Cost management IN WORLD CLASS COMPANIES

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Managing cost purely by cost element often results in increased cost. This article looks at the various approaches used by World Class Companies which develop and evaluate multi-dimensional views of cost and fully understand the behavioural implications.

Cost management is becoming more scientific and complex than ever before. World class companies realise that many factors complicate cost management, such as more complex organisational structures and processes, global competition and intricate causal relationships among costs. Gone are me days when the typical 10% across the board cut in expenses has preserved the bottom line in times of financial stress. The approach of managing cost purely by cost element, which represents a singular view of the organisation, often results in increased cost due to its short term focus or its negative effect on quality or organisational effectiveness.

The World Class Company (WCC) manages cost by developing and evaluating multi-dimensional views of cost and by a thorough understanding of the behavioural implications, both strategic and operational. Costs are managed with the objective of adding value to the organisation and not necessarily to reduce cash flow. This implies that costs can be managed by increasing them.

Several approaches to cost management are identifiable in WCCs. No approach can, however, be singled out as the most effective and discretion must be applied in particular circumstances. Approaches in this article are categorised into those which contribute to competitive ability of the firm and those which focus on the effective utilization of resources.

Enhancing competitive ability

Strategic value chain focus

WCCs fundamentally challenge the way customer requirements are met. This implies a continual evaluation of its value chain and the way it adds value to its products. Value chain analysis may reveal competitive disadvantages and may focus attention on more cost effective ways of achieving customer satisfaction. The mere assumption that "things have always been done this way" no longer holds.

Shank and Govindarajan[1] warn that the usual value added focus, (ie value added only by the firm) is too limited as it misses important opportunities for exploiting linkages with the firm's suppliers and customers. This implies that significant cost savings may result from arrangements with suppliers and customers in order to eliminate duplication or activities which may be unnecessary.

In constructing an effective value chain, particular attention is to be given to the number and extent of support activities. Support activities should be minimised. Extensive management support and control could, for example, be reduced by fewer layers of management and more computerised control. Elaborate support structures may take the focus of the primary object, ie the customer. Calculation of the so-called 'bureaucracy indicator' (relationship between primary and support activities) may indicate an imbalance in this regard.

Quality focus

The era of zero defects has dawned on the WCC. Quality is, however, not necessarily free, as many proponents of quality management systems wish to advocate. WCCs know the cost of preventing defects, appraisal and failure and also the opportunity cost (price of non-conformance PONC). Financial management of quality programmes is considered a high priority.

Although certain firms (such as Motorola) have announced dramatic savings by the use of quality techniques, many pronounce that their quality programmes had not achieved tangible results. In an Arthur D Little[2] survey of 500 American companies, less than one-third felt that their quality programmes were having a significant effect. In Britain less than 20 out of a 100 companies believed their quality programmes achieved "tangible results".

Advanced Manufacturing Technologies (AMT)

There is little doubt that the application of AMT (or the so-called New Manufacturing Environment) has contributed greatly to the success of WCCs. AMT consist of a variety of methodologies such as Just-in-Time philosophies, Flexible Manufacturing Systems, Numerically Controlled Machines and CAD/ CAM systems. Use of advanced technologies has given WCCs greater flexibility and the ability to produce products at considerably reduced cost.

Continuous improvement

Turney and Reeve[3] describe continuous improvement programs to be "multifaceted, but they usually include steps to eliminate waste, reduce response time, simplify product design and improve quality". It is therefore a continuous effort to improve on previously accepted standards. It is questionable whether conventional standard costing systems will survive the thrust of this philosophy. Toshiro Hiromoto[4] comments in this regard that "several (Japanese) companies I studied also de-emphasize standard cost systems for monitoring performance".

Value engineering

Value engineering (new products) and analysis (existing products) was developed by successful Japanese companies. In essence it links spending on the attributes created in products or services with the value thereof to users. Although it is a common sense technique, it will focus attention on unnecessary spending on attributes which are not valued by the customer. This is another important mechanism to keep the customer in mind, in whatever the company may do.

The use of this technique is also fundamental to the application of the target costing approach. This is confirmed by Masayasu Tanaka[5]:"In large Japanese companies, value engineering techniques are applied to cost control activities to achieve the target cost".

External focus

WCCs live to be competitive. Bench-marking, best practice analysis and target costing are ingrained philosophies. Internally focused companies may well find conventional cost reduction techniques acceptable. This has very limited scope in making the company a world class competitor and should at best be used as a survival strategy.

Externally focused companies compare their performance with the best in the world and may apply severe structural adjustment to be able to

compete effectively. An external analysis provides insight into relative competitive advantages that may be pursued. The world at large is the basis of comparison and the objective is a continual strive to be the best.

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Effective utilisation of resources

Process focus

WCCs realise that the way things are done in a multifaceted organisation is no longer purely along functional lines. Functional divisions in organisations have introduced enormous amounts of organisational slack. Time, which happens to be one of the most important cost drivers in the modem organisation, is proverbially squandered in the 'move-stop-move' sequences found in functionally specialised organisations. A simple review of how many people handle any document in an organisation and how little work is actually done, will prove this point.

Processed focused organisations configure or design processes that meet customer requirements at minimum cost. That implies that such processes contain no unnecessary duplication, unnecessary movement, and contain no controls which can be achieved in a much more cost-effective manner. In a recent case in a large bank, it was discovered that the bank's business processes centred around various products (overdrafts, loans, savings accounts etc) that it offered clients. An analysis of these processes revealed that these could be rationalised into a single process to serve clients at much reduced cost.

Continued on page 8.

