LIUC

STRATEGIC COST MANAGEMENT
Why, what and how

Session 12 (a)

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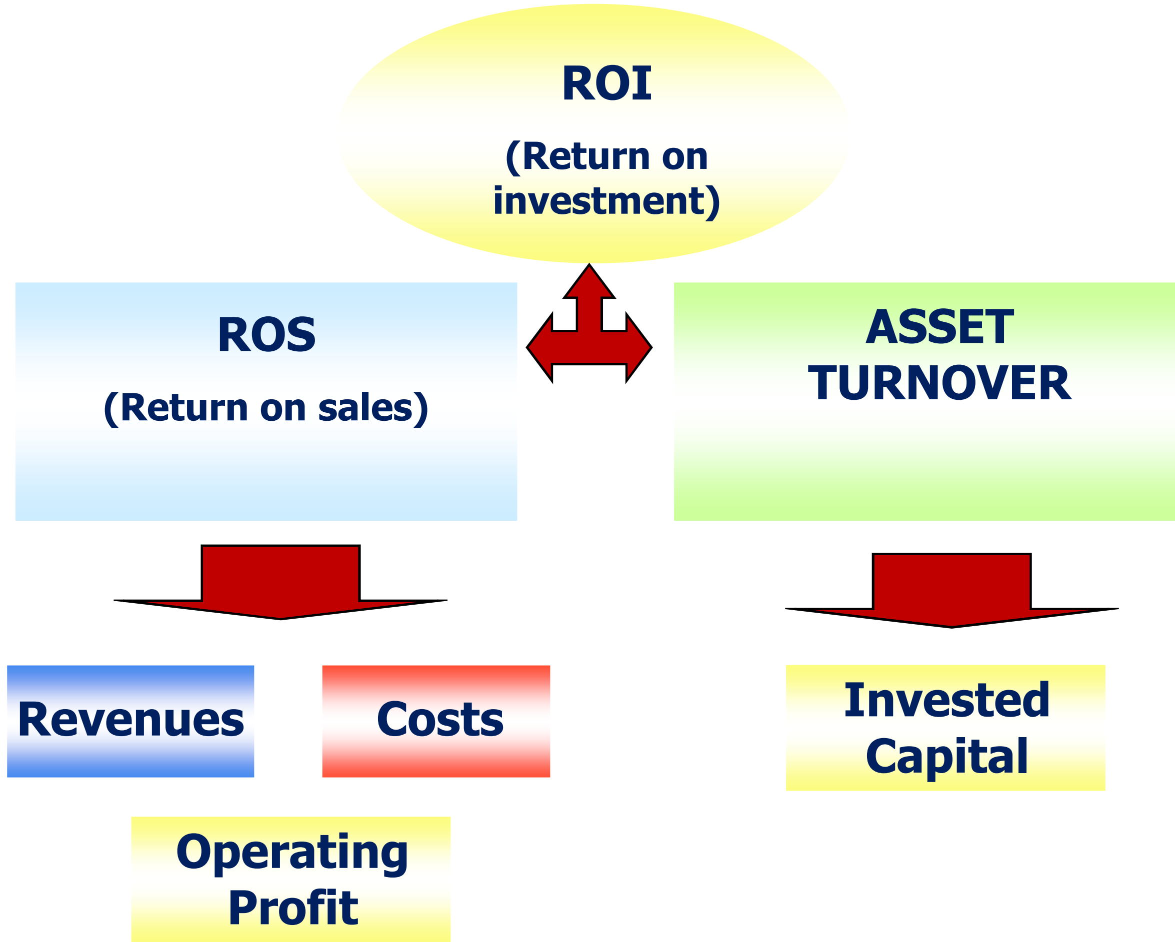
Agenda

- How to manage firm profitability?
- Traditional financial and managerial accounting
- The evolution of the external context and the lean enterprise
- The Confrontation strategy
- Strategic cost management
- Different business archetypes

