

## Performance management for strategic success: A detailed example

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### **Introduction**

De Waal (2007, p. 19) offers the following definition of strategic performance management (SPM):

“the process where steering of the organisation takes place through the systematic definition of mission, strategy and objectives of the organisation, making these measurable through critical success factors and key performance indicators, in order to take corrective actions to keep the organisation on track”.

Looking carefully at this definition, we might say that (from the accountant’s perspective) the most instantly appealing word in the definition is *measurable*. This article identifies two situations where a strategy might fail, and how accounting information can help managers avoid these two situations:

1. The strategy is inherently flawed. An example (which will be used for illustrative purposes in this article) is a strategy which pays insufficient attention to the profitability (or otherwise) of products at different stages of their product lifecycles.
2. The strategy is *capable* of succeeding, but the proposed manner of its implementation means that, in practice, it is likely to fail. For example, a successful firm is likely to have a strategy for ensuring that it develops an ongoing stream of new products to replace those which have reached the end of their lifecycles. However, it is important that this new product development (NPD) process is managed properly if the resulting new products are to be commercially successful. This issue is also illustrated in this article<sup>1</sup>.

These reasons for strategic failure are perhaps somewhat self-evident; certainly, managers from a wide variety of functional backgrounds are aware of these dangers. After all, strategy is (by definition) multi-disciplinary. The particular contribution of SPM lies in the various ways in which it brings measurement into the strategic management process, as the example in the next section of this article will show.

A necessary basic competence in SPM (both in practice and in the P2 examination) is to be able to identify what form of analysis is appropriate for the strategic problem in hand – in terms of *what* and *how* to measure, and also in terms how best to interpret the results. This is why SPM is a P2 subject, and why

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<sup>1</sup> Of course, there are other reasons why a strategy might fail. For example, a strategy may not suffer from either of the above weaknesses, but the organisation may omit to put in place the incentives necessary to ensure that individual staff members are motivated to implement the strategy which senior management have mapped out. However, it is not possible to address all possible reasons for strategic failure in a single article.

the syllabus indicates that candidates must be able to “select, integrate and apply SPM techniques” or “critically evaluate existing and proposed SPM structures as described in a particular case study”. This is in contrast to (for example) an examination paper at F2 level, where students can expect to be fairly clearly directed as to what specific analysis is required.

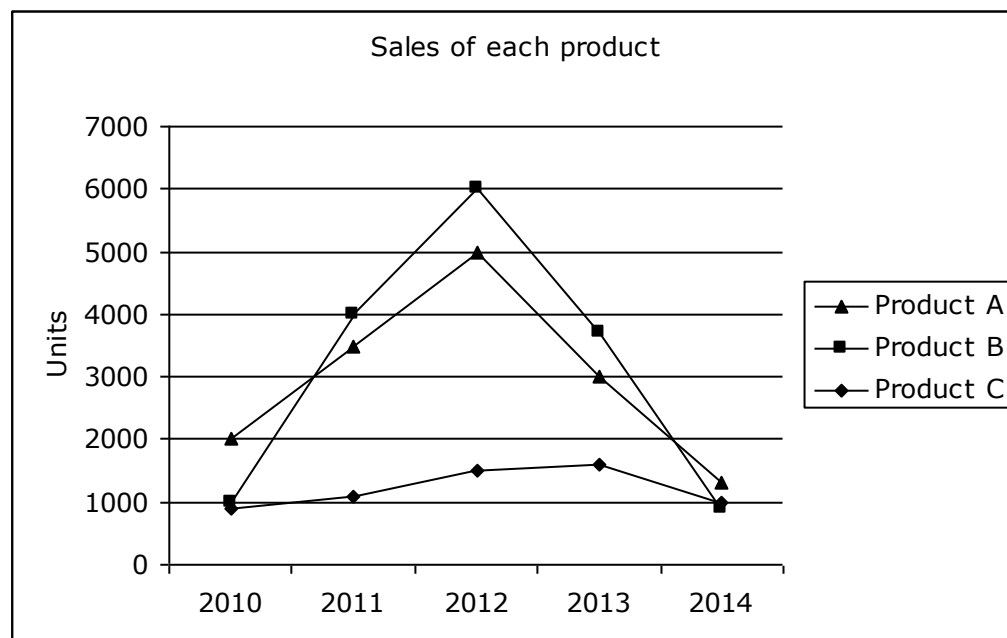
The rest of this article is devoted to an example (“ABC Ltd.”) which is designed to illustrate some of the issues identified above.

