The Strategic Focus of Cost Management

The competitive firm incorporates the emerging and anticipated changes in the contemporary environment of business into its business planning and practices. The competitive firm is customer driven, uses advanced manufacturing and information technologies when appropriate, anticipates the effect of changes in regulatory requirements and customer tastes, and recognizes its complex social, political, and cultural environment. Guided by strategic thinking, the management accountant focuses on the factors that make the company successful rather than relying only on costs and other financial measures. We are reminded of the story of the Scottish farmer who had prize sheep to take to market. When asked why his sheep were always superior to those of his neighbors, the farmer responded, "While they're weighing their sheep, I'm fattening mine." Similarly, cost management focuses not on the measurement per se but on the *identification of measures that are critical* to the organization's success. Robert Kaplan's classification of the stages of the development of cost management systems describes this shift in focus:[2]

Stage 1. Cost management systems are basic transaction reporting systems.

Stage 2. As they develop into the second stage, cost management systems focus on external financial reporting. The objective is reliable financial reports; accordingly, the usefulness for cost management is limited.

Stage 3. Cost management systems track key operating data and develop more accurate and relevant cost information for decision making; cost management information is developed.

Stage 4. Strategically relevant cost management information is an integral part of the system.

Critical success factors (CSFs) are measures of those aspects of the firm's performance that are essential to its competitive advantage and, therefore, to its success.

The first two stages of cost system development focus on the management accountant's measurement and reporting role, and the third stage shifts to operational control. In the fourth stage, the ultimate goal, the management accountant is an integral part of management, not a reporter but a full business partner, working on management teams to implement the firm's strategy. This requires the identification of the firm's critical success factors and the use of analytical, forward-looking decision support. **Critical success factors (CSFs)** are measures of those aspects of the firm's performance essential to its competitive advantage and, therefore, to its success. Many of these critical success factors are financial, but many are nonfinancial. The CSFs for any given firm depend on the nature of the competition it faces. The development and use of CSFs is taken up in Chapter 2.

Contemporary Management Techniques: The Management Accountant's Response to the Contemporary Business Environment

LO 1-3

Explain the contemporary management techniques and how they are used in cost management to respond to the contemporary business environment.

Management accountants, guided by a strategic focus, have responded to the six changes in the contemporary business environment with 13 methods that are useful in implementing strategy in these dynamic times. The first six methods focus directly on strategy implementation: the balanced scorecard/strategy map, value chain, activity-based costing and management, business intelligence, target costing, and life-cycle costing. The next seven methods help to achieve strategy implementation through a focus on process improvement: benchmarking, business process improvement, total quality management, lean accounting, the theory of constraints, sustainability, and enterprise risk management. Each of these methods is covered in one or more of the chapters of the text.

The Balanced Scorecard (BSC) and Strategy Map

Strategic information using critical success factors provides a road map for the firm to use to chart its competitive course and serves as a benchmark for competitive success. Financial measures such as profitability reflect only a partial, and frequently only a short-term, measure of the firm's progress. Without strategic information, the firm is likely to stray from its

[2] Robert S. Kaplan, "The Four-Stage Model of Cost System Design," *Management Accounting*, February 1990, pp. 22–26.

competitive course and to make strategically wrong product decisions, for example, choosing the wrong products or the wrong marketing and distribution methods.

To emphasize the importance of using strategic information, *both financial and nonfinancial*, accounting reports of a firm's performance are now often based on critical success factors in four different perspectives. One perspective is financial; the other three are nonfinancial:

1. **Financial performance.** Measures of profitability and market value, among others, as indicators of how well the firm satisfies its owners and shareholders.
2. **Customer satisfaction.** Measures of quality, service, and low cost, among others, as indicators of how well the firm satisfies its customers.
3. **Internal processes.** Measures of the efficiency and effectiveness with which the firm produces the product or service.
4. **Learning and growth.** Measures of the firm's ability to develop and utilize human resources to meet its strategic goals now and into the future.

The **balanced scorecard (BSC)** is an accounting report that includes the firm's critical success factors in four areas: (1) financial performance, (2) customer satisfaction, (3) internal processes, and (4) learning and growth.

