Strategic Cost Management

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Outline

- Definition of SCM
- Concept of SCM
- Why Strategic Cost Management
- Components of SCM
- Guiding principles of SCM
- Enablers of SCM

Cost Management Definition

- It is the establishment of programs that regularly analyze purchase requirements and suppliers to identify lowest total cost and maximize total value to the company. The development of a savings forecast by commodity is necessary to define budget parameters for building cost-of-goods structures(Desai & Pandya 2006).

Definition of SCM

- Strategic cost management can be defined as" scrutinizing every process within your organization, knocking down departmental barriers, understanding your suppliers' business, and helping improve their processes"(Desai & Pandya 2006)
- It is the overall recognition of cost relationship among the activities in the value chain and process of managing those costs relationships to a firm's advantage

Concept of SCM

Strategic cost management is understood in different ways in literature :

- Cooper and Slagmulder (1998a:14) argued that SCM is "the application of cost management techniques so that they simultaneously improve the strategic position of a firm and reduce costs".
- Cooper (1995a:89) stated that SCM includes all aspects of production and delivering the product; the supply of purchased parts, the design of products and the manufacturing of these products.

Concept of SCM

- Horvath and Brokemper (1998:585)- strategic cost management has emerged as a key element to attain and sustain a strategic competitive advantage through long-term anticipation and formation of costs level, costs structure, and costs behavior pattern for products, processes, and recourses.
- Porter (1998a) suggested that a firm has a choice of three generic strategies in order to achieve sustainable competitive advantage. They are cost leadership, differentiation, and focus.

Concept of SCM

- In his study, Hinterhuber (1997:11-13)- cost management is "a necessary course of action which acquires strategic significance the more it increases the number of options for discovering new opportunities or inventing new markets. Strategic cost management tends to be an integrated, proactive part of strategic management aimed at satisfying all key stakeholders."

Concept of SCM

- According to McIlhattan (1992: M1-1), strategic cost management is the skillful handling or directing of costs.
- Horngren et al. (2000:3) -cost management is not practiced in isolation. It is often carried out as a key part of general management strategies and their implementation.
- They define strategic cost management as the set of actions that managers take to satisfy customers while continuously reducing and controlling costs.

Concept of SCM

- Cost data is used to develop superior strategies in gaining sustainable competitive advantage
- SCM give clear understanding of the firm's cost structure in search of sustainable competitive advantage.

Concept of SCM

- Cost analysis in terms of overall value chain of which the firm is part which has a strong external focus
- The design of cost management system changes dramatically depending on the basic strategic position of the firm (Cost leadership, Product differentiation)
- Cost is a function of strategic choices about the structure of how to compete and managerial skills in executing the strategic choices

Concept of SCM

- The strategy of leadership in costs is identified as the ability of the company to produce its products and distribute them to the customers at costs that are lower than those of the competing companies.
- Factors that contribute to individual firms producing identical products at different costs are primarily determined by differences in technology, available capacities and existence of restriction of certain resources

Concept of SCM

- The adoption of strategic cost management practices by the companies has been the subject of several studies at (Reckziegel, Souza and Diehl, 2007, Marques et al, 2003,Ferreira, Silva and Batalha, 2010; Muniz, 2010, Souza, Collaziol and Damacena, 2010, Guilding, Cravens and Tayler, 2000; Bowhill and Lee, 2002; Dekker and Smidt, 2003, Waweru, Hoque and Uliana, 2005; Cinquini and Tenucci, 2006; Cadez and Guilding, 2007; Zoysia and Herath, 2007; Noordin, Zainuddin and Tayler, 2009; Angelakis, and Thério Floropoulos, 2010).

Concept of SCM

- Based on the findings of these studies, it is observed that the adoption of the strategic cost management practices, when segregated in countries, present higher frequency of use in developed countries like Japan, Italy and United States of America.

Why SCM

- The law of recurring costs: staff costs and expenses reduced but workload doesn't reduce at the same rate, behaviors don't change, costs elsewhere drift up offsetting cost savings
- Wrong costs eliminated: many employees don't understand the real costs because the standard costing systems and their allocation processes usually "easiest" costs cut first.
- Cost reduction is a true path to sustainable competitive advantage

Why SCM

- Costs cut outside strategy: in response to a crisis, short term needs, weakening the strategic strength of an organization, one time reductions neither followed up nor maintained

- Mistrust because of top down viewed as sensitive, not suited to employee involvement.

