CGMA® BRIEFING

RETHINKING THE VALUE CHAIN

The extended value chain

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Two of the world's most prestigious accounting bodies, AICPA and CIMA, have formed a joint venture to establish the Chartered Global Management Accountant℠ (CGMA®) designation to elevate and build recognition of the profession of management accounting. This international designation recognises the most talented and committed management accountants with the discipline and skill to drive strong business performance. CGMA designation holders are either CPAs with qualifying management accounting experience or associate or fellow members of the Chartered Institute of Management Accountants.

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THE EXTENDED VALUE CHAIN

Traditional value chain analysis focused largely on in-house operations and supply chain issues. These considerations remain critical but today's business dynamic demands a more holistic view of the entire extended value chain which also encompasses the demand chain whilst recognising that the extended value chain must operate symbiotically within a wider business environment.

This briefing paper charts the global trends affecting business generally and reflects on how these issues are impacting extended value chains. In the face of unprecedented change, the Chief Finance Officer (CFO) has a pivotal role; to understand and articulate the extended value chain as well as develop a strategic perspective necessary for its future development. Ten practical suggestions point to how the CFO can develop strategies to meet these challenges and help their organisation build and maintain a successful extended value chain.

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INTRODUCTION

Although fragile and tentative, signs of a global economic recovery are being reported. An IMF report prepared for the G20 meeting in Australia in February 2014 forecasts the world economy will grow by 3.7% this year based on economic strengthening in the United States, UK and Japan alongside continued solid progress in China and many emerging markets, as well as a resumption of growth in the euro area.

Recognising the underlying fragility of this return to growth, the G20 countries committed to work to reinforce the recovery from the recession by aiming to increase global growth by at least two percentage points over the next five years. It is against this background that Chief Executive Officers (CEO) are feeling more optimistic and slowly refocusing from survival to growth.[1] 44% of CEOs now think that the global economy will improve over the next twelve months; this compares with less than 20% just a year ago.

By the same token, in an effort to compensate for weak sales during the recession, many companies expanded into faster growing emerging markets as a way to bolster growth. As a result of currency depreciations and a general weakening of demand in the emerging markets, many are now looking carefully at the returns being generated by those investments.[2]

Against this background of potential gain and pain in emerging markets, how can companies position themselves to take advantage of opportunities that arise and mitigate risk? One answer is by a careful analysis of their business environment, activities and market offering; in short by examining their entire value chain.

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Value Chain Analysis tool

View the tool to help analyse your value chain and understand your organisation's key capabilities and areas for improvement.

Porter's Value Chain

In his 1985 book "Competitive Advantage," Michael Porter defines the value chain as the set of activities that an organisation carries out to create value for its customers. Porter proposed a general-purpose value chain that companies can use to examine all of their activities and see how they are connected. Porter's division of the value chain into Primary and Support activities was largely based on the manufacturing model prevalent at the time.

Primary Activities including:

- **Inbound logistics**
  The receiving, storage and inventory control of input materials
- **Operations**
  The value-adding activities that transform these inputs into the final product
- **Outbound logistics**
  Activities required to get the finished product to the customer
- **Sales and marketing**
  Getting potential buyers to purchase the product
- **Customer service**
  Activities that maintain and enhance the product's perceived value in the marketplace.

Support Activities namely:

- **Procurement**
  The purchasing activity which acquires the raw materials and other inputs necessary to support the value-adding activities
- **Technology**
  Research and development, process enhancement and other innovation activities used to support the value chain
- **Human resources management**
  Recruitment, development, retention and compensation of employees
- **Firm infrastructure**
  Finance, legal, corporate management and governance.

View **Porter's Five Forces of Competitive Analysis** and use the framework to help you assess the competitive strength of your organisation.

Initial value chain analysis (see box out) was largely focused on the manufacturing sector but the skills necessary apply equally to a wider range of industries including construction, mining, healthcare, financial services, banking, consulting, telecomm and many more. The aim is to identify sources of competitive advantage which Porter argues derives from those activities the business does which are:

- Done better than competitors
- Done differently from competitors
- That create unique benefits
- Done at a lower cost than competitors.

As Porter developed his work further, he introduced the concept of a value system which linked an entity's value chain to the value chains of upstream suppliers and downstream buyers recognising that the development of competitive advantage depends not only on the entity-specific value chain, but also on the entire value system of which the entity is a part.

However, this concept of a value system remains essentially linear; inputs which can be materials, products or intellectual content are sourced and then converted by a series of entities each aiming to create additional value for the ultimate end customer.