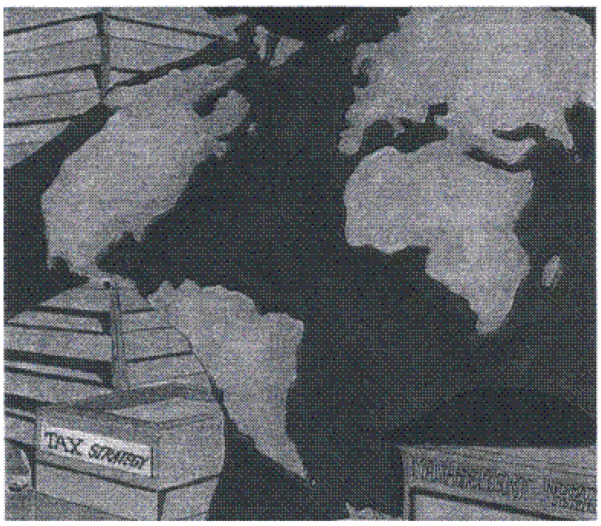
Cost management

Continued from page 7

Miller[6] states that "the new paradigm for cost management is focused on managing processes and the relevant activities". This implies also a focus on the so-called "upstream decisions" which may affect costs for a long time to come.

Waste focus

One of the best hidden cost factors in modem organisations is waste. WCCs have waste measurement and management systems in place to minimise the occurrence thereof. Waste manifests itself in many forms, often difficult to detect in an organisation. Capacity waste and material waste, (being some of the better known forms of waste), are often hidden away in inflated product costs. These costs should instead be measured and their causes managed. Many other forms of waste, such as manpower, energy, sales, etc, often go undetected.



Thomas Johnson[7] points out that waste often occurs in the "so-called indirect activities such as moving, storing, inspecting, waiting and setting-up".

Cost of capital focus

Time, in modem society, is a very important cost driver. Time has opportunity cost implications in so-called 'time to market' or 'time to deliver or respond' etc. Time may have specific cost implications in production-, inventory- or customer cycles.

Time costs can most effectively be measured by utilising the Cost of Capital concept and Residual Income concept. Time costs are, however, a hidden cost factor in many companies. WCCs not only know their COC, but also focus on the effective utilisation of this important cost by identifying the cost of time delays in the value chain, from when cash is disbursed, to when cash is finally received from customers. COC management in WCCc certainly goes beyond mere tight inventory control or debtors management. Knowing the particular effects of inflation or growth and its impact on the organisation may help the organisation to create long term shareholder value. Cost of capital control may also help the business to eradicate unprofitable products and customers.

Output focus

Many ordinary companies still suffer from the syndrome that a control over the inputs will automatically result in increased profitability.

WCCs have long discovered that an output focus on the operations is the only approach that yields positive results. The output focus goes hand in hand with an understanding of the required inputs and of the relationships to produce those outputs economically.

Activity focus

The introduction of Activity Based Management systems has focused attention at the appropriate level to evaluate performance. The activity is proving to be a useful basis to evaluate and measure not only cost but also quality, productivity and capacity. Above all, it is the appropriate level to analyse causality of cost. WCCs understand and measure the drivers of activities (cost drivers), the drivers of processes (process drivers and triggers), resource drivers etc. They understand which of their costs are affected by volume-, batch-, facility-/ process or any other changes which may alter cost structures.

Furthermore, being able to classify the nature of activities such as value adding or destroying, discretionary or essential, mandatory or strategic etc. helps the organisation to eliminate unnecessary work. Companies that attempt to eliminate people without eliminating work, usually pay a price in the form of decreased effectiveness or decreases in service levels or quality. These factors have long term negative consequences for the well-being of the business.

People focus

WCCs focus on the effective utilisation of their workforce. This certainly does not only imply getting the most output per employee work hour. Organisational productivity also depends on innovative ideas of people to increase output with reduced inputs. Shields and Young[8] consider that "in the long term, the decisions and actions of employees cause costs; only employees can make decisions and take actions to reduce costs. Thus, the key to effective long term cost reduction is employees — their beliefs values, and goals". Employee empowerment is one of the key issues in productivity improvement.

Long term focus

Fixed cost is a term which does not exist in the vocabulary of the WCC. Cost management is viewed from a long term perspective and all costs are therefore considered to be variable and manageable. This approach is prevalent in successful Japanese companies. Sheridan[9] reports "that their business and economic structure does not pressure companies so much into short term performance".

WCCs have long learned that many cost decisions have long term influences and that the limited accounting horizon of one year is not adequate to evaluate products and projects with life spans exceeding several years.

Elimination of constraints

Eli Goldratt has introduced the world to the Theory of Constraints, a philosophy that eliminates constraining factors in organisations. Techniques such as Throughput Accounting "have gained prominence in this regard as a means of evaluating the most economic course of action.

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WCCs have come to realise that generally accepted accounting practice often provides meaningless information for managing a business. Instead such companies are developing an accounting subset which facilitates management and not external reporting. Life cycle accounting, technology accounting, a future focus and not an historical focus, all help WCCs better to understand the important decisions which are based on accounting information.

The chances are good that an accounting system tailored to meet external reporting requirements will distort costs.

McNair and Carr" argue that accounting should aim to add value to the (World Class) organisation by moving towards decision support as the key value adding task. Toshiro Hiromoto noted in this regard: "Accounting policies should be subservient to corporate strategy, not independent of it".

Conclusion

Cost management practice has responded to the challenge posed by companies developing into WCCs with the introduction of new or renovated methods, some of which were reviewed in this article. The implementation of these methods, where appropriate, will assist your company to improve and, it is hoped, to compete with WCCs.

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