

Chapter 15

Managing costs and time for customer value

Cost management

- ◆ Improvement of an organisation's cost effectiveness through understanding and managing the real causes of cost
- ◆ Main focus is on cost reduction, but also focus on improving other aspects of performance such as quality and delivery.

Conventional versus contemporary approaches

- ◆ Drivers of cost
 - ▲ Conventional: managers control costs by bringing them into line with some predetermined goal
 - ▲ Contemporary: reduces costs by identifying waste and eliminating it through identifying the real cost drivers

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Conventional versus contemporary approaches

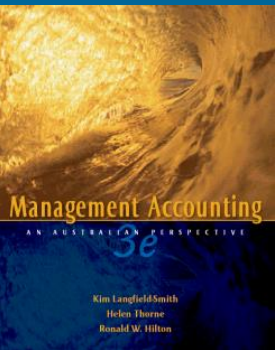
- ◆ Strategic perspective
 - ▲ Conventional: control costs within the organisation
 - ▲ Contemporary: cost management also concerned with achieving value for the customer
 - ❖ A strategic perspective

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Conventional versus contemporary approaches

◆ Process perspective

- ▲ Conventional: control costs by reporting results for responsibility centres based on functional areas of the business
- ▲ Contemporary: recognises that customers' needs are met by processes which flow across the business



Activity-based management (ABM)

- ◆ Process of using information from activity-based costing to analyse activities, cost drivers and performance so that customer value and profitability are improved
- ◆ Customer value
 - ▲ The value a customer places on particular features of a product or service

Using ABM to reduce costs

- ◆ Identify the major opportunities for cost reduction
- ◆ Determine the real causes of these costs
- ◆ Develop a program to eliminate the causes, and, therefore, the costs
- ◆ Introduce performance measures to monitor the effectiveness of cost reduction efforts

Identifying the major opportunities

- ◆ Value-added activities
 - ▲ Provide essential value to the customer, or are essential to the functioning of the business
- ◆ Non-value-added activities
 - ▲ Do not add value to a product or service from the customers' perspective or for the business and, therefore, can be eliminated

Building activities into processes

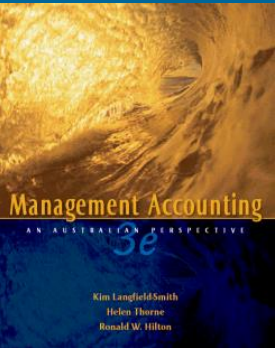
- ◆ Eliminating non-value-added activities requires a clear understanding of the way work is done in an organisation
- ◆ Linking activities into processes
 - ▲ A series of activities that are linked together to achieve a specific objective
 - ▲ Often cross the boundaries of responsibility centres, such as functional departments

Cost driver analysis

- ◆ Identification of root-cause cost drivers for the major non-value-added activities
- ◆ Analysis of root-cause cost drivers of value-added activities may also lead to more efficient use of resources
- ◆ Value-added management (or value analysis)
 - ▲ The process of targeting and eliminating non-value-added activities

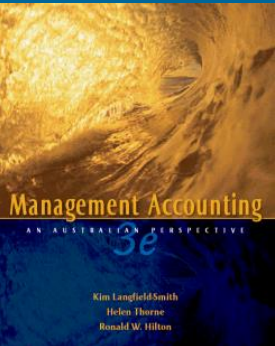
Measuring performance in cost reduction

- ◆ Activity-based performance measures can be used to monitor the effectiveness of cost reduction effort
- ◆ Performance measures may be based on previous activities



Impediments to implementing ABM

- ◆ Lack of awareness of ABM
- ◆ Uncertainty over potential benefits
- ◆ Extensive resource requirements to implement
- ◆ Resistance to change



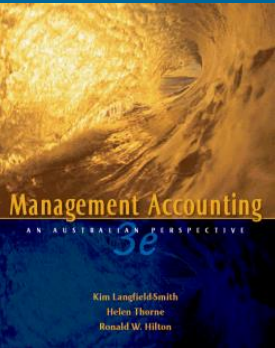
Business process re-engineering

- ◆ The fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical areas of performance such as cost, quality and delivery
- ◆ Focus is on strategic processes
 - ▲ Those processes that focus on achieving a company's business objectives and strategies