Increasingly the boundaries of value creating activities are becoming extended and blurred. There is now greater reliance on alternative forms of sourcing, multiple business partnerships and other developments that are reshaping these boundaries. As a consequence the analysis used as the basis for value chain decision making must broaden from factors relevant to 'direct control' and 'contractual arrangements' to encompass trends affecting extended value chains.

MAJOR TRENDS AFFECTING EXTENDED VALUE CHAINS

1. Globalisation

Globalisation of business refers to the increasing prevalence of value chains spanning multiple countries, through the flow of goods, services, technology and capital across national boundaries, to reach new markets and also reduce costs. Market globalisation has been facilitated by the decline in trade barriers and import tariffs.

In addition to the import and export of materials and services, a significant component of globalisation has been foreign direct investment into production or other business activities in another country. Often the primary driver for sourcing materials and services from other countries has been to secure cost savings.

However, emerging markets, typically with growing populations that have a younger age profile than their developed market counterparts, are also a focus for rising consumption as well as increasingly important sources of capital, talent and innovation. Organisations are deploying a range of strategies to capture the growth opportunities provided by emerging markets, such as building a local presence, developing partnerships or joint ventures with local companies or recruiting talent both to work in the region as well as outside it.

Downside risk of globalisation includes potential breach of intellectual property rights, currency or exchange rate volatility, multiple compliance requirements, greater exposure to illegal activities and the impact of geopolitical instability, creating complex governance challenges. Additionally complex, global value chains bring vulnerability to increasingly severe weather events and other natural disasters. As a consequence, organisations need to be more aware of the potential for their value chains to be disrupted and develop mitigating strategies that will help to build a more resilient value chain.

Greater consumer awareness would naturally be seen as an advantage of globalisation, opening new markets and deepening penetration of established markets, however, it also brings the potential for significant unforeseen costs and reputational risk issues for instance as a result of the tragic loss of life from the collapse of the Rana Plaza building in Bangladesh (see case study below).

The impact of globalisation is to extend the scope of the value chain and the influences on it. Social media and the internet bring information about distant events and reaction speedily on to the doorstep of organisations. World events need to be viewed with a wide lens to identify potential risks as well as opportunities.

CASE STUDY

COSTS AND RISKS OF THE EXTENDED VALUE CHAIN AT PRIMARK

In April 2013 the Rana Plaza building in Savar, near Dhaka, Bangladesh, collapsed. The building housed several factories, one of which produced low-cost garments for Primark, the clothing retailer operating across Europe. A Bangladeshi government investigation found that poor quality construction materials and building code violations were among the "series of irregularities" that caused the collapse which killed 1,138 and injured more than 2,500 others.

Rapid communications generated significant consumer awareness which undoubtedly contributed to the reaction of Primark to the disaster amidst accusations of driving poor working conditions to maintain low garment costs. Primark stepped in to provide assistance to those affected by the building collapse including those working for suppliers to other companies. To date, Primark has committed some US$2m to a food distribution programme and short-term financial support.

Significantly Primark is carrying out building surveys in Bangladesh to assess the structural integrity of factories supplying its stores and has become a signatory of a new Fire and Building Safety accord in Bangladesh alongside nearly 100 garment brands, retailers, trade unions and NGOs which is aimed at ensuring sustainable improvements to working conditions in the Bangladesh garment industry.

2. Demographic change

We are in the midst of a major redistribution of the world's workforce with slow or no population growth in some countries contrasting with rapid expansion especially in working populations in others. By 2020, the median age will be 43 in Europe, 38 in China and only 20 in Africa.[3] This pattern of demographic change will be significant.

The tremendous growth in working-age population in countries such as China and South Korea is well publicised but it may come as a surprise to many to consider that this growth has now peaked. According to a UN population report countries such as India and Nigeria will provide the next surge with nearly a million workers joining the labour force in India every month for the next two decades.[4]

The distinction between 'developed' and 'emerging' markets will become less marked as the balance of economic power becomes less concentrated. Over the course of the next 15-20 years, per capita incomes in some markets currently referred to as 'emerging' will approach the levels in today's developed economies. Over the same period the proportion of the world's middle class living in Asia-Pacific will double to two-thirds and the next wave of emerging markets, including Turkey, Mexico and Indonesia, will be rising.

Cities currently generate about 80% of global economic output and the trend is for increasing urbanisation with the number of city dwellers projected to rise by over 70% over the next four decades.[5] Clearly this will result in both challenges and opportunities; over-crowding, poverty and pressure on social facilities and services will contrast with the further concentration of consumer demand. As inequalities become more marked so too will the potential for both social protest and unrest.