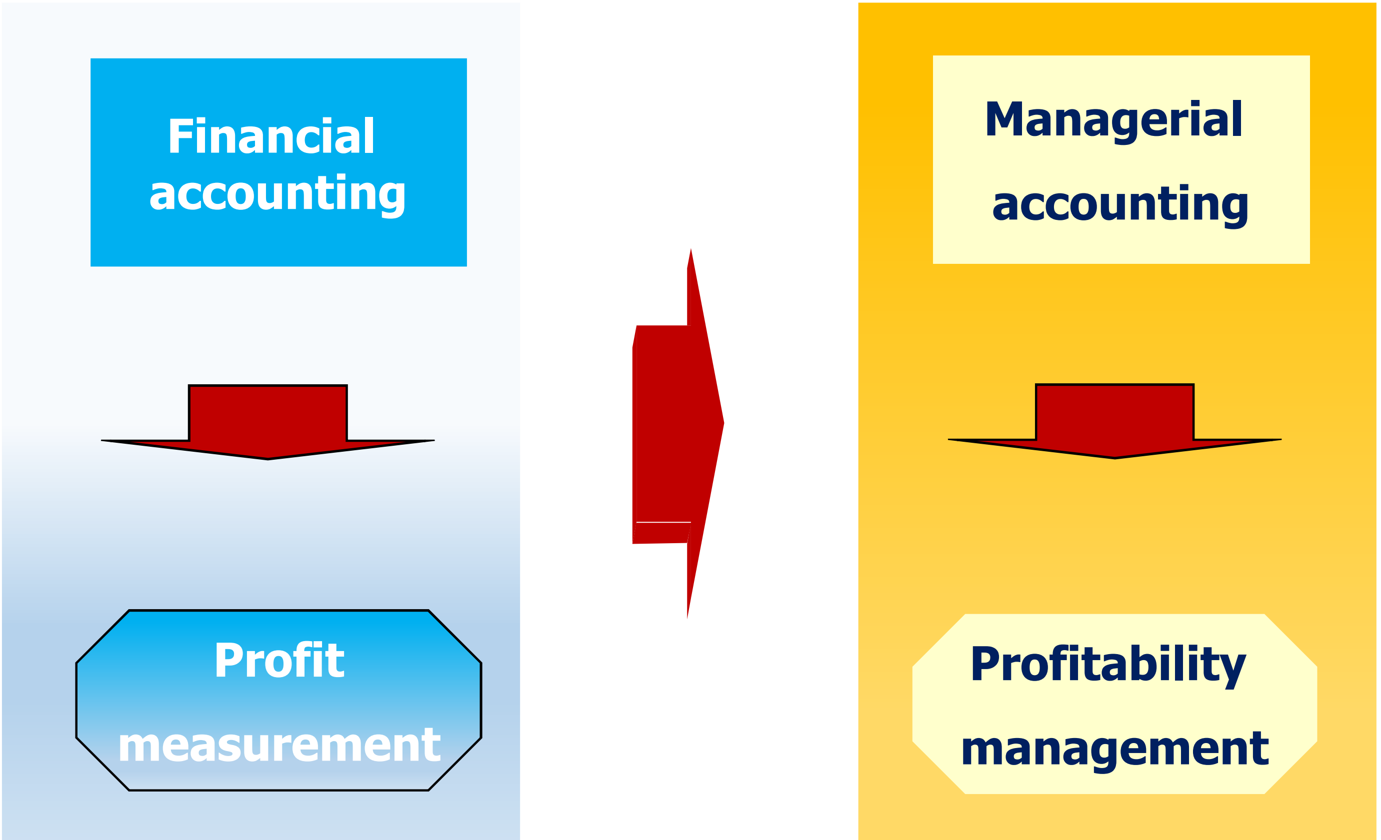
Firm profitability



Firm profitability

- What are the determinants of firm profitability?
- What are mechanisms and principles to manage firm profitability?
- How can we jointly consider short term and long term horizons in decision making?
- How can we consider the contribute of different actors of the value chain?
- How can we consider the specific characteristics of different industries?

The evolution of performance and cost measurement systems



Cost accounting and management accounting

COST ACCOUNTING

Performance evaluation

Cost centers

Standard costing

MANAGEMENT ACCOUNTING

Responsibility accounting

Responsibility centers

Budget and plan

Consistent with the paradigm of Fordism!

The evolution of the external context

- Technological innovation, innovative products and services, but **great knowledge diffusion at very low costs** for customers and competitors

- **Intensification and globalization** of competition on **products and services** markets: decreasing of prices and reduction of life cycles

- **Intensification and globalization** of competition on **supply markets** of production factors and financial markets: high competition for financial resources, raw materials and human capital

- **Changes in the consumption models**: low prices, high quality, fast time to market, high variety and customization

- **Automation and over capacity** in manufacturing: high fixed costs and issues in saturing the installed capacity

- Revenues growht caused by **product substitution** (instead of first demand)
- Economies of **scope, variety and experience** (instead of only economies of scales)

The evolution of the external context

The Consumer Economy and Information Economy

Lean enterprise
Paradigm of Toyotism

Customers' needs

Competitors' moves

How to compete?