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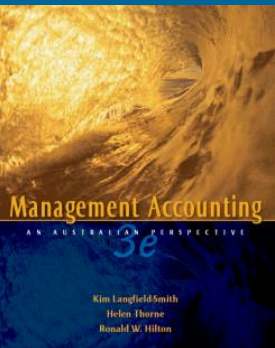
Business process re-engineering

- ◆ Preparing a business process map
- ◆ Establish goals
- ◆ Reorganise work flow
- ◆ Implement the program



Business process re-engineering versus ABM

- ◆ ABM focuses on incremental, continuous improvement of processes
- ◆ Business process re-engineering involves fundamental changes to the way processes are structured
- ◆ Both use activity analysis to identify processes and activities



Life cycle costing

- ◆ Accumulate and manage costs over the life cycle of the product
- ◆ Four stages of the product life cycle
 - ▲ Product planning and initial concept design
 - ▲ Product design and development
 - ▲ Production
 - ▲ Distribution and customer (logistic) support

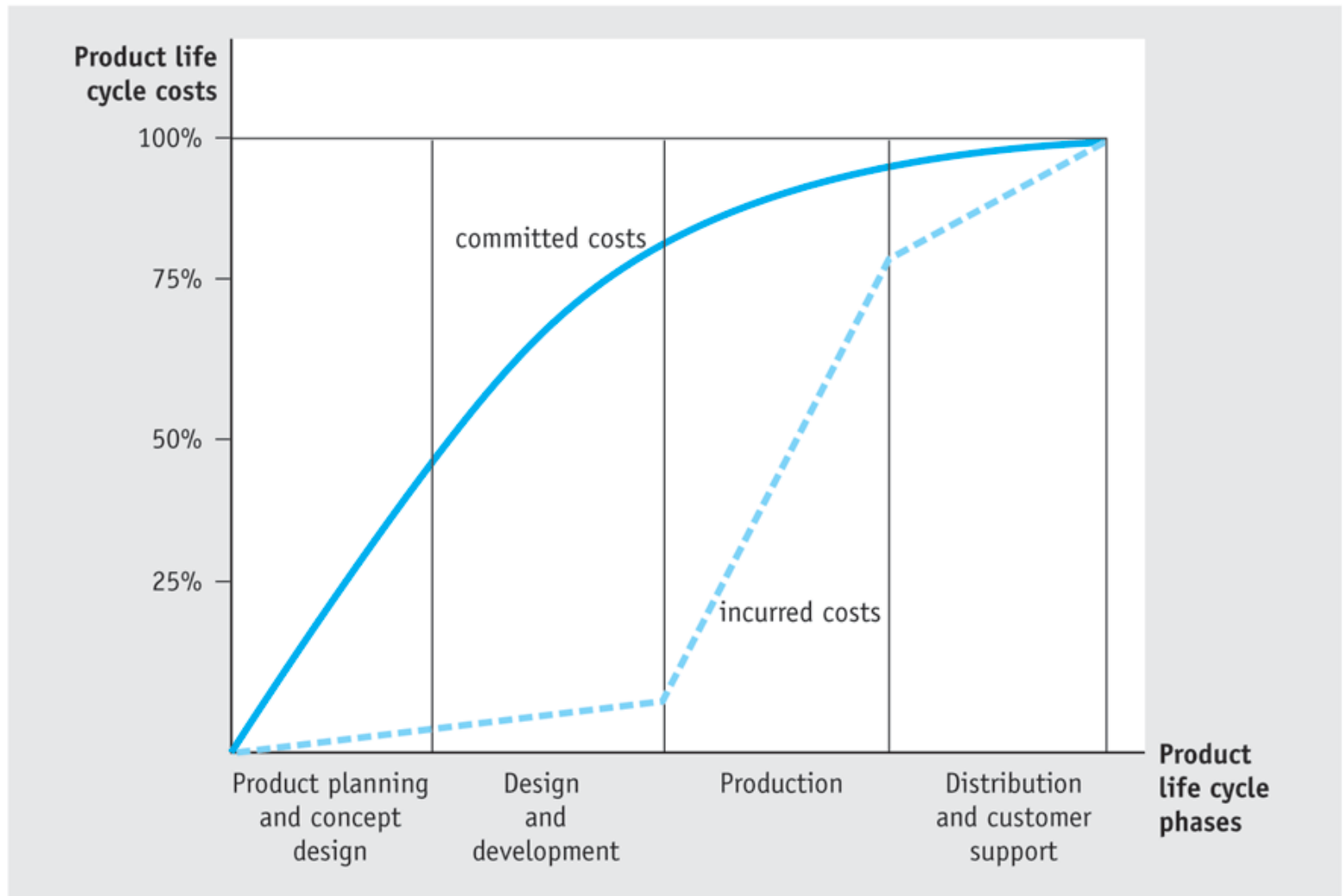
Life cycle budgeting

- ◆ Involves estimating the expected costs and revenues for each year of the expected life of a product
- ◆ Useful in product mix or pricing decisions

