BANGLADESH COST ACCOUNTING STANDARDS

BCAS - 23

Strategic Cost Management

BACS 23: Strategic Cost Management

23.1 Introduction

Strategic cost management (SCM) deals with measuring and managing costs and aligning them to the business strategy. The cost and management accounting information thus developed would help managers to understand and implement the strategy, diagnosis the performance and influence behavior and decisions. It is the analysis of cost in a broader context, where the strategic elements become more conscious, explicit, and formal. Cost data is used to develop superior strategies in route to gaining sustainable competitive advantage. SCM gives a clear understanding of the firm's cost structure in search for sustainable competitive advantage through cost reduction. It is the managerial use of cost information explicitly directed at one or more of the four stages (strategy formulation, communicating the strategy, implementing and controlling) of strategic management. Overall recognition of the cost relationships among the activities in the value chain, and the process of managing those cost relationships to the attainment of firm's strategic objectives are the main focal point of SCM. This standard provides a basic guideline of SCM which is not an exclusive one and it should be read in conjunction with other relevant standards.

23.2 Objectives

The main objective of this standard is to provide a basic guideline to those companies who plan to undergo cost analysis as a part of strategic analysis. It tries to facilitate the practitioners to apply SCM as a driver to ensure sustainable competitive advantage. The standard presents relevant analysis covering three core components of SCM which are,

- a) Strategic positioning;
- b) Cost driver analysis; and
- c) Value chain analysis.

23.3 Scope

23.3.1 This standard will work as a guideline to those companies who have decided to apply cost management as a part of their strategy.

23.3.2 It extends discussion to cover three important components of SCM which are strategic positioning, cost driver and value chain analysis.

23.3.3 This standard may be followed by companies and other business or non-business organizations where cost and management accounting is in practice either as a statutory obligation or to support management decision making process.

23.4 Key Features

The key features of this standard are pointed below -

- a) Presenting basic idea of strategic cost management;
- b) Providing a brief outline of strategic positioning, cost driver and value chain analysis;
- c) Discussing on the SCM framework;
- d) Aligning different types of cost with strategy; and
- e) Listing tools for value chain analysis as an important component of SCM.

23.5 Definitions

The following terms are used in this standard with the meanings specified -

23.5.1 Strategic Cost Management: SCM is the process of identifying, accumulating, measuring, analyzing, interpreting, and reporting cost information useful to both internal and external groups concerned with the way in which an organization uses its resources to meet its objectives.

23.5.2 Value Chain Analysis: Value chain analysis relies on the basic economic principle of advantage - companies are best served by operating in sectors where they have a relative productive advantage compared to their competitors. Simultaneously, companies should ask themselves where they can deliver the best value to their customers.

23.5.3 Strategic Positioning: A company's relative position within its industry matters for performance. Strategic positioning reflects choices a company makes about the kind of value it will create and how that value will be created differently than rivals.

23.5.4 Differentiation: Driving up prices is one way to increase profitability. To command a premium price, a company must deliver distinctive value to customers. This is differentiation.

23.5.5 Cost Leadership: Driving down costs is another way to increase profitability. To compete on cost, companies must balance price with acceptable quality. This is cost leadership.

23.5.6 Cost Driver Analysis: Examination, quantification, and explanation of the monetary effects of cost drivers associated with an activity.

23.5.7 Executional Cost Drivers: Executional cost drivers are factors that a firm can manage in short-term as a part of operational decision making to reduce costs. They are derived from the execution of the business activities such as capacity utilization, plant layout, work-force involvement, design of the production process, and supplier relationships.

23.5.8 Structural Cost Drivers: Structural cost drivers are strategic in nature because they involve decisions that have long-term effects on the firm's total costs. They are derived from the business strategic choices about its underlying economic structure such as scale and scope of operations, complexity of products, use of technology, and complexity.