Why SCM

- Traditionally companies have been under pressure to cut costs in the short-term without really thinking about sustainable change, impact on the people and integration with the overall business strategy
- It is evident that yesterday's tactical solutions despite consuming considerable resources have failed in many organizations to deliver planned reductions in the cost base.
- Arbitrary cost reduction activities can breed uncertainty, anger and resistance which overtime will eat away the success of programmes

Pillars of SCM

- Strategic position analysis
- Cost driver analysis
- Value chain analysis

Strategic Position Analysis

- Strategic positioning analysis is an approach for researching what future environments might be like in your internal corporate structure as well as your external environment and determining how you can use the choice of business strategies to get from your current situation to these desirable goals.

Strategic Position Analysis

Porter five forces model

- New entrants
- Suppliers force
- Buyers force
- Rivalry among competitors
- Substitute goods
- Low Cost Leadership
- Product Differentiation

Cost driver analysis

- Is concerned with determining what the actual drivers of activity costs are within the company's operations. The most used type of analysis for this is activity based costing (ABC) which aims to establish what indirect costs can be related to specific activities.
- For example, indirect costs such as maintenance actually driven by the number of machines or activities being performed per hour.

Cost driver analysis

- Structural cost drivers relate to strategic management choices the company undertakes in relation to actual structure of their operations as well as the complexity of their products and technologies used.
- Executional cost drivers relate to the actual operational processes and norms within operation. The effective use of staff, process layouts, just-in-time processes, etc. all have a bearing on the cost of executing activities within the firm.

Structural drivers

- Favorable location, number of locations
- Number of plants, scale, degree of centralization
- Management style and philosophy
- Number of product lines, number of unique processes, number of unique parts
- Scope, buying power, selling power
- Sales volume in units or Kshs, number of different customers
- Types of process technologies, experience
- Debt level, debt capacity, favorable tax status
- Cumulative volume in the activity, time in operation

Executional drivers

- Employee morale level, turnover rates, degree of involvement
- Quality management approach, employee training level, return
- merchandise rates, customer satisfaction ratings
- Plant layout efficiency; throughput time, ability to convert from one product/service to another
- Product configuration
- Capacity utilization, number of production or service facilities
- Lead-time from product concept to production, R&D cost compared to competitor

Value Chain Analysis

- A systematic approach to examining the development of competitive advantage
- The chain consists of activities that create and build value
- They culminate in the total value delivered by an organization
- Helps determine which type competitive advantage to pursue and how to pursue it
- Value is referred to as the price the customer is willing to pay for a certain offering

Value Chain Analysis

Primary Activities

- Inbound logistics
- Operations
- Outbound logistics
- Marketing and Sales
- Service

Support Activities

- Firm infrastructure .Human Resource Management
- Technology .Procurement
- Finance

Create competitive cost base

- Keep cost under continued observation through targeted key performance indicators
- Know current best practice and regularly benchmark the cost base against competitors
- Have effective decision-making processes
- Execute periodic, tightly focused tactical cost reduction projects under an effective project management discipline
- Ensure compliance through strict governance and robust supplier management
- Understand net profitability by customer, product, market and channel.

Cost effective strategy execution

- Continually challenge the business model to shape investment choices
- Analyse key cost data to show the cost implications of new opportunities, products and customers
- Ensure poor areas of customer and product profitability are understood and continually addressed
- Ensure that growth is funded through cost efficiency
- Robustly track the execution of strategy against plans and manage performance
- Embed a culture of cost consciousness in the organisation but invest in those areas that will deliver the greatest return

Continuous improvement

- Actively track the customer experience and market place, being able to effectively assess the costs of response
- Review the external environment for different cost effective methods or business models
- Be alert to potential market entrants from any area, recognizing that lower cost competition can arise from different industries
- challenge operational costs to drive investment in critical research and development
- monitor complexity throughout the business, constantly simplify execution whilst enhancing service delivery
- Recognise that employee satisfaction and performance drives financial success and structure rewards accordingly

Guiding Principles of SCM

- Understand what causes the cost and revenue structure of the business
- Identify the firm's activities and select those that can be used to sustain a competitive advantage
- Understand and reduce inter-functional complexity
- Increase effectiveness and continuously improve costs.
- Use strategy to manage costs.
- Build skills.
- Involve employees in decisions.

