

FUNCTIONAL-LEVEL STRATEGY

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Abstract

Enterprises operating in developing markets often tend to have simpler organizational structures and focus on a finite set of products and services, at least at the very beginning. In this situation, functional-level strategy is particularly important to management and this report provides an introduction to establishing and implementing functional-level strategy, including suggestions regarding the appropriate organizational structure and culture.

I. Introduction

Each function within a company (e.g., R&D, marketing or manufacturing) should strive to acquire and develop the resources necessary for it to become a functional-level core competency that can be converted into a competitive advantage for the company as a whole. For example, companies can become market leaders based on their unique skills and competencies in efficient production and/or on the strength of their brand name and associated good reputation. Functional-level core competencies generally fall into one of two major areas: (1) the ability of the company to execute specific functional activities more efficiently and at a lower cost than competitors (“low cost advantage”); and (2) the ability to perform specific functional activities in a way that clearly and positively differentiates the products and services of the company from those offered by competitors (“differentiation advantage”). A low cost advantage from reducing manufacturing costs obviously allows the company to reduce its prices in relation to those quoted by competitors. A differentiation advantage that is valued by the customer allows the company to increase the profit margin on its products because it is able to charge and collect a higher price from customer.² However, it is difficult to simultaneously differentiate products and reduce costs and functional-level priorities must be guided by business-level strategies as to what path should be taken in positioning and promoting specific products. The main tools that a company can use to support its functional-level

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² A core competency is only valuable if it creates a competitive advantage. Accordingly, product differentiation should be pursued only if it results in products with unique features that customers actually value and are willing and eager to purchase. G. Jones, *Organizational theory, design and change* (5th Ed.) (Upper Saddle River, N.J.: Pearson/Prentice Hall, 2007), 210. See also M. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York, NY: The Free Press, 1985).

strengths and build them to the point where they become a core competency is identifying the most appropriate organizational structure for the functional activities and creating the proper culture within the function to develop the desired skills and methods of interaction.³

Each function relies on different and specific techniques for lowering costs and differentiating products and, taken together, these become the foundation for their functional-level strategies. In general, the most important goals and objectives for a functional-level strategy are achieving superior efficiency, quality, innovation and customer responsiveness. In order to measure the success of a functional-level strategy the company should identify and track specific performance metrics. For example, efficiency can be measured by looking at the volume of output for a given unit of input, product quality can be determined through measures of defects, innovation can be gauged by the number and value of novel features integrated into the company's products, and responsiveness can be evaluated through customer surveys and objective measures of support activities (e.g., average time required to respond to customer queries).

II. General Strategies for Creating Low-Cost and Differentiation Advantages

Some of the general strategies that various value-creating functions might use to create and maintain low-cost and differentiation advantages include the following⁴:

- The manufacturing function can reduce costs by developing skills and acquiring resources in flexible manufacturing technology and can achieve differentiation advantages by improving the quality and reliability of finished products.
- The human resources function can contribute to cost savings by reducing turnover and absenteeism and can support creation of a differentiation advantage by recruiting skilled personnel and implementing innovative training programs.
- The materials management function can reduce costs through technology (e.g., implementing a just-in-time inventory system and/or computerized warehousing) and developing long-term relationships with suppliers and customers and those relationships can also be used to create a differentiation advantage through the ability of the company to integrate high-quality materials into its products and provide suppliers with reliable and efficient distribution of their products.
- The sales and marketing function can lower production costs by increasing demand and can create differentiation advantages by creating and implementing sales and marketing strategies for targeted customer groups, tailoring product designs and features to customer requirements, and developing and promoting brand names.
- The R&D function can reduce costs by improving the efficiency of the company's manufacturing technology and can contribute to creation of differentiation advantages by developing new products and improvements and enhancements to the company's existing products.

³ G. Jones, *Organizational theory, design and change* (5th Ed.) (Upper Saddle River, N.J.: Pearson/Prentice Hall, 2007), 210-212.

⁴ *Id.* at 210.