23.5.9 Value: Value is referred to as the price that the customer is willing to pay for a certain offering.

23.6 Standards

23.6.1 **Strategic cost management is the application of cost management techniques so that they simultaneously improve the strategic position of a firm and reduce costs.**

23.6.2 **Strategic cost management can be applied in service and manufacturing settings and in not-for-profit environments.**

23.6.3 Strategic cost management has three important pillars, viz., strategic positioning, cost driver analysis and value chain analysis.

23.6.4 **There are three types of cost management initiatives: those that strengthen the firm's competitive position, those that have no impact on the firm's position, and those that weaken it.**

23.6.5 The first class of initiative can be illustrated by a hospital that redesigns its admissions process for patients so that it becomes simpler, faster, and less stressful on the patients to be admitted. If patients have a choice of hospital they will enter, the new process will make the hospital more attractive to them. Hence, the strategic position of the firm has been strengthened.

23.6.6 The second class of initiative can be illustrated by an insurance company that redesigns its accounts payable system to make it more efficient. This project has no strategic significance other than to make the firm more profitable. Unless the additional profitability is significant, the project will have no strategic implications. The strategic position of the firm remains essentially unchanged.

23.6.7 The third class of initiatives can be illustrated by an airline's decision to reduce headcount by no longer having "floaters" ask passengers why they are queuing up to get their tickets. This question is important because at this airline's hub there are two types of ticket desks and hence two sets of queues. One type of desk deals with normal conditions, and the other desk deals with special conditions. The average passenger does not know which the appropriate queue is because there is no easy way to delineate between the two. When queues are long, being in the wrong one is very upsetting, especially if a passenger has waited over an hour in one queue and then is told, "You are in the wrong queue. Start again over there." This cost-reduction initiative leads to extreme customer dissatisfaction and thus weakens the airline's strategic position, which is based on high levels of customer service.

23.6.8 The ways the three initiatives are different often are not as great as might first appear. To convert the third example from a negative to a positive simply requires a change in orientation. The correct starting point is not to remove the floaters but to ask why they are needed in the first place-that is, to undertake a root cause analysis. There are two answers to the floater question: first, because there are two types of desk, and, second, because demand exceeds processing time-hence the queues. The most effective cost management initiative would be to reduce processing times so that the queues go away, then collapse the two types of desks together. This procedure removes both sources of passenger dissatisfaction and, if successful, reduces costs. The initiative now illustrates strategic cost management in action.

23.6.9 **As a rule of thumb, initiatives that lead to a weakening of strategic position should never be undertaken. They should be viewed not as cost reduction programs but as revenue reduction programs.**

23.6.10 For example, passengers will begin to avoid the hub that has excessive queues and high queuing errors during bad weather and fly direct or to another hub, both instances frequently requiring a switch to another airline. In most cases, the resulting revenue reduction will exceed the cost savings many times over.

23.6.11 Firms can benefit by undertaking a quick audit of every cost management initiative they have planned or are currently undertaking and see how many actually strengthen their strategic position. If the answer is very few, then it is time to refocus the firm's cost management program. For example, cost reduction programs that "reduce costs 10%

across the board" are at best strategically neutral and typically weaken the firm's strategic position. For this reason, among others, the cost "savings" frequently disappear once the crisis is over.

23.6.12 Occasionally, managers argue that the savings will be so great that weakening the firm's strategic position will be offset by the increased profitability. We are almost never persuaded by this argument. We believe that there always are solutions that will enable the costs to be reduced and the firm's strategic position to be strengthened, not weakened. Once a firm grasps the concept of strategic cost management, finding ways to achieve both objectives (simultaneously reduce costs and strengthen strategic position) is easier than it first appears.

23.6.13 The design of cost management systems changes dramatically depend on the basic strategic positioning of the firm between cost leadership and product differentiation.

23.6.14 **The choice between cost leadership and product differentiation is very typical to the strategic goal of firms which is set at the discretion of management and the standard doesn't favor one over another.**

23.6.15 Cost leadership is an appropriate choice in commodity business where market is matured and a cost is usually targeted. On the other hand, product differentiation is more market driven and mostly chosen in fast changing rapidly growing market.