An accounting report based on the four perspectives is called a **balanced scorecard (BSC).** The concept of balance captures the intent of broad coverage, financial and nonfinancial, of all factors that contribute to the firm's success in achieving its strategic goals. The balanced scorecard provides a basis for a more complete analysis than is possible with financial data alone. The use of the balanced scorecard is thus a critical ingredient of the overall approach that firms take to become and remain competitive. An example of a balanced scorecard is shown in Exhibit 1.4.

The **strategy map** is a method, based on the balanced scorecard, that links the various perspectives in a cause-and-effect diagram.

The **strategy map** is a method, based on the balanced scorecard, that links the various perspectives in a cause-and-effect diagram. For many companies, high achievement in the learning and growth perspective contributes directly to higher achievement in the internal process perspective, which in turn causes greater achievement in the customer satisfaction perspective, which then produces the desired financial performance. The strategy map is therefore a useful means in understanding how improvement in certain critical success factors contributes to other goals and to the ultimate financial results. We cover the balanced scorecard throughout the text; particularly in Chapters 2, 18, and 20.

The Value Chain

The **value chain** is an analysis tool firms use to identify the specific steps required to provide a product or service to the customer.

The **value chain** is an analysis tool organizations use to identify the specific steps required to provide a competitive product or service to the customer. In particular, an analysis of the firm's value chain helps management discover which steps or activities are not competitive, where costs can be reduced, or which activity should be outsourced. Also, management can use the analysis to find ways to increase value for the customer at one or more steps of the value chain. For example, companies such as General Electric, IBM, U-Haul, and Harley-Davidson have found greater overall profits by moving downstream in the value chain to place

EXHIBIT 1.4
The Balanced Scorecard: Financial and Nonfinancial Measures of Success

Financial Measures of Success	Nonfinancial Measures of Success
Sales growth	**Customer**
Earnings growth	Market share and growth in market share
Dividend growth	Customer service (e.g., based on number of complaints)
Bond and credit ratings	On-time delivery
Cash flow	Customer satisfaction (customer survey)
Increase in stock price	Brand recognition (growth in market share)
	Internal Processes
	High product quality
	High manufacturing productivity
	Cycle time (the time from receipt of a customer's order to delivery)
	Product yield and reduction in waste
	Learning and Growth
	Competence of managers (education attained)
	Morale and firmwide culture (employee survey)
	Education and training (training hours)
	Innovation (number of new products)

a greater emphasis on high-value services and less emphasis on lower-margin manufactured products. A key idea of the value-chain analysis is that the firm should carefully study each step in its operations to determine how each step contributes to the firm's profits and competitiveness. The value chain is covered in Chapters 2, 13, and 17.

Activity analysis
is used to develop a detailed description of the specific activities performed in the firm's operations.

Activity-based costing (ABC)
is used to improve the accuracy of cost analysis by improving the tracing of costs to products or to individual customers.

Activity-based management (ABM)
uses activity analysis and activity-based costing to help managers improve the value of products and services and increase the organization's competitiveness.

Activity-Based Costing and Management

Many firms have found that they can improve planning, product costing, operational control, and management control by using **activity analysis** to develop a detailed description of the specific activities performed in the firm's operations. The activity analysis provides the basis for activity-based costing and activity-based management. **Activity-based costing (ABC)** is used to improve the accuracy of cost analysis by improving the tracing of costs to products or to individual customers. **Activity-based management (ABM)** uses activity analysis and activity-based costing to help managers improve the value of products and services and increase the organization's competitiveness. ABC and ABM are key strategic tools for many firms, especially those with complex operations or diverse products and services. ABC and ABM are explained in Chapter 5 and then applied in several of the chapters that follow.

Business intelligence
is an approach to strategy implementation in which the management accountant uses data to understand and analyze business performance.

Business Intelligence

Business intelligence (also called *business analytics* or *predictive analytics*) is an approach to strategy implementation in which the management accountant uses data to understand and analyze business performance. Business intelligence (BI) often uses statistical methods such as regression or correlation analysis to predict consumer behavior, measure customer satisfaction, or develop models for setting prices, among other uses. BI is best suited for companies that have a distinctive capability which can be derived from measurable critical success factors. BI is similar to the BSC because it focuses on critical success factors; the difference is that BI uses analytical tools to develop predictive models of core business processes. BI is covered in Chapter 8.

