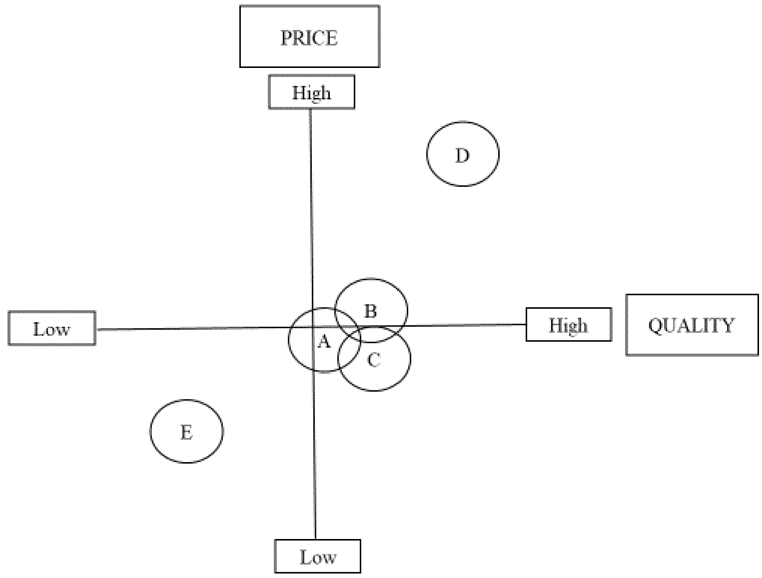

Figure 6.3 Competitor position grid.

A similar idea could be employed for cost leadership and differentiation. Figure 6.4 illustrates a slightly different representation of the choices available.

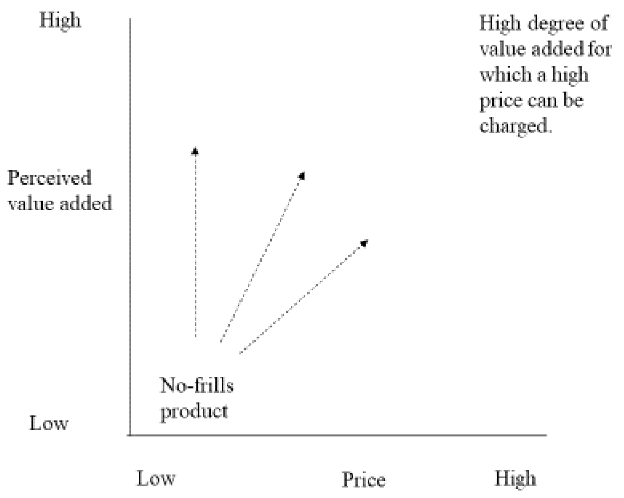

Figure 6.4 Strategic choice between the degree to which competition is based on a low-cost base or degree of added value.

The idea behind figure 6.4 is that if, for example, enough volume could be attained to keep the cost base low, it might be possible to add a high degree of added value. It is not, therefore, just a case of being a stark choice between one or the other but finding a balance between the two that provides a market offering that is sustainable in the long term. It can be used as a form of cluster analysis by mapping the competitors on the grid and identifying potential gaps in the market. Possible strategies can then be evaluated to determine if the position is sustainable in the long term. It may be evident that some strategies are not sustainable in the long run, such as providing a low degree of added value and charging a high price. Still, the process of mapping competitors can provide some useful insight into where a potential competitive advantage could be developed.

Learning activity. Think of some products and services that you enjoy. Who are the competitors in the marketplace? Where in the market is your preferred brand positioned? Do they have an element of differentiation?

6.4 Pricing strategy

Active reading. Note the strong link between accounting and marketing in developing the pricing strategy. Also, take note of the other accounting techniques where the price is a significant factor in the analysis.

Pricing strategy is an integral part of the organization's competitive strategy and can be used to support the position of the product or service in the marketplace. Price can be defined as a measure of the value exchanged by the buyer for the value offered by the seller. The primary business model is to sell something for more than it cost to produce or provide. The price should, therefore, reflect the value-added.

Price is part of the basic marketing mix of price, product, place, and promotion (McCarthy, 1964) and the extended mix said to be applicable to service sector organizations, which adds participants, physical evidence, and processes (Booms and Bitner, 1981). The price directly impacts on the income of any organization and ultimately on the profits of a commercial organization. Although there has been criticism of the 4 and 7 P's framework (see, for example, Rafiq and Ahmed, 1995), it is still widely taught. Some of the criticisms focus on the issue that although organizations attempt to integrate their marketing strategy fully, the various components of the 4 or 7 P's are developed or delivered by different departments within the organization. Customers also experience the effect of the various P's at different times, occasions, and places. Accountants are more likely to have direct input to the price component than other elements of the mix. Although techniques such as target costing (section 7.8) and life cycle costing (section 7.9) mean that input into the product or service design is possible, and some would say desirable.