As these demographic changes intensify further global trends will become increasingly significant. European Audit Committee Chairs are reported to be concerned about the growing gap between available skills and employers' needs as competition for talent accelerates, as well as the fight for resources.[6]

Access to essential resources is expected to become more difficult as demand from more widespread economic prosperity, a rising middle class in emerging markets and urban concentration increases pressure on the world's ecosystem. This challenge is expected to be met with a new wave of clean technologies, energy-efficient processes and innovative sources of energy.

In the 1990s off-shoring became synonymous with efforts to benefit from lower wage costs in developing countries. By 2008, increases in wage rates in those developing countries coupled with increased transportation costs significantly changed the economics of a number of off-shoring decisions.[7] Near-shoring (manufacturing in an adjacent or nearby country) was becoming more economically favourable for a number of high technology products like servers, copiers and TVs and for certain heavy products like copiers and TVs, the balance was tipping in favour of even re-shoring manufacturing back to the home nation.

Juxtaposed with social and ecosystem issues, urbanisation is proving to be a catalyst for cities in emerging countries to benefit from growing levels of education and enhanced standards of living. The relative importance of these large conurbations as centres of innovation and demand is growing and as a result a new manufacturing strategy is emerging – 'Next-Shoring'.[8]

A next-shoring strategy emphasises the importance of proximity to demand and proximity to innovation for effective location decision making with respect to extended value chains. Both proximity to demand and proximity to innovation will be critical in a world where growing demand, particularly from new markets, values the way that products are adapted to best suit local market dynamics and where co-innovation will drive new and exciting supply chain developments.

We are facing a 'new normal' world that will set fundamental challenges affecting the design of successful value chains. The questions to be answered will be less about whether to locate in one country or another and more about how to construct extended value chains that best recognise and utilise local centres of demand, knowledge and expertise.

3. Digitisation

The volume and variety of data available for analysis is expanding exponentially with the amount of data created every day expected to double every three years. The use of cloud computing and new mobile technologies has become an everyday experience and new digital mobile devices increasingly replace PCs as the access point of choice.

As a consequence, the amount and quality of data available for analysis is virtually unlimited and has given rise to the term 'big data'. In the view of nearly nine in ten (87%) of the finance professionals surveyed for the CGMA report, *From Insight to Impact – unlocking opportunities in big data*, this trend has the potential to fundamentally change the way business is done and the scope of value chain analysis will need to evolve accordingly.[9]

Business will face the challenge of managing this rapidly growing data interchange between themselves and their customers and other stakeholders. The digital revolution has put more power than ever before in the hands of these stakeholders. Social networks are proving to be effective at providing a platform for sharing of information, advice and experience. This advent of the private citizen as a 'global journalist' is leading to increasingly transparent price and value differential between competing businesses. It also highlights the rising demand for broader transparency and the need for trust in business and related institutions.

Digitisation is driving the rapid pace of change in technology in manufacturing processes that have the potential to disrupt established value chains but which also create opportunities for innovative business models. For example, additive manufacturing techniques, such as 3D printing, have moved away from the production of simple plastic prototypes. The latest 3D printers can tackle complex mechanisms using a wide range of materials. The economic potential of 3D printing is significant: McKinsey Global Institute research suggests that it could have an impact of US$550bn a year by 2025.[10]

As adaptive manufacturing technology develops there will be opportunities for manufacturers to extend their value chain and potentially link directly to end users by creating relatively small facilities close to their ultimate customer. These facilities could allow a greater degree of customisation, transform after sales service and, coupled with online design capabilities, be the latest evolution of the traditional linear 'manufacturer to customer' relationship.

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THE ROLE OF THE CFO

The analysis of these key global trends shows that the transformation of business will continue unabated. So what is the role of the CFO, supported by the finance function, in the analysis and management of an extended value chain?

Articulate the value chain

The fundamental requirement is to capture relevant, reliable, complete and timely data and turn it into information and insight that can be used to articulate the extended value chain. A thorough description of the extended value chain will help board discussions to focus on matters relevant to business success and provides a framework to cascade this understanding throughout the organisation and also to key external players in your extended value chain.

Develop a strategic perspective

The CFO needs to look beyond the current value chain and explore the commercial potential of embracing an even wider range of innovative business relationships and new markets. However, alongside the commercial upside, the CFO needs also to evaluate risks inherent in these less tested or even un-tried business arrangements so that decisions can be made which align the organisation's risk exposure with its risk appetite.
The strategic analysis needs to be balanced and the data as complete and reliable as possible in the circumstances and it is the role of the CFO and the finance function to deliver this.