SCM Enablers

- Redefinition of procurement business processes
- Maximize the leverage effect of purchasing
- Sharing of Risks and Rewards
- Supply chain visioning
- Diffusion of best practices in the organization
- Strategic alliances
- Planned change management
- Supply base rationalization
- Existence of shared supplier-customer strategies
- Minimization of transactional activities of
- Shifting of supply chain costs

SCM Enablers

- Top management support and sponsorship
- Information systems
- Identity of total cost drivers
- Cost models
- A strategic cost management plan
- Effective cross-functional teams
- Known Business strategies
- Alignment of supply strategies with business strategies
- Total cost approach to procurement
- Balanced Approach to Sourcing
- Performance Measurement

Top management support and sponsorship

- Without this forget the whole idea of cost management. However, to get this support, top management must understand the value of supply chain management to the bottom line. If management seems reluctant to recognize this from internal efforts alone, cooperative efforts with suppliers and/or customers may help to convince them.

Information systems

- To capture spending by commodity or service, supplier, and geographical area. Information can be used to: identify opportunities for synergy with other supply chain members in areas such as leveraging spend, pooling knowledge, acquiring/providing/sharing technology, identify areas where transfer of best practices will reduce costs, optimize location and use of resources, such as inventories, in the supply chain, and help to identify total cost drivers.

Identity of total cost drivers

- What are all of the elements that make up the total cost in a given supply chain? Total cost drivers may vary by geographical areas and may include items such as logistics, transportation, inventory, lead time, lack of infrastructure, lack of qualified or trained personnel, lack of qualified suppliers, and production impact of particular products or services. Additional drivers that may be present in a global analysis could include tariffs and duties, currency exchange rates, hostile political or geographical environments.

Cost models

- If models of major costs in the supply chain are not available, they may need to be developed. Cost models may have to be adjusted by country or region in global supply chain situations. Some techniques for modeling costs include learning curve analysis, experience effect analysis, price productivity analysis, implied set-up cost analysis, should-cost analysis, comparative process analysis, and cost breakdown analysis. The Purchasing Handbook is handy in this area.

A strategic cost management plan

- There must be known cost management objectives and a plan as to how you are going to achieve them. One approach to prepare such a plan is to use a three-step approach that includes: classifying purchases, matching cost analysis tools with the purchase classifications, and focusing on strategic cost management techniques to achieve cost management results.

Effective cross-functional teams

- Vital to the success of any cost management effort because of the varied departments and functions that are affected and need to be involved to implement cost management initiatives. All parties either affected by the costs in question or involved in generating those costs need to be involved in the applicable cost management teams.

Known Business strategies

- To develop purchasing cost management strategies, overall business strategies must be known. The maximum effect of strategic cost management in the supply chain can only be achieved when supply chain strategies are aligned with overall business strategies. Obviously, to achieve alignment, overall business strategies must be known to the supply chain team.

Alignment of supply strategies with business strategies

- To be most effective, purchasing cost management strategies must be aligned with overall business strategies. This enabler is key to successful strategic cost management and also to obtaining full support of top management. Do not make the mistake of concentrating cost management efforts in an area that management considers unimportant, or in an area of the business that is not strategically important to the company and/or may be up for divestiture.

Total cost approach to procurement

- Frequently the most significant cost reductions in a supply chain do not result from lower prices. Price is important but it is not the only cost. Costs other than price may have more reduction potential or may be easier to reduce than price itself. Do not overlook any cost element. Sometimes costs that are indirectly linked to the use of products or services may contain large reduction potential as a result of changes in the purchased products or services.

Balanced Approach to Sourcing

- It is inefficient to either purchase everything through alliances or purchase everything on a transactional basis.
- All purchases must be analyzed and categorized according to criteria such as total spend, long-term vs. short-term need, strategic importance, and supply base capabilities. From such an analysis individual purchase categories can be identified as candidates for strategic alliances, small-value purchase techniques, and transactional approaches.

Performance Measurement.

- Without measurements you don't know where you are, where you came from, or where you are going.
- established for all aspects of a strategic cost management plan that are critical to its success.
- the first step in establishing measurements is to identify critical success factors and then develop indicators to measure how well they are being achieved.
- used to report success, to identify problem areas, and as the basis for taking corrective action.

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