When thinking about pricing, it is essential to understand the pricing objective. For example, is the objective to achieve volume sales, for example, market penetration, or to maximize profits? These indicate a low price or high price, respectively. Pricing could also be determined by reference to the three Cs: cost, which is the lowest price an organization would ideally wish to set unless adopting a loss leader approach; customer-perceived price, which is the price that customers would be prepared to pay determined by marketing research; or competitor pricing in which the price is set at the level of a competitor where competition is focused on product rather than price.

There is also a link between pricing and the marketing communications strategy used on the initial product launch, which is illustrated in Table 6.2.

Table 6.2 Pricing strategy

	Low level of marketing relying on word of mouth	**High level of marketing spend using a full range of communication techniques, especially advertising**
Low price	Slow penetration	Rapid penetration
High price	Slow skimming	Rapid skimming

The choice can be to penetrate the market or skim profit off the market before competitors follow. The pricing objective is particularly relevant to new product development. There are also implications for manufacturing, as discussed in Chapter 4 under the product life cycle (section 4.4.), where a decision must be made concerning the level of production and initial inventory levels. Also, pricing becomes a weapon under intense competition in the mature stage of the life cycle, or a means of survival when following a harvest strategy. This decision provides another example of where the techniques discussed are not used in isolation but are relevant to many different stages of strategy development and implementation, hence supporting the strategic management process.

Some markets, such as business to business markets, may operate a market pricing approach, in which the market determines the price. Where market pricing is the norm understanding the cost base, or being able to estimate costs quickly via standard costing methods, become significant as pricing without this understanding can create problems later. For example, a CEO of a consulting engineering firm is reputed to have said that cost-plus pricing no longer works as they bid for the contracts under a competitive tendering scheme. Hence, they put in a bid at a price they think will win the contract. Then once the contract is acquired, they figure out how to do it for that price. This approach to pricing can be dangerous as too many jobs obtained like this on a potentially low margin in an increasingly competitive market may not be sustainable in the long run. It may also mean that the quality of the work is substandard, which will impact on the organization's reputation and ability to win contracts in the future. In cases such as this, it would be safer to use the concept of target costing (section 7.8) to ensure that a viable product can be produced at a cost that allows a profit to be made before the bid price being submitted.

Other considerations include price sensitivity, which can vary among the purchasers. Price sensitivity differs depending on the market. In consumer markets, it is the end consumer that reacts to price changes. However, in business-to-business markets, an intermediary who can pass on any price increases to their customer will not be as price sensitive as one that is unable to pass on increases in their costs. This emphasizes the need for organizations to work together through the supply chain.

The price elasticity of demand (Figure 6.5) is also a factor in matching production capacity with customer demand. The price elasticity of demand is calculated as:

$$\frac{\%\ change\ in\ quantity\ demanded}{\%\ change\ in\ sale\ price}$$

When the demand is elastic (that is greater than 1), a reduction in price will have a more significant impact on the quantity demanded. If inelastic, there is less of an effect. Apart from the impact on demand, the total revenue is also affected. When demand is elastic, if the price is lowered, it creates a more significant increase in demand, and total revenue would increase, but when the price is increased, there is a substantial reduction in demand, and total revenue will fall. When inelastic, a fall in price might reduce total revenue as the rise in demand may not be enough to compensate for the reduction in price. When the price is raised under inelastic conditions, the total revenue may increase as the impact of the small decrease in demand may not have that great an effect. Understanding the elasticity of demand and price sensitivity is crucial as it will affect the overall profitability of the product or service. It has implications for promotional pricing and discounts to encourage sales.