Target costing
determines the desired cost for a product on the basis of a given competitive price so that the product will earn a desired profit.

Target Costing

Target costing is a method that has resulted directly from the intensely competitive markets in many industries. **Target costing** determines the desired cost for a product on the basis of a given competitive price, such that the product will earn a desired profit. Cost is thus determined by price. The firm using target costing must often adopt strict cost reduction measures or redesign the product or manufacturing process to meet the market price and remain profitable.

Target costing forces the firm to become more competitive, and, like benchmarking, it is a common strategic form of analysis in intensely competitive industries where even small price differences attract consumers to the lower-priced product. The camera manufacturing industry is a good example of an industry where target costing is used. Camera manufacturers such as Canon know the market price for each line of camera they manufacture, so they redesign the product (add/delete features, use less expensive parts and materials) and redesign the production process to get the manufacturing cost down to the predetermined target cost. The automobile industry also uses target costing. Target costing is covered in Chapter 13.

Life-cycle costing
is a method used to identify and monitor the costs of a product throughout its life cycle.

Life-Cycle Costing

Life-cycle costing is a method used to identify and monitor the costs of a product throughout its life cycle. The life cycle consists of all steps from product design and purchase of raw materials to delivery and service of the finished product. The steps typically include (1) research and development; (2) product design, including prototyping, target costing, and testing; (3) manufacturing, inspecting, packaging, and warehousing; (4) marketing, promotion, and distribution; and (5) sales and service. Cost management has traditionally focused only on costs incurred at the third step, manufacturing. Thinking strategically, management accountants now manage the product's full life cycle of costs, including upstream and downstream costs as well as manufacturing costs. This expanded focus means careful attention to product design, since design decisions lock in most subsequent life-cycle costs. See Chapter 13 for coverage of life-cycle costing.

Benchmarking
is a process by which a firm identifies its critical success factors, studies the best practices of other firms (or other business units within a firm) for achieving these critical success factors, and then implements improvements in the firm's processes to match or beat the performance of those competitors.

Benchmarking

Benchmarking is a process by which a firm identifies its critical success factors, studies the best practices of other firms (or other business units within a firm) for achieving these critical

success factors, and then implements improvements in the firm's processes to match or beat the performance of those competitors. Benchmarking was first implemented by Xerox Corporation in the late 1970s. Today, many firms use benchmarking. Some firms are recognized as leaders, and therefore benchmarks, in selected areas—for example, Nordstrom in retailing, Ritz-Carlton Hotels in service, The Boeing Company in manufacturing, and Apple Computer in innovation, among others.

Benchmarking efforts are facilitated today by cooperative networks of noncompeting firms that exchange benchmarking information. For example, the International Benchmarking Clearinghouse (**www.apqc.org**) and the International Organization for Standardization (ISO) (**www.iso.org**) assist firms in strategic benchmarking.

Business Process Improvement

> Whether you think you can or whether you think you can't—you're right.
>
> *Henry Ford*

Henry Ford realized that the right attitude is important to success. That belief is what continuous improvement is all about. **Business process improvement (BPI)** is a management method by which managers and workers commit to a program of continuous improvement in quality and other critical success factors. Continuous improvement is very often associated with benchmarking and total quality management as firms seek to identify other firms as models to learn how to improve their critical success factors. While BPI is an incremental method, business process reengineering (BPR) is more radical. BPR is a method for creating competitive advantage in which a firm reorganizes its operating and management functions, often with the result that positions are modified, combined, or eliminated.

Business process improvement (BPI) is a management method by which managers and workers commit to a program of continuous improvement in quality and other critical success factors.

Total Quality Management

Total quality management (TQM) is a method by which management develops policies and practices to ensure that the firm's products and services exceed customers' expectations. This approach includes increased product functionality, reliability, durability, and serviceability. Cost management is used to analyze the cost consequences of different design choices and to measure and report the many aspects of quality, including, for example, production breakdowns and production defects, wasted labor or raw materials, the number of service calls, and the nature of complaints, warranty costs, and product recalls.