### **ABC Ltd. and its product portfolio**

ABC Ltd. was established in early 2010 as a manufacturer of consumer goods. The company proposes to produce and market three products (A, B and C) in the first instance. The directors recognise that demand for all three products is likely to reflect a classic lifecycle pattern – i.e., demand will take some years to build up towards a peak and will decline thereafter. The following sales forecast has been developed for the years up to 2014 (there is likely to be some limited demand after that year but it is too far in the future to forecast with any accuracy):

| Product | Sales units in 2010 | Sales units in 2011 | Sales units in 2012 | Sales units in 2013 | Sales units in 2014 |
|---------|---------------------|---------------------|---------------------|---------------------|---------------------|
| A:      | 2,000               | 3,500               | 5,000               | 3,000               | 1,300               |
| B:      | 1,000               | 4,000               | 6,000               | 3,700               | 900                 |
| C:      | 900                 | 1,100               | 1,500               | 1,600               | 1,000               |

This data is illustrated in the following graph, where the product lifecycle shape is evident:



The following financial data is also provided about each product:

| Product | Selling price, per unit | Contribution margin | Fixed costs of production & marketing, per annum |
|---------|-------------------------|---------------------|--------------------------------------------------|
| A:      | €10                     | 40%                 | €5,300                                           |
| B:      | €12                     | 35%                 | €8,400                                           |
| C:      | €15                     | 35%                 | €7,770                                           |

Suppose that the company plans to launch all products immediately (in 2010) and to continue producing and marketing them so long as there is any demand for them. How might we evaluate this proposed plan of action?

1. So far as Products A and B are concerned, an analysis of the data reveals that it is optimal to cease making these products after the end of 2013:

|                                | Product A           | Product B              |
|--------------------------------|---------------------|------------------------|
| Contribution per unit          | 40% * €10 = €4      | 35% * €12 = €4.20      |
| Annual breakeven point (units) | €5,300 / €4 = 1,325 | €8,400 / €4.20 = 2,000 |

In both cases, the annual breakeven point exceeds the predicted sales demand in 2014 (and in subsequent years, since the sales demand is expected to continue to decline).

2. Predicted demand for Product A exceeds breakeven point in all years from 2010 to 2013 inclusive, so there is no doubt about the financial viability of this product in this 4-year lifecycle. In the case of Product B, it is tempting to suggest that it should be produced only in the years 2011 to 2013 inclusive, since the predicted sales demand in 2010 (of 1,000 units) is less than the breakeven point. However, this is probably unrealistic: the higher sales in 2011 to 2013 are probably only achievable if the company makes the effort to begin (in 2010) the process of building up a market for the product, even though 2010 would be something of a "loss leader" for the subsequent years. Specifically, Product B should be produced over a lifecycle of 2010 to 2013 inclusive, because the following analysis shows that the product is profitable over this lifecycle as a whole:

|                                                                           | Product B                                          |
|---------------------------------------------------------------------------|----------------------------------------------------|
| Sales demand (2010 to 2013 inclusive):<br>1,000 + 4,000 + 6,000 + 3,700 = | 14,700 units                                       |
| Contribution                                                              | €4.20 per unit                                     |
| Fixed costs (2010 to 2013 inclusive):<br>4 years * €8,400 =               | €33,600                                            |
| Lifecycle profit                                                          | (14,700 * €4.20) minus €33,600<br>= <b>€28,140</b> |

3. If similar analysis to that conducted at steps (1) and (2) is applied to Product C, it is evident that ABC Ltd. should probably not launch this product at all:

|                                | Product C              |
|--------------------------------|------------------------|
| Contribution per unit          | 35% * €15 = €5.25      |
| Annual breakeven point (units) | €7,770 / €5.25 = 1,480 |