Managing costs through a life cycle costing

- ◆ A lack of awareness, or uncertainty about how to calculate life cycle costs
- ◆ Not easy for products with longer lives as it is more difficult to assess
 - ▲ Changes in consumer tastes
 - ▲ Impact of competitors' actions
 - ▲ Effects of inflation

EXHIBIT 15.7 Life cycle costs and cost commitment for a typical product



Source: Adapted from Burstein (1988, p. 261)

Target costing

- ◆ A system of profit planning and cost management that determines the life cycle cost at which a proposed product must be produced to generate the desired level of profit
- ◆ Three steps in the target costing process

The target costing process

- ◆ Market-driven costing
 - ▲ Determine target selling prices
 - ▲ Determine target profit margin
 - ▲ Calculate allowable cost
 - ❖ The target cost at which a product must be produced if it is to be sold at the target selling price and generate the required rate of return

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The target costing process

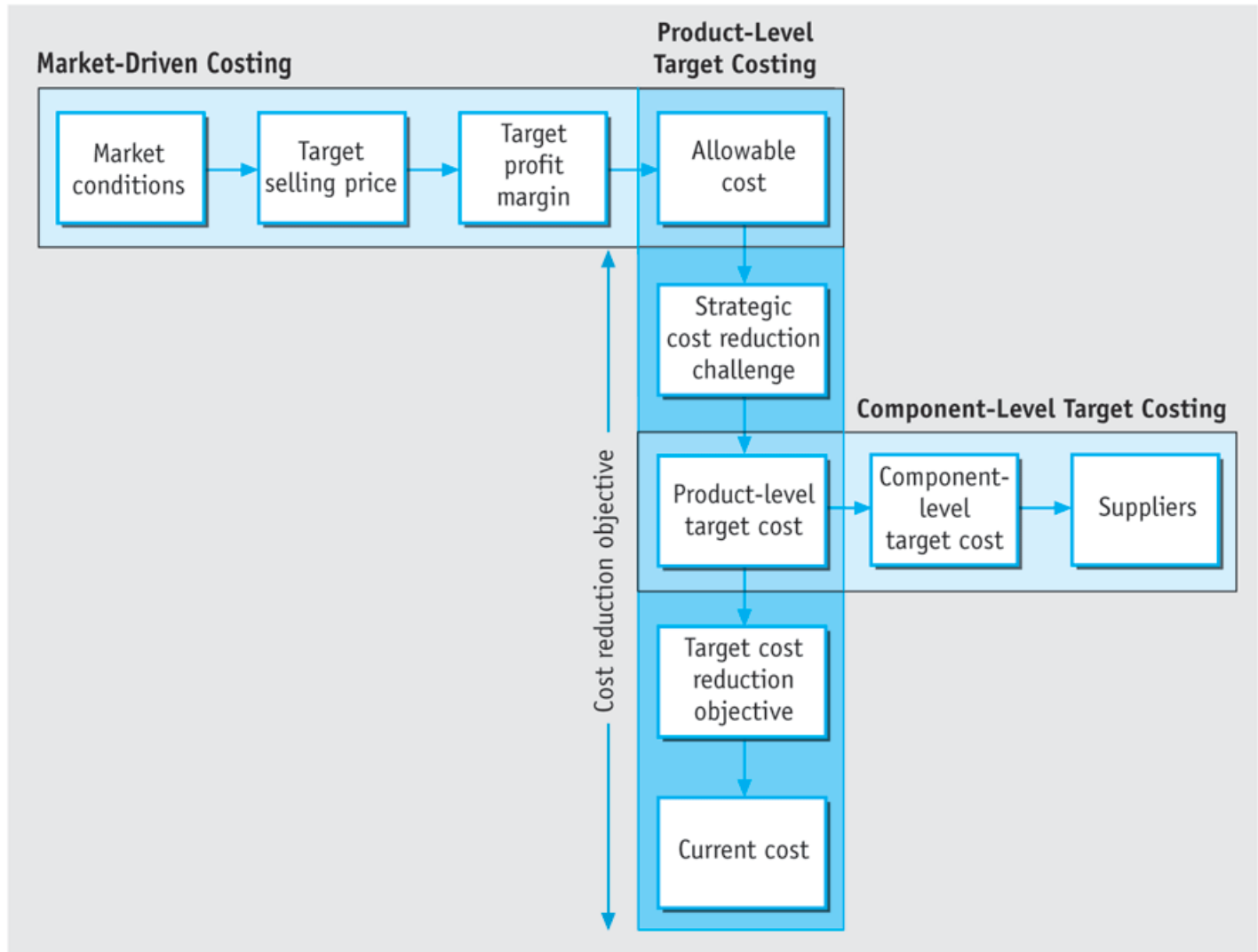
- ◆ Product-level costing
 - ▲ Cost reduction objective is the degree of cost reduction needed to achieve the allowable cost
 - ▲ Need to estimate the current cost—the cost that the product could be manufactured for, prior to any cost reduction objectives
 - ▲ Product level target cost is the difference between the current cost and the target cost reduction objective