23.6.16 Once chosen, management's action should be very much particular aligning it with the chosen strategy.

23.6.17 Cost is a function of strategic choice about the structure of how to compete and managerial skill in executing the strategic choices between structural cost drivers and executional cost drivers.

23.6.18 Structural cost drives the product cost of the organization across -

- a) Scale: how big an investment to make in manufacturing, R&D, and in marketing resources?
- b) Scope: Degree if vertical integration
- c) Experience: how many times in the past the firm has already done what it is doing again?
- d) Technology: what process technologies are used at each step of the firm's value chain?
- e) Complexity: how wise a line or products of services to offer to customers? (usage of ABC)

23.6.19 Executional cost determines the firm's cost position to execute the strategy successfully. These cost drivers are scaled with the performance.

23.6.20 For strategic analysis, volume is usually not the most useful way to explain cost behavior. In a strategic sense, it is more useful to explain cost position in terms of the structural choices about executional skills that shape the firm's competitive position.

23.6.21 Not all the strategic drivers are equally important all the time, but some of them are very important in every case. For each driver there is a particular cost analysis frame work that is critical to understanding the positioning of a firm.

23.6.22 Value chain analysis is a systematic approach to examining the development of competitive advantage. The chain consists of a series of activities that create and build value. They culminate in the total value delivered by an organization.

23.6.23 Value chain analysis helps to determine which type of competitive advantage to pursue, and how to pursue it.

23.6.24 Value chain analysis considers external focus perspective, linked with activities from raw material suppliers to ultimate end user.

23.6.25 Cost containment is a function of the cost drivers regulating each value activity exploiting linkages with suppliers, customers and process within the firm.

23.6.26 Insights for strategic decision by identifying the cost drivers at the individual activity level and develop drivers by controlling those drivers better than competitors or by reconfiguration of value chain.

23.6.27 A company needs to know its position in the industrial chain to get strategic insights. Knowing the supplier power and buyer power can have a significant effect on how external linkages are exploited.

23.6.28 For example, an ice cream producer makes BDT 0.15 profits from every pound of ice cream sold. The retailer makes a BDT 0.05 profits for every pound he sells. It means that the producer enjoys 75% of the profits giving the producer higher power than the retailer. Focus of external value chain is to select a particular market to sell the product initially. Then, it is easy to develop the value around that market. It is well established that all the segments are not the same.

23.6.29 Making a strong alignment among strategic positioning, cost driver and value chain analysis is important to achieve cost management targets as spelled out at strategy. Strategic cost management framework as given in the appendix shows the relationship.

23.6.30 Attacking particular value chain, reducing the cost of that value chain, reconfiguring the value chain and aligning it with the strategic goal is the main motto of strategic cost management. Strategic cost management is a philosophy that needs to be believed and practiced.

23.7 Recording and Reporting

23.7.1 Strategic cost management initiative is taken at the top and a dedicated team should be involved in the whole process of formulation, implementation and monitoring process.

23.7.2 Organization should have its own policy regarding recording and reporting of following information:

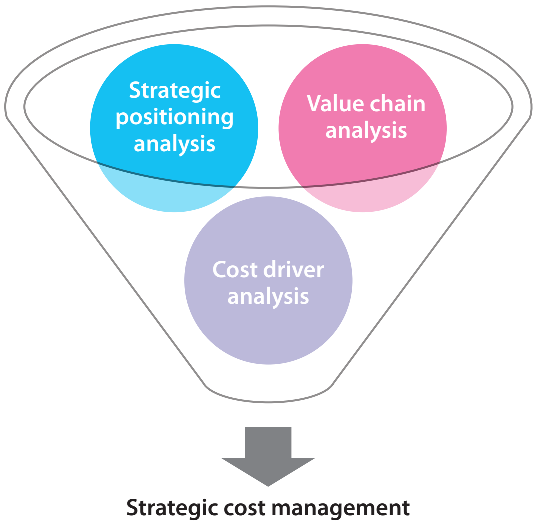
a) Choice of strategic positioning, cost leadership or product differentiation;
b) Choice of cost drivers, structural or executional;
c) Cost reduction strategies with reference to value analysis;
d) Value chain related activities;
e) Periodic evaluation report;
f) Strategic cost management framework for the firm (one is given in appendix);
g) List of tools applied by the firm as a part of strategic cost management (one is given in appendix); and
h) Any other types of reporting as required.