Total quality management (TQM) is a method by which management develops policies and practices to ensure that the firm's products and services exceed customers' expectations.

Lean Accounting

Firms that have adopted lean manufacturing, which is one of the six key aspects of the contemporary business environment (see page 8), will also typically use lean accounting. **Lean accounting** uses value streams to measure the financial benefits of a firm's progress in implementing lean manufacturing. Lean accounting places the firm's products and services into value streams, each of which is a group of related products or services. For example, a company manufacturing consumer electronics might have two groups of products (and two value streams)—digital cameras and video cameras—with several models in each group. Accounting for value streams can help the firm to better understand the impact on profitability of its lean manufacturing improvements. TQM and lean accounting are covered in Chapter 17.

Lean accounting uses value streams to measure the financial benefits of a firm's progress in implementing lean manufacturing.

The Theory of Constraints

The **theory of constraints (TOC)** is used to help firms effectively improve a very important critical success factor: cycle time, the rate at which raw materials are converted to finished products. The TOC helps identify and eliminate bottlenecks—places where partially completed products tend to accumulate as they wait to be processed in the production process. In the competitive global marketplace common to most industries, the ability to be faster than competitors is often a critical success factor. Many managers argue that the focus on speed in the TOC approach is crucial. They consider speed in product development, product delivery, and manufacturing to be paramount as global competitors find ever-higher customer expectations for rapid product development and prompt delivery. TOC is covered in Chapter 13.

The **theory of constraints (TOC)** is used to help firms effectively improve the rate at which raw materials are converted to finished products.

Sustainability

Sustainability means the balancing of the company's short- and long-term goals in all three dimensions of performance—social, environmental, and financial.

Sustainability means the balancing of the organization's short- and long-term goals in all three dimensions of performance—social, environmental, and financial. We view it in the broad sense to include identifying and implementing ways to reduce cost and increase revenue as well as to maintain compliance with social and environmental regulations and expectations. This can be accomplished through technological innovation and new product development as well as commonsense measures to improve the social and environmental impacts of the company's operations. Ford Motor saves money through improvements in its storm water draining system at its River Rouge, Michigan, plant; other leaders in sustainability include Toyota and Honda motor companies, McDonald's, and Walmart, among many others. The Dow Jones Sustainability Indices (**www.sustainability-indices.com/review/annual-review-2014.jsp**) identify and rank companies according to their sustainability performance. Sustainability is a key topic and is covered in each chapter; look for the sustainability icon next to problems involving this management technique.

Enterprise Risk Management

Enterprise risk management (ERM) is a framework and process that firms use to manage the risks that could negatively or positively affect the company's competitiveness and success.

Enterprise risk management (ERM) is a framework and process that organizations use to manage the risks that could negatively or positively affect the company's competitiveness and success. Risk is considered broadly to include (1) hazards such as fire or flood; (2) financial risks due to foreign currency fluctuations, commodity price fluctuations, and changes in interest rates; (3) operating risk related to customers, products, or employees; and (4) strategic risk related to top management decisions about the firm's strategy and implementation thereof. For financial service firms particularly, ERM has become a much more important topic since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), which requires new regulations for these firms. To indicate how widely used ERM has become, a 2013 survey of more than 1,000 risk management professionals by the Risk Management Society (RIMS) found that 63% of the organizations surveyed (**www.rims.org/aboutRIMS/Newsroom/News/Pages/2013RIMSERMSurveyNowAvailable.aspx**) either had an ERM program in place or were currently implementing one. A recent survey of 100 senior finance executives by the American Productivity and Quality Center (APQC) indicates that only one in five of the executives were satisfied with their company's corporate risk management systems. So while there has been progress in risk management, there is apparently continuing room for improvement (**www.apqc.org**). The text explains the role of ERM in Chapters 10, 11, and 12.

How a Firm Succeeds: The Competitive Strategy

A **strategy** is a plan for using resources to achieve sustainable goals within a competitive environment.

