Strategic Cost Management

(Relevant to PBE Paper II – Management Accounting and Finance)

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Introduction

Strategic cost management (SCM) is an overall system for recognising and measuring the cost and value relationships among the different processing activities in the value chain, and for managing the cost relationships for achieving companies' benefits. It is also known as cost management theory.

Strategies

In addition to cost management, strategy plays an important role in SCM. Strategy is the means by which a company makes decisions for what it will or will not do. As a strategy is conducted, management accounting information gives feedback and assists accounting control. There are three general strategies to be considered: cost leadership, product differentiation, and focusing. Each can be described briefly as follows:

1. Cost Leadership Strategy
   For average products or services, customers prefer to buy them at lower prices. Companies adopting this strategy aim to provide the same or better value to customers at a lower cost than that offered by competitors. Companies might redesign product specifications so that fewer parts are needed, lowering production costs and maintenance costs after sales.

2. Differentiation Strategy
   For fashionable or unique products or services, companies wish to strive to enhance customer value by improving on the overall product experience that customers receive. This strategy is a means of achieving customer recognition. For example, computer retailers may provide repair services on-site, a service not offered by other competitors in the business.

3. Focusing Strategy
   Companies choose or focus on a specific market or customer segment in which to compete. For example, Google Inc., the biggest IT services company, has targeted particular types of customers through pattern analysis of Web search results and tailors its Web advertisements to target particular sets of customers.

Competitive Environment

In the modern competitive environment, companies are greatly concerned with their investment and related utilization of resources. They make efficient spending decisions based on a strategic vision and their capabilities to develop value from that investment. For a long time, companies have attempted to cut costs in the short-term without really considering sustainable growth and integration with the company business strategy.

To face increasing global competition, new markets, and tightening regulation, flourishing companies must develop a multi-dimensional cost competence. SCM utilizes cost and management accounting data about a company and its competitors for use in developing and monitoring the business strategy. It emphasizes cost reduction and continuous improvement and change, rather than merely recording costs.

It has been observed that the established cost control systems mostly maintain the status quo, and that the methods of performing the current activities are not reviewed. SCM goes a step further and attempts several approaches for efficient management of costs. For example, a useful cost reduction strategy allows managers to concentrate on direct savings to achieve maximum value. This is an effective way of reducing costs and increasing revenues, thus facilitating better overall business performance.

Michael Porter's concepts of cost leadership and differentiation have had a significant impact on company management. The concepts provide the basis of the strategic approach to cost management, as they explain what a company should do to achieve success.

SCM has become crucial in establishing company strategies for accomplishing organizational objectives. Different cost drivers are clearly determined and managed. The identification of key cost drivers helps companies, especially service companies, to focus on important activities, which usually constitute over 80% of the total costs.

Benefits of Strategic Cost Management

Strategic cost management provides numerous benefits to companies. First and foremost, it provides the business with an improved picture of its sources of profit.

In the value chain management of a business, the benefits of SCM are recognized through the identification and analysis of value chain segments. Some benefits are as follows:

(i) Development of a framework for guiding the strategic allocation of business resources to the core business processes and activities;

(ii) Improvement of the business by identifying its cost drivers, leading to value-added articulation of its strategic plans into costing measures; and

(iii) Facilitating the business in assessing and analysing how activity-based techniques can be adopted at different levels throughout the business to improve its cost accounting functions, such as in budgeting, job costing and process costing.

The Industrial Value Chain

Value creation and addition activities begin from the purchase of basic raw materials and continue to the disposal of the finished product by the end-user customers. Of key importance to a value-chain framework is the realization that various production activities are arranged to form complex linkages. There are internal linkages within the company and external linkages outside the company.

Internal linkages refer to the relationships among activities that are arranged within a company's portion of the value chain. External linkages refer to the company's value-chain activities that are performed with its suppliers on the back side and customers on the front side.

Main Activities of Strategic Cost Management in the Industrial Value Chain

There are five main activities and applications of strategic cost management in the value chain. They are arranged in sequence as: 1. product design; 2. product costing; 3. activity analysis; 4. make or buy decisions; and 5. marketing channel decisions.