These strategies are described in greater detail in other chapters in this publication dealing with specific functional activities; however, it is useful to look at one functional area—materials management—as an illustration. Strategies established for the materials management function can have a significant impact on both inputs and outputs in a company’s value creation process. Managers in the materials management function can use cutting-edge business processes and technology to reduce the costs associated with inventory management (i.e., storing and shipping), such as by implementing a just-in-time inventory system and/or computerized warehousing. Just as importantly, specialists in the materials management function can use their negotiating skills and experience to develop and nurture long-term relationships with suppliers and distributors that can be converted into both low cost and differentiation advantages.

On the supplier (input) side, a strong vendor relationship based on trust and communication can lead to more favorable pricing and payment terms and expedited shipping and in some cases suppliers are willing to invest in specialized assets that can be used to produce inputs that are customized to their customer’s particular specifications and quality requirements.⁵ With respect to distribution (output), the materials management function can make a significant contribution to sales performance by establishing computerized links with major customers that can track customer inventory levels. Whenever a customer sells a product a record of the transaction is electronically transmitted to the company and when the customer’s inventory of the product falls to a pre-established level a restocking order is automatically placed with the company so that shipments can be made on a timely basis to ensure that the customer always has sufficient stock-on-hand of fast-moving items to meet the demand established by end users and capitalize on immediate sales opportunities.⁶

Inventory control systems established and managed by the materials management function can also enhance efficiency through stronger integration of the activities of business partners up and down the value creation chain. For example, when the automatic restocking order is received from a customer in the example above the inventory control system can also be configured to simultaneously send reports to suppliers so that they are able to arrange their production activities so that they are properly synchronized with fulfilling the restocking requirements of the company’s customers. This type of arrangement makes the entire supply chain process more efficient, thus creating a low cost advantage for all parties—the supplier, the company and the customers acting as the distributors of the company’s products. In addition, a strong inventory control systems can also create a differentiation advantage for the company in the eyes of its suppliers and customers since the system reduces the likelihood that sales will be lost because product is not where it needs to be when the end user is ready to purchase. One way that this differentiation advantage can be measured is

⁵ Id. at 211. See also E.S. Buffa, “Positioning the Production System--A Key Element in Manufacturing Strategy,” in Fahey, *The Strategic Planning Management Reader*, 387-395.

⁶ Id. at 211.

through the calculation of the “in-stock rate,” which analyzes whether a product is actually in stock at a customer’s location when requested by an end user.⁷

III. Role of Structure in Functional-Level Strategy

The efficacy and strength of functional resources depends heavily on the ability of the company to coordinate the deployment and use of those resources, which means that structure must be also recognized as an important element of functional-level strategy.⁸ There is no single structure that be considered optimal for every functional area and it is important for each function (e.g., R&D, manufacturing and sales/marketing) to create an internal organizational structure that is specifically suited to its resources (i.e., personnel, technology, plant and equipment, etc.) and the functional domain in which it operates.

The relationship between functional-level strategies and structure can be understood by reference to the choices made by different types of functions with regard to the well-recognized basic characteristics of organizational structures, including “mechanistic” versus “organic” structures, “tall” versus “flat” organizations, “centralized” versus “decentralized” decision making processes and “standardization” versus “mutual” adjustment.⁹ Traditionally manufacturing functions in the US tended to have a tall hierarchy with centralized decision making and relied heavily on standardized procedures. The result was a relatively mechanistic structure that fit well with the production line approach to the pace of work. On the other hand, effective R&D is more likely to occur with an organic structure with a minimum of hierarchy and tolerance for decentralized decision making that empowers skilled engineers and scientists to use and trust their skills and knowledge when solving problems that arrive in the course of the innovation process.¹⁰ In any event, the likelihood that a functional department will demonstrate the coordination skills necessary for the department to become a core competency of the company depends in large part on the skills and talents of the functional management team in designing a functional structure that is closely and positively aligned with the resources the department uses in its value-creation activities.¹¹

When designing their own functional-level organizational structure the managers of each department need to ask several fundamental questions:

⁷ Id.