The evolution of the external context

Lean enterprise

Customers' needs

Competitors' moves

- **Modular** production systems and processes
- **Flat and lean** organizational structure and networking
- **Great diffusion** of information and knowledge
- Pursuing **jointly** profitability, promptness, product-service quality and functionality, as well efficiency, effectiveness and flexibility
- **Small** production lots with **high** variety of products
- **Reduction** of set-up time and zero defects
- **Symplified** products, services and processes
- **Interfunctional** and **interorganizational** approach

The Confrontation Strategy

In most global and competitive industries, the key to gain success is the integrative management of cost, quality, and functionality in the long term.

- ***Cost***: value of resources used consistent with selling price
- ***Quality***: technical/aestetich specifications consistent with quality perceived by customers
- ***Functionality***: technical/aestetich specifications of product/service that satisfy customer's needs

Survival triplet

When lean Enterprises Collide: Competing through Confrontation, Robin Cooper - Harvard Business School

The Confrontation Strategy

Survival triplet

- There is a «**Survival zone**» arising from different customers' needs and competitors' moves
- But there are not durable competitive advantages!
- There is the need to jointly implement differentiation strategies along with cost leadership strategies

The Confrontation Strategy

Survival triplet

- The objective is to gain at least a minimum level of performance, for each aspect (quality, cost and functionality).
- At any time, the features of the survival triplets of different competitors define the survival zone of an industry.
- A company have to maintain and manage its competitive position in the short time, in order to place itself inside the survival zone, with regard to all three variables.

The diffusion of strategic cost management, and in particular of target costing, has been motivated by the need to support the confrontation strategy

The Confrontation Strategy: an example (1)

In Company A the strategy, organization and performance of after sales department significantly depend on the strategic objectives, plans and programs defined by the headquarters.

The **most important goals are customer satisfaction, retention and loyalty** and not only short term profitability.

In order to achieve these goals, the headquarters:

1) assure the development and design of reliable cars, which are able to satisfy customer needs with the requested functionality, quality and time to market. Product reliability has a great and positive impact on the company image and brand and customer perception of quality;

2) focus on the configuration of the supply chain network and processes, according to the Just-in-Time (JIT) principles, in order to assure a minimum level of stocks, the production levelling, the consistency between production and demand quantity and mix, the production flows continuity, and zero defects along the value chain, from suppliers to dealers.

3) In order to assure the efficiency and effectiveness of the JIT system, the headquarters project and implement into subsidiaries and dealers mostly the same organizational model, developed internally and based on processes and activities. Dealers are requested to order spare parts daily and not to sell them to independent dealers, in order to assure a steady flow of orders, maintain low stocks, facilitate the forecasting of spare part needs, and take up not much room.

The Confrontation Strategy: an example (2)

4) The logistic department represents a unit inside marketing department, in order to emphasize the importance of brand image and customer satisfaction;

5) The performance of the subsidiaries and dealers is measured and evaluated with regard to the following aspects:

- customer satisfaction and retention,
- service capacity vs unit in operations,
- spare part service rate,
- monthly stock.

6) The after sales department does not have profit goals, but it is a cost center.

7) All systems, processes, activities and performance indicators are devoted to gain the most important objective of customer loyalty in the long term.

Lean enterprise: managerial issues

- Create **customer value**
- **Jointly** consider variety, quality and customization of products and services
- Launching products and services **better and faster** than competitors
- **Accelerating the innovation** of products, services and processes
- Managing **jointly** costs, prices, quality, and functionality
- Focus both on **medium term decisions** that commit future firm resources and capacity, and on the **saturation of fixed costs** in the short term

Generate short term profitability levels consistent with future growth and development needs

Emphasis on planning the level of future costs in the medium term and on their saturation in the short term

The determinants of firm profitability

- Planning future firm resources and capacity
- Defining product/service offerings consistent with customer value
- Shortening time to market and product/service life cycle

- Committed and indirect costs
- Product/ service functionalities
- Managing profitability in the life cycle and in the supply chain

Strategic cost management: main objectives

- Defining an acceptable **level of costs, consistent with the product-service value delivered to customer**, more than to optimize the use of existing technologies, as standard costing does.