An organization succeeds by implementing a **strategy,** that is, a plan for using resources to achieve sustainable goals within a competitive environment. Finding a strategy begins with determining the purpose and long-range direction, and therefore the mission, of the company. Exhibit 1.5 lists excerpts from the mission statements of selected companies. The mission is developed into specific performance objectives, which are then implemented by specific corporate strategies, that is, specific actions to achieve the objectives that will fulfill the mission.

> If you don't know where you are going, you will probably end up somewhere else
>
> *Laurence J. Peter*

EXHIBIT 1.5
Mission Statements of Selected Companies

Procter & Gamble (pg.com)
To provide branded products and services of superior quality and value that improve the lives of the world's consumers, now and for generations to come.

Google (google.com)
To organize the world's information and make it universally accessible and useful.

Merck (merck.com)
To make great things happen.

Tyson Foods (tyson.com)
To make great chicken, beef, pork and prepared foods that help bring families and friends together.

EXHIBIT 1.6
Tyson Foods Corporate Strategy

Source: Tyson Foods (**tyson.com** and the September 2014 annual report).

We seek to achieve a leading market position for our products via our principal marketing and competitive strategy, which includes:

- identifying target markets for value-added products;
- concentrating production, sales and marketing efforts to appeal to and enhance demand from those markets; and
- utilizing our national distribution systems and customer support services.

EXHIBIT 1.7
Cost Management Focus in Prior and Contemporary Business Environments

	Prior Business Environment	Contemporary Business Environment
Cost management focus	Financial reporting and cost analysis; common emphasis on standardization and standard costs; the accountant as financial accounting expert and financial scorekeeper	Cost management as a tool for the development and implementation of business strategy; the accountant as business partner

EXHIBIT 1.8
Consequences of Lack of Strategic Information

- Decision making based on intuition instead of accurate and timely information
- Lack of clarity about direction and goals
- Lack of a clear and favorable perception of the firm by customers and suppliers
- Incorrect investment decisions; choosing products, markets, or manufacturing processes inconsistent with strategic goals
- Inability to effectively benchmark competitors, resulting in lack of knowledge about more effective competitive strategies
- Failure to identify most profitable products, customers, and markets

See the Tyson Foods corporate strategy in Exhibit 1.6. Note that in Exhibit 1.5, Tyson Foods broad mission statement is explained in terms of more specific objectives, which are in turn operationalized through specific corporate strategies.

Organizations also are using cost management to support their strategic goals. Cost management has shifted away from a focus on the stewardship role, that is, product costing and financial reporting. The new focus is on a management-facilitating role: developing cost and other information to support the management of the firm and the achievement of its strategic goals (Exhibit 1.7).

Without strategic information, the firm is likely to stray from its competitive course, to make strategically wrong manufacturing and marketing decisions: to choose the wrong products or the wrong customers. Some of the consequences of a lack of strategic information are shown in Exhibit 1.8.

Developing a Competitive Strategy

LO 1-4
Explain the different types of competitive strategies.

In developing a sustainable competitive position, each firm purposefully or as a result of market forces arrives at one of the two competitive strategies: cost leadership or differentiation.[3]

Cost Leadership

Cost leadership
is a competitive strategy in which a firm outperforms competitors in producing products or services at the lowest cost.

Cost leadership is a competitive strategy in which a firm outperforms competitors in producing products or services at the lowest cost. The cost leader makes sustainable profits at lower prices, thereby limiting the growth of competition in the industry through its success at reducing price and undermining the profitability of competitors, which must meet the firm's low price. The cost leader normally has a relatively large market share and tends to avoid niche or segment markets by using the price advantage to attract a large portion of the broad market.

[3] This section is adapted from Michael Porter, *Competitive Advantage*, The Free Press, 1985. The Porter concept of strategy is widely used. See for example, Michael E. Porter, "The Five Forces that Shape Strategy," *Harvard Business Review*, January 2008, pp. 79–93. An alternative framework for strategy is the resource-based view of the organization, as explained by David J. Collis and Cynthia A. Montgomery, "Competing on Resources," *Harvard Business Review*, July–August 2008, pp. 140–150.