Report to the directors of K2 Adventure Gear Ltd (K2) on the application of Strategic Cost Management to improve competitive positioning and expansion.

Executive summary

-Strategic cost management measure and manage cost to align them to business strategy, improving the strategic position of K2.
-Three key elements of Strategic Cost Management is a Strategic Plan, a Value Chain Analysis and Activity-based management.
-Strategic cost management can assist in choosing an expansion plan as opportunities identified by the analysis may be more compatible with a certain plan, overall providing the best outcome for K2.
-A value chain diagram is presented below and it is used to help explain how the K2 Direct channel operates.
-The ROI of the two distribution channels is 50% for K2 Retail and 89.6% for K2 Direct.
-The combination of a higher net margin (30% sales for K2 Direct compared to 20% sales for K2 Retail) and higher asset utilisation (34% x sales for K2 Direct compared to 40% x sales for K2 Retail) means a higher ROI for K2 Direct.
-There are various advantages to K2 Direct, however, it is dependent on K2 Retail as it requires brand awareness and a strong clientele base.
-Expansion of K2 Direct is recommended, this is reliant on K2 further investing in the infrastructure of K2 Direct. K2 Retail must be maintained as a physical presence is vital to the continued success of K2 Direct and K2's overall position in the market.

Introduction

K2 Adventure Gear Ltd (K2) develops and designs specialist outdoor clothes. CEO, Hilary Edmund, is keen to protect the firm's competitive position as a specialist supplier of high-quality adventure clothing and expand the business. However, there are concerns about the competitive threat posed by large diversified retailers selling cheaper, but lower quality, adventure clothing.

Main report

(a) An explanation, in general terms, of how Shank and Govindarajan's Strategic Cost Management (SCM) technique might be helpful to the management of K2.

Strategic cost management is a tool used to measure and manage costs to align them to business strategy, improving the strategic position of firms, while simultaneously reducing cost.

Strategic Cost Management (SCM) would be beneficial to the management of K2 as it enables the company to review the current strengths of their strategic position and the source of their competitive advantage by analysing their current strategic plan. This allows the company to determine areas of strengths and weaknesses to identify opportunities within alternative approaches (using VCA within SCM to improve linkages between activities to identify whether to vertically integrate or outsource), which may strengthen the company's position.
These opportunities are often cost centred, allowing for K2 to provide customers with an equivalent service at a lower cost or an improved service at the same cost.

(b) A description of the three key elements of Strategic Cost Management, and an explanation of how each of them could be applied to K2 to help management decide on the most appropriate expansion plans.

A Strategic Plan

Management must have a clear and common understanding of the company's strategic plan and the company's method of maintaining its competitive advantage, as it allows management to work in unison to strengthen K2's position. This clarity is particularly important in a market environment where competitive threats are growing.

K2 current strategy is the differentiation method. This assumption is made on the basis that K2 is a specialist supplier of high-quality adventure clothing which has "warm and cool" properties, K2 provides these products at a higher price than competitors in the adventure clothing market.

Understanding this strategy and K2's position may assist in selecting the most appropriate expansion plan, as it allows for the plan most complementary to K2's strategy to be selected. This will allow for the maximisation of K2 resources, in relation to maintaining K2's competitive advantage.

Value Chain Analysis
Value chains are a set of value-producing activities stretching from suppliers to final customers. A value chain analysis should identify key activities that go into changing the inputs for a product or service, into an output that is valued by the customer.
These activities can be compared to those of competitors in the adventure clothing market, allowing K2 to identify opportunities where it may be able to strengthen its market position by improving its current strengths or reducing cost whilst maintaining or enhancing customer values.