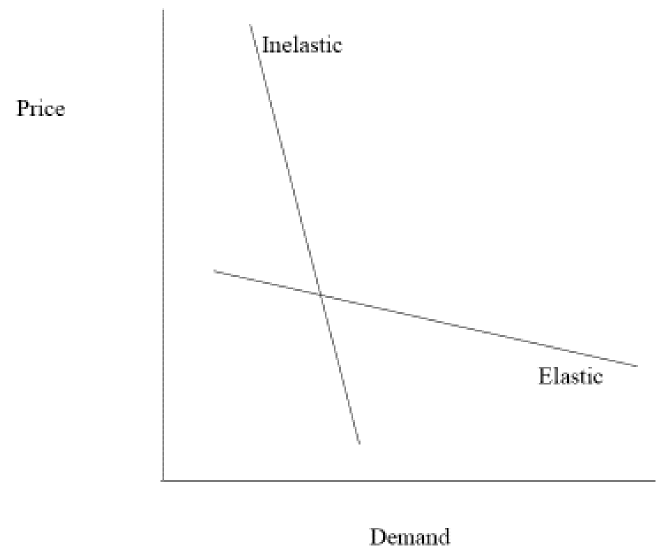

Figure 6.5 Elastic and inelastic demand curve

There are also phycological pricing points to consider, such as the $99 or $5.95. The perception of price and quality can also be factors. For example, consumers have been known to make quality judgments based on price. Charging too little could make the product appear cheap, or developing an exclusive brand could support a much higher price as consumers purchase it for its prestige value.

Price can be a competitive weapon and is often used in this way in the growth stage of the product life cycle. The first mover, having already established a market share, can afford to cut margins to deter competitors. However, price decreases to deter competitors can result in a price war with the resultant impact of reducing the margins for all players in the market. It is often difficult to raise the price again, especially if there are low switching costs for consumers. Accountants can aid the decision-making process of the initial pricing decision and on the impact of adjusting prices through the life cycle. Techniques such as activity-based costing (section 6.6), customer profitability analysis (section 4.7), target costing (section 7.8), life cycle costing (section 7.9), and simple techniques such as cost volume profit analysis (Appendix B.3) all have something to offer.

Learning activity. Think about the different categories of products that you purchase or would like to purchase. Categories include convenience/essentials (toothpaste, food), shopping goods (TVs, mobile phones, sound systems), and specialist goods (expensive cars, Rolex watches).

How much emphasis do you put on price in your purchasing decision in each category?

If you place a high emphasis on price in certain categories, would an appropriate strategy be based on striving to be the cost leader? In categories, if any, where you do not emphasize price, would differentiation be more appropriate?

Do you think that understanding customer buying behavior would help in developing a competitive strategy?

6.5 The value creation system revisited

Active reading. Note the need to ensure consistency of competitive strategy throughout the whole of the value system. Also, the importance of information flows through the value system.

One of the critical elements for the success of an organization today is the development of a sustainable competitive advantage. Ideally, that advantage needs to be unique, sustainable, and valued by and relevant to the customer. The problematic element today is the sustainability of a competitive edge. The internal analysis can aid the development of the competitive advantage, as a detailed analysis of the strengths and weaknesses relative to the competition can help to establish not only a core competence but also a distinctive competence that the competitive advantage can be built around. A core competence can be described as an activity that the organization needs to be good at to survive in the industry, whereas a distinctive competence is an activity at which the organization excels to a higher degree than its competitor organizations (Mooney, 2007). In Chapter 4, section 4.9, the analysis of the value creation system was put forward as a useful tool to aid the development of competitive advantage. The wider value creation system can also be used to support the strategies of cost leadership and differentiation.

Configuring the value creation system to support the strategy is a critical part of sustaining a competitive advantage. It is vital to ensure that the competitive strategy is consistent throughout the entirety of the supply chain. It is, therefore, significant in supplier evaluation (section 4.10) and customer profitability analysis (section 4.7). It is not confined to business-to-business markets, but also in consumer markets where the customer adds value, such as the do-it-yourself (DIY) market or flat-pack furniture. In consumer markets, the strategy is targeted at customers who purchase based on low price, or who are looking for the features of a differentiated product.

The importance of information flows within the value system should also not be understated as these can be as crucial as physical flows of products, for example, flows of data from the customer to the suppliers or partner organizations. Retailers who sell a washing machine and arrange for a local plumber to install it at the customer's convenience need to make sure that it is a profitable enterprise for all parties. Therefore, the availability of cost information through the supply chain can be significant. The provision of complementary services is becoming more common in the complex supply chains developing in today's business environment.

It was noted in Chapter 4 during the discussion of the internal analysis that activity-based costing (ABC) can be used within the value creation system to identify the costs of activities and support the competitive strategy. ABC can aid the support of a cost leadership strategy by assisting in the management of costs that are critical in the provision of the product or service. Similarly, as a differentiation strategy might be concerned with providing a higher quality or increased value-added, enabling a higher price to be charged, ABC can again assist in the management of the activities.