⁸ Id. at 212 (citing also D. Miller, “Strategy Making and Structure: Analysis and Implications for Performance” *Academy of Management Journal*, 30 (1987), 7-32).

⁹ Id. at 213. For further discussion of each of these characteristics of organizational structure, see *Organizational Structure* (Ch 3).

¹⁰ Id. at 213-214. See also P.R. Lawrence and J.W. Lorsch, *Organization and Environment* (Boston: Graduate School of Business Administration, Harvard University, 1967).

¹¹ Id. at 214.

- How many hierarchical levels of management control are necessary to achieve the optimal level of control and coordination for the department's activities? The opposite ends of the spectrum on this characteristic are tall and flat organizations.
- What amount of decision making authority can and should be decentralized and pushed lower in the departmental managerial hierarchy?
- How much reliance should be placed on standardized rules and operating procedures as opposed to granting managers and employees throughout the department the flexibility to make choices regarding the use of the department's resources based on the specific circumstances they are confronting at that time, a management choice often referred to as "mutual adjustment"?

How these questions are answered, and the design decisions that follow, determine whether the functional structure leans more toward "mechanistic" (i.e., predictable behavior supported by a tall organization, centralized decision making and standardization) or "organic" (i.e., flexibility and mutual adjustment supported by a flat and decentralized organizational structure). As noted above, the most suitable type of organizational structure for R&D is "organic" (i.e., flat and decentralized and heavily reliant on the creation and use of smaller teams to conduct the necessary R&D activities) since this allows and encourages people to proactively initiate change as needed in order to cope with the unforeseen situations that typically arise when developing new technologies and products. In the manufacturing area, the traditional preference for a mechanistic structure alluded to above has eroded in the face of evidence from Japanese firms that development of a core competency in the manufacturing function is more likely to occur in an organic environment in which the hierarchy is flattened and managers and employees on the production line are empowered through decentralization and encouragement of mutual adjustment. The organizational structure for the sales function generally tends to be relatively flat and decentralized and managers and employees rely on standardized reporting systems to exchange information on sales activities and the changing requirements of customers. Salespeople do have some discretion in tailoring the tone and content of their sales pitch when dealing with specific types of customers; however, standardization still plays a dominant role in that salespeople must adhere to the messages developed by the marketing group and follow uniform guidelines regarding pricing and bundling of products and services.¹²

IV. Role of Organizational Culture in Functional-Level Strategy

Another important element of creating core competencies through the development and execution of a functional-level strategy is establishing the proper culture within the functional department. In general, organizational culture in this context can be thought of as the set of shared values that the members of the functional department (i.e., the managers and employees) use and rely upon when interacting with one another and with other stakeholders outside of the department. Functional culture is important and potentially valuable because it is extremely difficult, if not impossible, for a competitor to imitate given that the values and practices are deeply imbedded and often intangible.

¹² Id. at 213.

While companies often duplicate the organizational structure used by competitors, including operating systems and compensation plans, they may fail to achieve the same results (e.g., more effective control and coordination) simply because they cannot replicate the cultural norms and values that managers and employees within the competitor rely on to operate efficiently and collegially within their chosen structure.¹³

One of the elements of organizational culture is indeed the structure and operating procedures implemented by the managers. For example, a large firm seeking better control over its widespread operations may establish a multi-divisional structure and a company looking to attain certain performance goals may implement a new incentive-based compensation system to motivate employees to act in ways that are consistent with achieving those goals. However, formal structures and incentive plans are just one piece of the puzzle and the contribution of the department culture to creating a core competency is a function of several other factors including allocation of property rights, ethical norms and values within the department and the talents and personal characteristics of the senior departmental managers. For example, companies looking to establish an entrepreneurial culture in their R&D departments supplement their choice of a flat, decentralized and organic organizational structure with strong cultural norms that emphasize hard work, cooperation and tolerance for experimentation and informed failure. In addition, all functional departments can strive for improved performance, such as high product quality in the manufacturing area, by establishing cultural values that emphasize participation and commitment and allocating property rights (e.g., stock ownership, profit-sharing plans and/or job tenure) in a way that directly rewards performance and builds and maintains loyalty to the department and the company as a whole.¹⁴ Finally, the HR department can contribute to the cultural aspects of each functional-level strategy by assisting with the recruitment of new employees who share the terminal values of the company and contributing to creation and implementation of functional orientation and training programs that socialize new recruits and educate them about the desired core values within the functional department.¹⁵