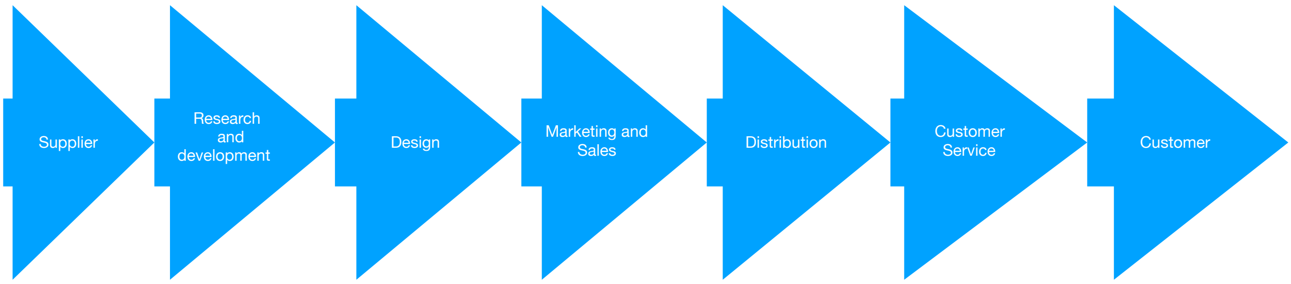
These opportunities may be "reconfiguring the value chain" by vertical integration, outsourcing activities in value-chain that are not making good returns or treating suppliers/buyers as partners to seek mutually beneficial process improvements.

A value chain analysis may help with selecting the most appropriate expansion plan, as opportunities identified by the analysis may be more compatible with a certain plan, overall providing the best outcome for K2.

Activity-based management
Activity-based management (ABM) is used to gain a better understanding of cost behaviour and to reduce costs. This is achieved through ABM as this tool is used to identify and reduce/eliminate activities that do not add value to the customer (e.g staff lunch, staff survey) and streamline cost for value-adding activities (e.g staff training, marketing).
Reducing costs will strengthen the firm's strategic position, as it allows for a better financial position for K2 and allows the firm to offer competitive prices.

This may help with selecting the most appropriate expansion plan, as a certain expansion plan may provide more opportunities to reduce/eliminate cost behaviour in K2's activities, overall increasing the profitability and financial position of K2.

(c) A diagram that outlines the second level (major processes) value chain for K2 direct, and an accompanying narrative to explain how the K2 Direct channel operates.



1. Supplier;
K2 Direct outsources the production of its adventure clothing from two key suppliers who manufacture all K2 designed clothes under license in mainland China. The suppliers then ship finished clothes, weekly, direct to distribution hubs in Sydney and Auckland.
2. Research and development;
The research and development team search for high quality, specialist materials to create a product range that is "warm and cool" at the same time. This is to improve existing products and strengthen points of weakness.
3. Design;
The design team incorporate the research conducted by the development team into the design of the product line.
4. Marketing and sales;
The marketing and sales team have specialist departments to deal with the K2 Direct business, which supports mail order, telephone and internet sales of 'key products'. Most

marketing activity is relevant to either distribution channel as it is focussed on the K2 brand, but there is some specific K2 Direct marketing.

5. Distribution;

When an order is placed, K2 Direct customers also pay the extra cost of shipment, by New Zealand Couriers in NZ or DHL in Australia, from the distribution hub to the customer's home - no expense nor asset of K2 is expended in this process.

6. Customer Service;

K2 specialist departments support mail order, telephone and internet sales of 'key products'.

7. Customer;

The customer receives the goods.

(d) Using the information provided in the estimated income statements and balance sheets, a calculation of the return on investment for each channel.

Return on Investment (ROI) by Channel (financial figures in $000s).

ROI= Operating Profit/Net asset investment

	K2 Retail	K2 Direct
Operating Profit	4,000	3,000
Net Asset Investment	8,000	3,350
ROI	50%	89.6%

(e) An explanation of the key differences between K2 Direct's value chain and the value chain of the K2 Retail core business and your conclusion as to what effect each of these differences will have on K2's overall net margins and return on investment. (financial figures in $000s).

K2 Retail requires distribution from the distribution hub to the retail stores (K2 uses its fleet of vehicles to ship clothes from the distribution hubs to its 20 retail stores, 15 in New Zealand and 5 in Eastern Australia.), hence in K2 Retail, distribution comes prior to sales and marketing.
K2 direct has no distribution to retail stores, therefore, it bears no post hub distribution costs which are $1400 (7% of the cost for K2 retail sales) for K2 Retail (the cost of delivering the product is paid for by the customer in K2 Direct).
In addition to this, K2 Retail requires a delivery vehicle and thus an investment of $800.
When compared to K2 Direct in the form of distribution, K2 Retail will have a lower ROI as it has a greater cost and higher investments.