Notice that this annual breakeven point exceeds the predicted sales demand only in two years (2012 and 2013). Clearly Product C should not be produced from 2014 onwards, but the question arises as to whether it is worthwhile to offer the product to the market in 2010 and 2011 (if this is necessary in order to build up demand for the product to the predicted higher levels in the following two years):

|                                                                         | Product C                                        |
|-------------------------------------------------------------------------|--------------------------------------------------|
| Sales demand (2010 to 2013 inclusive):<br>900 + 1,100 + 1,500 + 1,600 = | 5,100 units                                      |
| Contribution                                                            | €5.25 per unit                                   |
| Fixed costs (2010 to 2013 inclusive):<br>4 years * €7,770 =             | €31,080                                          |
| Lifecycle LOSS                                                          | (5,100 * €5.25) minus €31,080<br>= <b>€4,305</b> |

4. In summary, Product A should be produced in the years 2010 to 2013 inclusive. Product B should be produced over this same lifecycle, and Product C should not be produced at all. As has already been stated, these recommendations for Products B and C incorporate an assumption which is normally appropriate in the product lifecycle model, namely, that a firm must be willing to tolerate lower sales volumes in early years if it wants to achieve the higher sales levels at the peak years of the product lifecycle.

### **A reflection on the case of ABC Ltd.**

Three things can be said about the ABC Ltd. example. First, the analysis has revealed that the company's plan to sell all three products for so long as there is any demand for them is suboptimal. Second, although the analysis itself was not numerically complex (involving little more than application of the cost-volume-profit model), the challenge was to identify what kind of analysis was appropriate<sup>2</sup>. This is the starting point in dealing with strategic problems in real life, and this is why (at P2 level) examination candidates are typically expected to identify the appropriate form of analysis (rather than being explicitly told what calculations are required).

The third thing is that, as things stand, ABC Ltd. knows not only that demand for its products will peak in 2012 but also that none of its existing products is commercially viable after 2013. Therefore, as well as managing its existing product portfolio, ABC Ltd. should have a new product development (NPD) process so that it can bring new products on stream in the reasonably near future.

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<sup>2</sup> It should also be said that there is no such thing as a "complete" analysis of a strategic problem. For example, the analysis here takes no account of the time value of money.

Of course, accountants (even those operating at the strategic level) are not likely to be wholly or mainly responsible for the NPD process. NPD requires cross-functional teamwork, with marketing, engineering, R & D, and financial staff all pooling their expertise to facilitate the development of profitable new products (Cagan & Vogel, 2002, pp. 139-142). A typical accountant's role in such a team is to evaluate the cost and revenue implications of product design features which may be proposed by colleagues such as marketers and technical staff. In this way, the accountant can help to increase the likelihood that the team will design *profitable* (and just technically excellent or exciting) products.

One reason why it is important to get product design right is that it is the characteristics of the design which (to a significant extent) determine the cost of production. The design determines not merely the types of materials and labour which will be used, but also the frequency of the activities which create overhead costs (for example, unnecessarily complex product designs are often prone to cause machine breakdowns or other errors in production). Traditional cost control techniques (such as variance analysis) are only useful once production has actually begun. However, the scope for such traditional cost control techniques to influence costs is limited in practice, since it is typically the decisions made at the product design stage which have the greatest influence on what the costs of production will be.

## **Conclusion**

Two possible reasons for strategic failure were suggested at the beginning of this article.

One reason was that a strategy itself might be inherently flawed. The need to avoid this problem was illustrated by showing how the profitability of ABC Ltd.'s product portfolio could be improved over the products' lifecycle.

The second reason was that, although the strategy itself may be capable of succeeding, there may nevertheless be potential pitfalls in the manner of its implementation. The example used here was the management of the new product development (NPD) process in ABC Ltd. It was shown that, for NPD to succeed (in the sense of resulting in the development of commercially viable products), the cost implications of particular designs should be assessed before the designs are finalised. Once a product design has been finalised and production has commenced, traditional cost control techniques (such as variance analysis) have only very limited potential to influence costs.

## **References**

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De Waal, A. (2007). *Strategic performance management: A managerial and behavioural approach*. Basingstoke, Hampshire: Palgrave.