23.8 Effective Date

This standard will be effective from January 1, 2017 onwards.

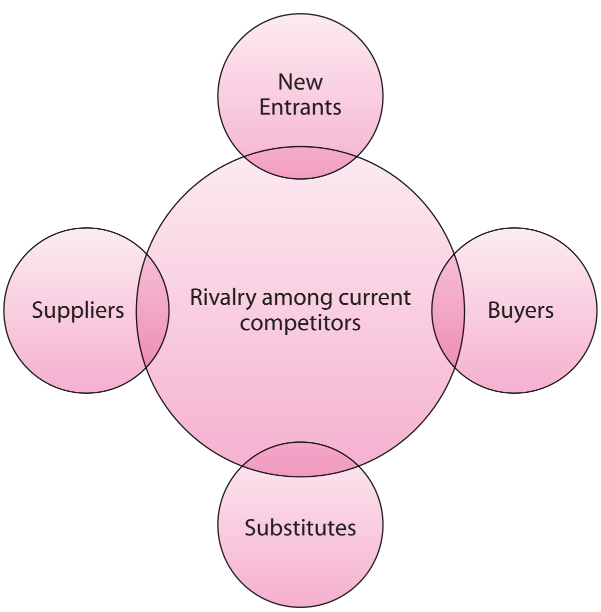
Appendix 23A

Composition of Strategic Cost Management



Appendix 23B

Competitive Forces Model



Source: Adopted from Porter's 5 force model.

Appendix 23C

Different cost and different strategy

	Primary Strategic Emphasis	
	Product Differentiation	**Cost Leadership**
Role of product cost in assessing performance	Not very important	Very important
Importance of flexible budgeting for cost control	Moderate to Low	High to very high
Perceived importance of meeting budgets	Moderate to Low	High to very high
Importance of marketing cost analysis	Critical to success	Not done on formal basis
Importance of product cost as an input to pricing decision	Low	High
Importance of competitor cost analysis	Low	High