1. Product Design
   Product designers usually do not have cost information, thus they are likely to start by creating designs that may not be cost-efficient. To begin, companies start forming teams comprising product designers, production engineers, management accountants and marketing managers as part of their new product development efforts. However, some companies spend less effort on product design, thus leading to high product costs and frequent design changes.

2. Product Costing
   Product cost information is essential to companies. This information is necessary for companies to recognize the activities that relate to each product or to more product groups, and to decide on appropriate pricing and other company policies. It is of essential importance to work out the correct product costs.

3. Activity Analysis
   It is crucial to clarify activities that add cost but not value for customers. These are non-valued activities and need be reduced from the business in order for the company to maintain its competitive position.

   Non-value added activities comprise inspection, internal movements and waiting for the next operation. These relate to increases in production or service lead time and hence unnecessary expenses. To deduce, a business that has a large number of non-value added activities would form barriers to the introduction of new products in a timely manner and within acceptable cost limits.

4. Make or Buy Decisions
   Make or buy decisions are important strategic considerations, especially under cost leadership. For instance, the decision to outsource a component is likely to result in a number of activities, leading to additional overhead. A sophisticated assessment of costs enables managers to outsource only those parts that are not strategically significant or are more economical for outsiders to produce.

5. Marketing Channel Decisions
   Selection of product distribution, either through traditional wholesaling and retailing channels or through modern electronic business channels, can benefit from the SCM approach. The decision to sell to specific customers through specific channels is one possibility.

   SCM approaches need value chain team members to work together to identify process improvements that reduce costs across the value chain, for instance, team-based value engineering, on-site supplier assistance, cross-enterprise cost reduction, joint brainstorming effort on product development, supply chain redesign effort, and supplier suggestions. The cost measures vary among suppliers, manufacturers and distributors. An example of a manufacturer's internal linkage is described below.

Internal Linkage Analysis Example

The cost details of producing a machine component are as follows:

Direct materials: $3 per component; no minimum ordering cost.

Direct labour: $12 per direct labour hour; no minimum basic wages.

Purchasing: Three clerks, each of which earns a $150,000 annual salary; each clerk is capable of processing 2,500 purchase orders per year. Variable processing costs: $5 per purchase order processed for clerical work, computer services and postal delivery.

Warranty: Two repair agents, each of which is paid a salary of $140,000 per year; each repair agent is capable of repairing 2,500 units per year. Variable repair costs: $20 per component repaired.

The expected number of units to be produced is 10,000.

Activities	Activity Driver	Activity Capacity	Current Activity Demand	Expected Activity Demand
Material usage	Number of parts	100,000	100,000	40,000
Production	Direct labour hours	5,000	5,000	2,500
Purchasing components	Number of orders	7,500	6,250	3,250
Warranty repair	Number of defective products	5,000	4,000	2,500

Through combined efforts of cost engineering, the cost reduction from exploiting internal linkages can be:

Material usage	$180,000	(100,000 − 40,000) $3
Labor usage	30,000	(5,000 − 2,500) $12
Purchasing	165,000	[$150,000 + $5 (6,250 − 3,250)]
Warranty repair	170,000	[$140,000 + $20 (4,000 − 2,500)]
Total	$545,000	
Units	10,000	
Unit savings	$54.50	

This example illustrates how internal activity-based costing measures can help a company to calculate and save on operation costs, thus enhancing the internal linkage value.

Concluding Remark

To move beyond cost savings and value enhancement opportunities in the internal linkage analysis, a successful strategic cost management system has to integrate a series of other cost and management accounting techniques for practical uses. They are:

1. Activity Based Costing (ABC);
2. Activity Based Management (ABM);
3. Target Costing;
4. Total Quality Management (TQM);
5. Benchmarking;
6. Business Process Reengineering (BPR);
7. Just in Time (JIT) Inventory Control System;
8. Balanced Score Card;
9. Kaizan Costing;
10. Six Sigma;
11. Life Cycle Costing (LCC); and
12. Theory of Constraints (TOC).

All of these assist in cost control, decision-making and performance measurement of the whole value chain. For a detailed illustration of each of these techniques, please refer to related articles.