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The target costing process

- ◆ Component-level costing
 - ▲ Breaking down the product-level target cost into target costs for components
 - ▲ Value engineering (VE): reviewing the product or process design to make changes to reduce cost, while still maintaining the functionality of the product
- ◆ Pursue continuous improvement once production begins

EXHIBIT 15.8 The target costing process



Source: Cooper & Slagmulder (1999, p. 166)

Key features of target costing for cost management

- ◆ It is price led
- ◆ Focuses on the customer and customer expectations
- ◆ Based on principles of life cycle management, placing primary emphasis on managing downstream and manufacturing costs
- ◆ Cross-functional, involving managers from across the value chain

Managing time

- ◆ Time dictates the rate at which products are produced and revenue generated
- ◆ Time determines how long resources are tied up in processes, and unavailable for other uses
- ◆ Time delays lead to inventory build-ups
- ◆ Time to develop new products and delivering products to customers may be key to innovation

Time-based management

- ◆ Measures for developing new products and services
 - ▲ New product development time: time from identification of initial concept to release of product to the market
 - ▲ Break-even time (BET): the time from identification of initial concept to when a product has generated enough profit to pay back the original investment

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Time-based management

- ◆ Time take to fulfil a customer's order
 - ▲ Measures of customer response time, order receipt time, production lead time (cycle time),
- ◆ Reliability in meeting scheduled delivery dates

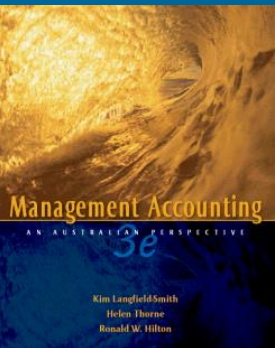


EXHIBIT 15.11 Managing time drivers

| Time Drivers | Possible management approaches |
|---|---|
| Poorly structured order, production and delivery processes | Conduct value analysis to identify and remove non-value-added activities. Implement continuous improvement processes. Use business process re-engineering to completely redesign processes. |
| Bottlenecks in order, production and delivery processes | Manage throughput by identifying and resolving bottleneck resources. Attempt to minimise 'lumpiness' and unpredictability in customer demand. |
| Poor quality | Develop a total quality management (TQM) culture, supported by appropriate measures of quality costs and quality drivers.* |
| Inefficient inventory management | Improve supply chain management to minimise delays caused by inadequate and poor quality supplies.* |
| Poorly structured R & D processes in developing new products and services | Use target costing to manage the product design and development process. Ensure that value engineering minimises production time as well as cost. |
| * TQM and supply chain management are described in Chapter 16. | |

Managing throughput

- ◆ The theory of constraints
 - ▲ Focuses on identifying and removing bottlenecks to improve the rate of throughput
 - ▲ Recognises the rate of production is limited to the capacity of the constraints (or bottlenecks) that exist
- ◆ Throughput accounting
 - ▲ Measuring effects of bottleneck and other operational decisions using measures of throughput, inventory and operating expenses