V. Managerial Implications

The first thing that functional managers need to do is identify the specific functional resources and/or coordination abilities that serve as the foundation for an actual or potential core competency of the function. Once that step is completed the manager should develop and implement plans to improve or strengthen these resources and abilities. All plans should be accompanied by specific performance metrics that can be tracked in order to ensure that satisfactory progress is being made toward elevating the

¹³ Id. at 214. See also J.B. Barney, "Organization Culture: Can It Be a Source of Sustained Competitive Advantage?" *Academy of Management Review*, 11 (1986), 791-800. For further discussion of organization culture generally, see *Organizational Culture* (Ch 7).

¹⁴ Id. at 214-215.

¹⁵ Id. at 214. See also S.M. Oster, *Modern Competitive Analysis* (New York, Oxford University Press, 1990).

functional core competencies to the level at which they become a true competitive advantage for the company as a whole.¹⁶ Functional managers should also look outside of their own companies to benchmark their performance against competitors and identify industry-wide best practices that can be applied to management of their own departments or units. Specifically, functional managers should select several competitors and attempt to learn as much as possible about the way that they collect and allocate resources and organize and control their activities. The information derived from this survey can be used as part of the planning process for strengthening the competencies within the manager's own function and can be particularly valuable in setting measurable performance objectives.¹⁷ Finally, functional managers should pay specific attention to how the function's current resources and coordination abilities are being impacted by the organizational structure within the function and the function's prevailing cultural norms and values. Using information about best practices of competitors the manager should consider whether changes in structure and/or culture can be successfully implemented in a way that improves the function's core competencies.¹⁸

Functional managers should also be prepared to develop and implement detailed action plans for their strategies, a process which should include the following¹⁹:

- Describe the specific strategy to be followed and make sure that it supports the overall strategy and vision for the organization.
- Define the anticipated outcomes expected from following the strategy, such as improvement in the efficiency of workflow and/or increased market share or profitability. Outcomes should be defined as specifically as possible and, of course, should support the chosen strategy for the function (i.e., "low-cost" or "differentiation" advantage).
- Define your time schedule for implementing and completing execution of the strategy including the beginning and ending dates for the project and all key milestones.
- Describe the resources necessary to implement the plan (e.g., staffing, capital, information, raw materials and equipment) and how these resources will be provided.
- Outline the specific steps to be followed to execute the strategy and assign the person responsible for overseeing the action plan.
- Develop a feedback system that includes reports from the responsible person on a timely basis regarding the progress of the project and makes that person accountable for the success of the project. Reports should cover actions taken, resources used, milestones achieved and, most importantly, surprises and problems that might dictate a change in direction.

¹⁶ Id. at 215.

¹⁷ Id.

¹⁸ Id.

¹⁹ L.U. Hendrickson and J. Psarouthakis, *Dynamic Management of Growing Firms: A Strategic Approach* (Second Edition) (The University of Michigan Press, Ann Arbor, MI: 1998), xxxii.

Many organizations develop their strategic and operational plans using inputs from the various key functions; however, no function should be allowed to follow a plan that has not been vetted by senior management to ensure that it is properly aligned with the overall strategic plan for the organization and the goals and objectives of other units.²⁰

²⁰ L.U. Hendrickson and J. Psarouthakis, *Dynamic Management of Growing Firms: A Strategic Approach (Second Edition)* (The University of Michigan Press, Ann Arbor, MI: 1998), 25.