  The target level of costs is defined **by an external driver** (its consistency with customer value), and not by internal efficiency objectives, defined by the firm

- Managing costs, by identifying and managing **cost drivers**, instead of measuring and control actual costs and comparing them with standard costs

- Defining not only product-service costs, component costs, production factor costs, but also the costs of product/ service **functionalities/attributes**
- Coping with **future committed costs** defined by strategic and investment decisions and not only with actual costs
- Managing **costs along the supply chain**, especially costs of suppliers

Strategic cost management: focus

- **Product/service functionalities/attributes** that are objects not considered by traditional managerial and cost accounting;

- The relationship among costs, customer value, product/service functionalities and attributes;

- Costs **committed in the R&D for product-service life cycle**, and not only sustained costs of production and sales phases of the life cycle;

- **Total cost of ownership** for customer

- **Future products and services** and not only actual ones

- **Supply chain** and not only the single firm.

Strategic cost management: categories

Strategic profitability planning

Customer value

Mechanisms which design and plan value-cost relation, committed costs and total cost of ownership in the life cycle and in the supply chain.

Future product-service

- Target costing
- Life cycle costing
- Inter-organizational cost management systems
- …

Performance measurement and profitability management

Transactions' value

Mechanisms which rationalize costs of activities and processes and measure performance results and drivers in the short term.

Actual product-service

- Performance Measurement Systems
- Activity Based Costing
- Activity Based Management
- …

Strategic profitability planning mechanisms

- They aim at **planning the company's long-term profitability, since the R&D** of new products and services, and at **reducing the cost of ownership** for the customer along the life cycle.

- They consider that about 80% of total product-service life cycle costs is committed during the early phases of R&D.

- They deal with costs committed in the product life cycle, total cost of ownership for customer, the relationship between customer value and cost, the configuration of the supply chain network.

- They consider the additional **role of the last phases of the life cycle**, such as after sales, dismissal and recycling, as well related services in the life cycle (i.e. maintenance, repairing, etc.).

Performance measurement and profitability management mechanisms

- They focus on managing **cost and profitability of existing** products and services.
- They consider mainly the efficiency of production processes and activities, as well cost and profitability generated **after the start of production phase**.
- They pursue the objective of **incremental improvement in existing** processes, operational procedures and products and services.
- They usually operate in the **context defined** by the decisions made during product-service design and development and network configuration.
- They can influence **about 20%** of total cost in the life cycle.
- They aim at improving, evaluating and measuring **short-term** performance.
- They generate information on product-service costs, useful to:
  - (i) measure profitability, through inventory valuation, and transfer pricing definition;
  - (ii) support decision-making (price definition, segment profitability analysis, make or buy, etc.);
  - (iii) manage and control efficiency in the use of resources
  - (iv) measure and evaluate managers' performance.

Future and actual costs

Future products and services

Functionality optimization

- Target costing
- Redesign to cost
- Life cycle costing

Actual products and services

Process optimization

- Activity Based Costing and Management
- Total Quality Management

Two different business archetypes

"Product-based" business archetype

•Typical of firms where the majority of committed costs arises as a consequence of the **characteristics and attributes of new products and services**, defined and decided in the R&D phase of the life cycle.

•There is a **direct relationship** between the company's profitability and each single PPS's profitability in its life cycle.

• Relevance of the **life cycle** of product and related services and of the **supply chain**.

• Mainly manufacturing companies with batch and discrete production processes and complex products made by assembling a relevant number of different components and using different and complex technologies.

• Also services focused on projects (i.e. software development)

"System-based" business archetype

•Typical of firms where profitability derives from the consistency between decisions concerning the investment in capacity**,** in the medium-long term, and the **ability to saturate the installed capacity** with sufficient volumes of transactions in the short run.

•The company's profitability in the short run arises in a **systemic way,** be exploiting economy of scales**,** and as a consequence of an adequate relationship between sunk fixed costs of capacity and sales volumes/revenues.

• **Marketing efforts** have a significant role in influencing customers' behavior to increase the number of transactions and contacts between the company and the customers, thus impacting on sales volume, and to assure the consistency between service offerings and different customer segments' needs, thus impacting on customer value and pricing.

• Services, especially **mass-market services** and manufacturing firms characterized by **continuous flow** production processes.

Strategic managerial control for different business archetypes

"Product-based" business archetype

Strategic profitability planning

- Target costing
- Life cycle costing
- Inter-organizational cost management system
- …

"System-based" business archetype

Performance measurement and profitability management

- Performance Measurement Systems
- Activity Based Costing
- Activity Based Management
- …