Moreover, K2 retail has retail stores which produce a cost of $4000 (20% of K2 retail sales), unlike K2 direct where products are shipped directly from hubs. Retail stores also require investments of Retail Store Stocks ($1,000) and Retail Store assets ($2000).
Again in this aspect of K2 Retail will have a lower ROI as it produces a unique cost that requires significant investment.

K2 Direct generates extra marketing costs through telephone directories and sponsored website links totalling $1000 (higher than expected by an extra 5% of sales), extra office costs of $1200 (12% of K2 direct sales) and admin assets investments of $800. When compared to K2 Retail in the form of Marketing K2 direct will have a lower ROI as it has a greater cost and higher investments.

Overall, K2 Direct has a lower total operating cost (70% of sales) than K2 Retail (80% of sales). Hence, the net margin of K2 Direct is higher than K2 Retail (30% compared to 20%).
Additionally, K2 Direct has a lower asset base (34% x sales or K2 Direct compared to 40% x sales for K2 Retail), leading to higher asset utilisation.
The combination of a higher net margin and higher asset utilisation means a higher ROI for K2 Direct.

(f) A summary of the main advantages and disadvantages, both financial and qualitative, of the K2 Direct channel compared to the K2 Retail channel, and your advice to the CEO on the most appropriate expansion plan for K2.

Advantages:

- The combination of a higher net margin and higher asset utilisation means a higher ROI for K2 Direct.
- Low risk, minimises the risk of theft, physical store damage, and in-store staff disputes.
- Direct retail gives K2 the ability to directly advertise to a customer using personalised adverts and online tools (e.g Facebook, Instagram, Twitter) which can aim adverts at K2's target market at a low cost.
- Direct retail is more convenient (place orders from home and get home delivery) and allows retail stores to continue operation regardless of the environment it operates in (e.g Pandemic). This enhances the ability to make sales.
- Full access to customer history - allowing for quick dispute resolution.
- Easy to expand, can increase the areas of K2 available by shipping to countries outside of Australia and New Zealand.

Disadvantages:

- Customers can only order 40% of products, this is frustrating for loyal customers and lowers the chances of repeat business.
- The increased cost of shipping may deter customers from purchasing K2's products, especially as there are diversified retailers in the market offering similar goods at a lower price.
- Shipping takes time and the duration of delivery may put off customers.
- In-store shopping provides customer's with a more unique experience that is catered to their needs, K2 direct is unlikely to be able to replicate a customer's connection with K2 that they make when shopping in a store (Lack of touch and feel of merchandise).
- K2 Retail allows for a stronger presence in the market and differentiates K2 from lower-priced competitors who only have an online storefront, without K2 Retail, K2 is unlikely to be able to maintain its differentiation strategy.

Advice:

Specialist departments that support mail order, telephone and internet sales of 'key products' for K2 Direct business is struggling to meet the growing demand. K2 should concentrate on increasing the staff and resource investment in this area and those in web development to ensure K2 Direct can maintain sales and customer satisfaction. This will ensure they maintain their market share.
If they feel like they are able to compete in the international market, K2 may consider shipping outside of Australia and New Zealand.

The ROI of K2 direct is strong at 89.6%, K2 should extend the product range beyond the current 40% that is available to maximise profit as customer demand indicates potential for increased sales. This will require an increased investment into inventory at the hub per $ of sales. This will decrease the current ROI for K2 Direct in the short term, but will likely increase the overall return for K2 in the long term.

K2 Retail Stores are imperative to K2's differentiation strategy - unless K2 could maintain direct sales without K2 Retail, it would be unwise for K2 to close its retail stores.
Instead, K2 may consider expanding into different areas in Australia. Currently, there are 15 retail stores in New Zealand and 5 in Eastern Australia. An expansion would spread brand awareness and allow K2 to gain shares within these regions.
In the long term, this will benefit K2 Direct, as gains in market share by K2 Retail will bring awareness to K2 direct.

Conclusion

K2 should strengthen K2 direct by investing more in specialist departments and its web development - additionally, it should expand its product availability.
Moreover, it may consider further expansion into the Australian market through K2 Retail.