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The CGMA designation holder is ideally placed to play a significant role in this new business environment requiring strategic thinking, the ability to draw together disparate data sources to provide insight with a future perspective.

Ten recommendations for successful value chain management

Articulate the Value Chain

✓ **Widen the focus**
Widen the focus from traditional supply chain analysis to encompass the demand chain to the same extent. It will be of little value to have the right product, at the right price but in the wrong place (ie your own finished goods store). In today's multi-faceted business context, it is not just the distributor and retailer that you need to include in this analysis but also those that comment on your product, service and business. Is the message about you and your market offering on social media and other online sources of comment? Extended value chains bring dependence on third parties and there is a need to take a holistic view embracing optimisation rather than maximisation across the entire extended value chain.

✓ **Do the legwork**
One of the greatest challenges of managing a global value chain is identifying who is essential to the chain's success and how do they operate. Who adds value and where? What are their strategic objectives? Who or what is their performance dependent on? What are their major risks? These questions will not be easy to comprehensively answer but building up such an end-to-end framework of critical value chain participants will aid the development of effective business strategies, spot potential for goal divergence and help identify and address third-party risk.

✓ **Review data flows**
Multi-entity/multi-national partnerships will highlight the need for efficient and reliable information exchange. The foundation of this exchange will be the ability for one system to seamlessly process information from another system without the need for intervention or interpretation. New technologies like low cost cloud-based systems can provide a common platform across a geographically diverse extended value chain and so help to gather vital information.

✓ **Recognise the external context**
Recognise the external context and the impact that it can have on extended value chain success. End to end value chain visibility is critical for monitoring activities in complex global value networks. What are the regulatory, political and social system and infrastructure requirements necessary to support operations across the value chain? How are these likely to develop in the future and how can adverse impacts on your extended value chain be mitigated?

Ten recommendations for successful value chain management

Develop a Strategic Perspective

✓ **What is value?**
The CFO has a pivotal role to play in the alignment of key performance indicators, tools and measurement criteria that relate to the extended value chain. Perhaps the major task is to articulate what criteria will be used to define 'value' in the context of the organisation's strategic objectives. Increasingly short-term, company specific measures are being replaced with longer-term metrics that have a broader base such as those based on natural capital accounting which can provide insight into the use of key resources and help to highlight opportunities and risks inherent in the extended value chain.

✓ **Look to the future**
Traditional value chain analysis has often been criticised for its focus on historical financial information. Business needs relevant information covering both the present and the future. Management accounting meets this need. Its systems collect, analyse and communicate information about business activity and the external environment. The information should be used to support decision making to evaluate and improve performance, to manage risks and to emphasise 'value creation' in the value chain.

✓ **Focus on business partnering**
Research by EY suggests that companies which have a strong business partnering relationship between CFO and the supply chain leader demonstrate much stronger alignment between the supply chain, the business and corporate strategy.[11] Nearly 50% of those polled in the EY research that reported such close business partnering also reported a more than 5% increase in earnings. This compares with just over 20% of respondents from companies with more traditionally demarcated relationships reporting a similar increase in earnings.

✓ **Learn to embrace dependency**
Learn to embrace dependency and be able to relinquish a degree of independence. Powerful business alliances will increasingly compete as extended value chains with constituent organisations sharing not only a common aim but also integrating their business processes and information systems.

✓ **Seize the opportunity**
Seize the opportunity to develop collaborative business partnerships. Research has demonstrated the link between close business partnering in the supply chain and improved performance.[12] Despite this evidence, the same research found that only 26% of finance executives and 21% of supply chain executives regard the CFOs contribution to the supply chain as primarily based on enabling such integrated business relationships. This presents an opportunity to gain competitive advantage which extends across the entire value chain, not just the supply chain.

✓ **But be realistic**
As value chains extend across multiple jurisdictions and touch points become even more remote then exposure to risk is heightened. These risks can include: exchange rate fluctuation, political interference in markets, environmental catastrophes, geopolitical instability, counterfeiting and bribery.

Within the broad economic context and the mega-trends of globalisation, demographic change and digitisation, business performance depends on effective strategy formulation and execution. This requires an understanding of the opportunities the macro environment provides and how to mobilise the right resources via an extended value chain to exploit these opportunities to create value for stakeholders, while managing risk. It is a constant exercise of balancing opportunity, costs, value and risks.

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Further resources

This briefing is the first in a series exploring the extended value chain. To find out more, visit **cgma.org/valuechain**

Value Chain Analysis tool
Analyse your value chain to understand your organisation's key capabilities and areas for improvement.

Porter's Five Forces of Competitive Position Analysis tool
A framework to help you assess the competitive strength of your organisation.

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