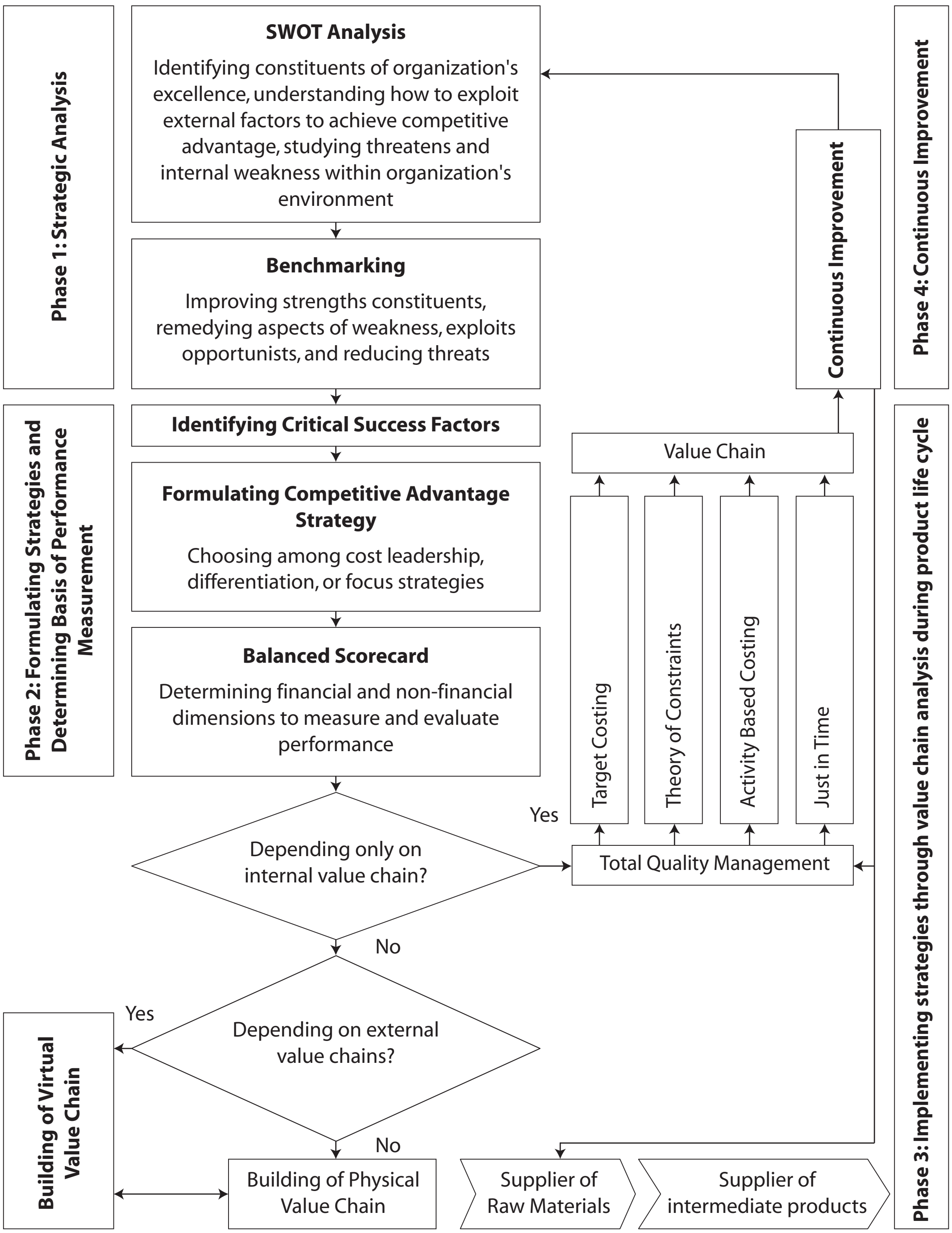
Appendix 23D

Tools in SCM

Tools	**Nature**
Value chain analysis	Add value to customers reducing costs, and understanding relation between business organization and booth customers.
Activity based Costing (ABC)	To provide accuracy in allocating indirect costs.
Competitive Advantage Analysis	Defining strategy that an organization could adopt to excel over rivals.
Target costing	Cost that an organization is willing to incur according to competitive price that could be used to achieve desired profit.
Total quality management (TQM)	Adopt necessary policies and procedures to met customers expectations.
Just-in-time (JIT)	A comprehensive system to buy materials or produce commodities when needed in appropriate time.
SWOT analysis	Systematic procedure to identify critical success factors of an organization.
Benchmarking	Process performed to determine critical success factor and study ideal procedures of other organization in order to improve operations and dominate market.
Balanced scorecard	Accounting report of critical success factors about the organization. It is divided into four major dimensions: financial performance, customers' satisfaction, internal operation, and innovation and Growth.
Theory of Constraints	A tool to improve rate of transferring material into finished goods.
Continuous improvement (Kaizen)	Conducting continuous improvements in quality and other critical success factors.

Appendix 23E

Strategic Cost Management Framework



Appendix 23F

Tools used for Value chain analysis

A firm can create a cost advantage by two different ways, by reducing the cost of individual value chain activities and reconfiguring the value chain as shown in the following figure: