Chapter 1 – Cost Management and Strategic Decision Making

LO 1: Understand how cost management supports strategic planning and decision making.

Characteristics of Cost management
Cost management is important to organisations because it is more than measuring and reporting costs that have occurred. Cost management is focused on the future impacts of current or proposed decisions. Cost management is an organisational commitment, a professional attitude, and a set of techniques to create more value at lower cost.

Commitment
First, cost management is an organisational commitment to improvement because it promotes the idea of continually finding ways to help organisations make the right decisions to create more customer value at lower cost.

Attitude
Second, cost management represents a proactive professional attitude that all costs of products and operation result from management decisions. In other words, costs do not just happen.

Techniques
Third, cost management is a set of reliable techniques that use diverse performance measures to assess the impacts of decisions. A cost management system is the set of cost management techniques that function together to support the organisation's goals and activities.

Cost management analysts use financial information, in combination with on-financial information, to improve performance, profit and processes.

LO 2: Structure business decision-making problems into objectives, alternative actions, criteria and expected outcomes.

Decision-making framework :
One objective of this framework is to reinforce that cost management is a purposeful activity – more value creation at lower cost – and a proactive attitude – decisions drive costs.

Stage 1: Setting goals and objectives

Tangible objectives: are benchmarks capable of being measured in some manner.

Criteria: Attributes on the basis of which the decision maker compares the decision alternatives and makes a decision. Without tangible objectives, direction and progress toward goals is unclear, and there is not enough guidance to support decision making about specific decision alternatives.

Stage 2: Gathering information
In this stage analysts collect information to understand the decision alternative through which organisational goals and objectives can be achieved. Information is gathered for two purposes: to identify decision alternatives, and to understand how each decision alternative helps to meet the organisation's objectives.

Organisations often identify alternatives by thoroughly seeking information from, among others:

- Employees
- Customers
- Competitors
- Universities
- Consultants
- The Internet

Financial criteria: Have a monetary unit of measurement, such as euros, dollars or pounds. Examples are acquisition price, material cost or labour cost.

Non-financial criteria: Fall into two categories. Quantitative, non-financial criteria have a non-monetary but still quantitative unit of measurement. Example include criteria regarding delivery time, production speed, process yield or size tolerances. Qualitative, non-financial criteria are expressed in words instead of numbers, such as a description of a supplier's innovative capabilities or testimonials from a supplier's other customers.

Sometimes a criterion is first non-financial and can be converted into a financial criterion. We call this financial quantification.

Managers need to find a balance for the required information quality, the dimensions of which are decision usefulness, subjectivity, objectivity, accuracy, timeliness, cost and relevance for current decisions.

Decision usefulness: The overriding consideration: does it help managers make sufficiently better decisions to justify the cost of the information.

Subjectivity: describes the degree of disagreement about what to measure, how to measure it, what the observed measure is, or whether the measurement is important.

Objectivity: The degree of consensus about measurement, is the mirror image of subjectivity. Clearly some measure are more subjective or objective than others; that is, all measures conceptually reside somewhere on a continuum from subjective to objective.

Accuracy: Precision in measurement

Timeliness: Means that information is available in time to fully consider it when making decisions.

Relevance: Refers to whether it is pertinent to a decision.

Relevant costs and benefits: Occur in the future and differ for feasible alternatives. Costs that differ for alternatives are also called differential costs.

Sunk costs: Costs that are in the past and cannot be changed any more are not relevant for decision making.

Costs that are in the future and are the same for all decision alternatives will not influence the comparison and are also not relevant for decision making. Similarly, non-financial information that is the same for all decision alternatives is irrelevant for the decision.

Stage 3: Evaluating alternatives
Once alternatives have been identified and information about every alternative has been gathered, the next stage of decision making is to evaluate the alternatives. Evaluating alternatives is done by aggregating the information that has been gathered in Stage 2.

Stage 4: Execution and tracking costs
The next stage of decision making is to put the selected alternative into practice, and to keep track of the actual costs and revenues.

Stage 5: Obtaining feedback
The final stage – although that is not really true, because decision making continues and we go back and forth between the different stages – is to obtain feedback.

At the operational level, the financial focus is on costs. The actual costs for the actual production are compared to its standard costs. Differences between the actual costs and the standard cost or 'allowable costs' are called variances.

Strategically, the focus is on financial performance of the entire organisation, or financial performance of decentralised units within the organisation. These units may also purchase goods and services from each other. In such cases, the transfer price influences the financial performance of both units.

LO 3: Describe and understand steps in strategic decision making.

Strategy: A organisations overall plan or policy to achieve its goals.

Strategic decision making: Determines 'where' and 'how' by choosing and implementing actions that will affect an organisation's future abilities to achieve its goals.

Rewards for profit-seeking firms generally mean financial incentives in the form of profits, cash flow and share price appreciation, although many profit-seeking firms also seek non-financial rewards such as improved social responsibility.

Risks, on the other had, can be defined as the possible variations in incentives, which might turn out to be very high or very low. High-risk strategies might offer very high rewards, but they also can result in very low or negative returns.

Build strategy: Requires the organisation to achieve high rates of sales growth. An organisation pursues the build strategy by identifying new market and customers with high growth potential. The build strategy is risky because the potentially high rewards will attract competitors who also want to be first and right.

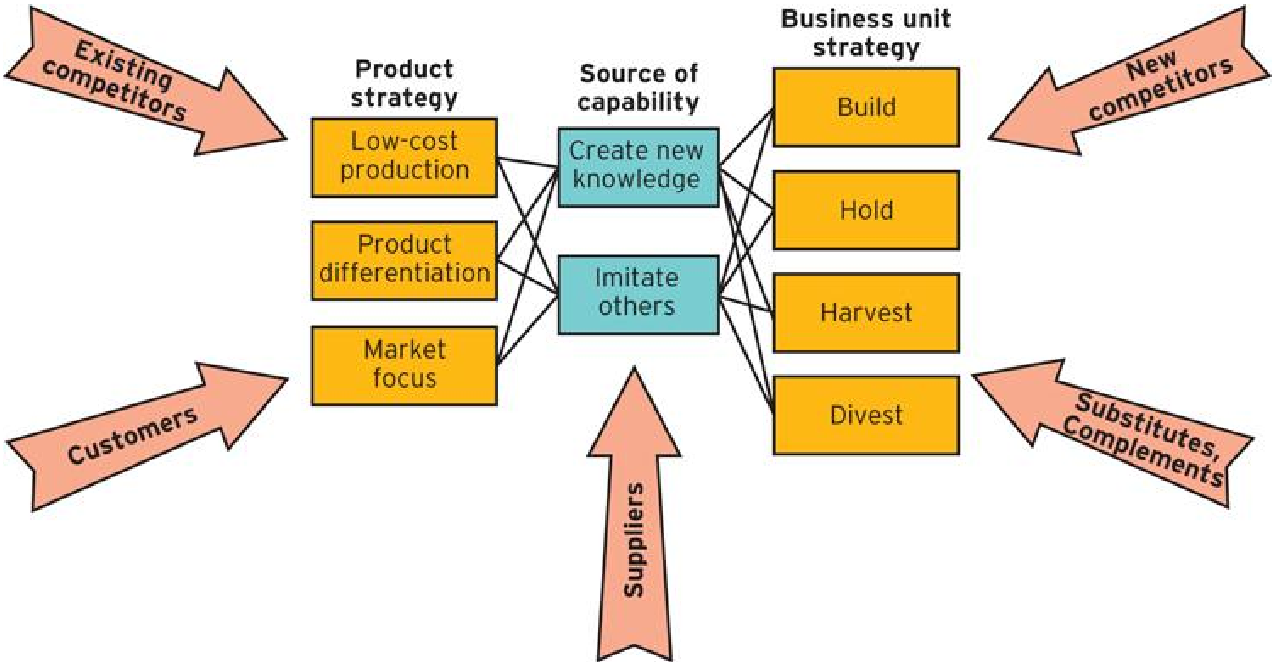
Hold strategy: Means that the organisation needs to maintain its current rate of growth, which reflects the overall market growth for a continuing market. To thrive with this strategy, an organisation usually must be a major competitor so that activities by other major competitors do not threaten its survival. The organisation must guard its market share to maintain stead growth. This strategy is less risky than the build strategy because the firm understands its market and competitors fairly well. Rewards are also lower because competition drives down profits.

Harvest strategy: Needs to maintain its cash flow, so some call this the 'cash cow' strategy. Firms that follow the harvest strategy usually operate in mature markets, which no longer experience much growth and might be on the verge of decline. Sometimes larger firms control harvest business units that provide cash to fund new build business units. Harvest firms need to maintain sales volume while cutting costs, particularly in anticipation of declining sales. Lower risks and rewards are more typical in harves firms than in either hold or build firms, but harvest firms can perform valuable functions as sources of internally generated cash.

Divest: Sometimes, or at the end of an organisation’s life cycle, the best strategy is to divest, and the organisation needs to exit the business at the lowest cost. The divest strategy can result from a realisation that is business unit is a bad fit with the rest of the organisation.

Finding the best route can be more successful when managers:
1) understand sources and threats to competitive advantages and
2) use effective decision-making techniques.

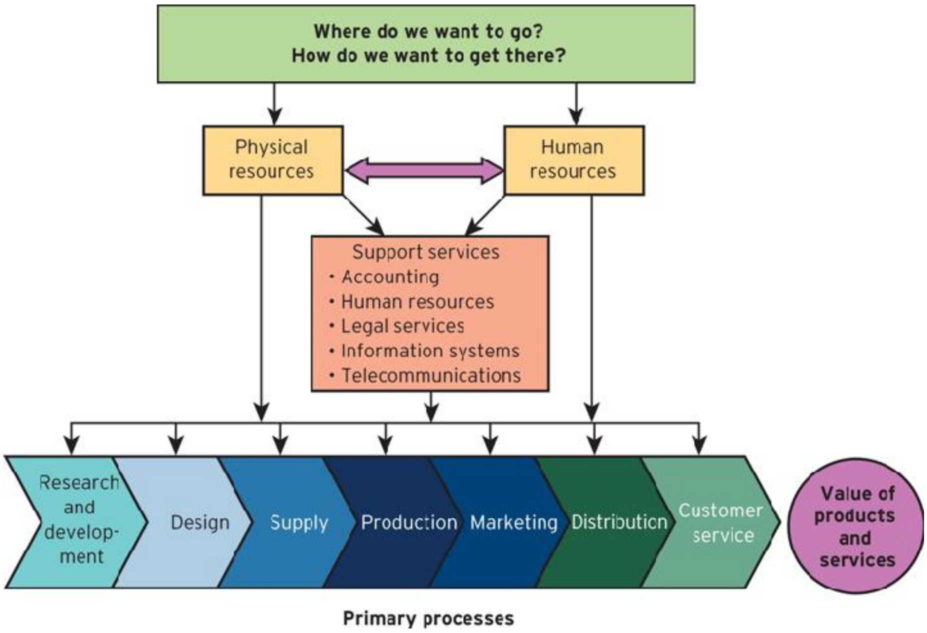
Competitive advantage: A resource, process or value chain that enables the organisation to provide more value, perhaps at lower cost, than its competitors.



Process: A related set of tasks, manual or automated, that transforms inputs into identifiable outputs.

Value chain: The relation of an organisation's processes that links ideas, resources, suppliers and customers; a competitive value chain does so in a superior way. The value chain begins by obtaining physical human resources and ends by providing products or services that customer value. Each part of the value chain describes a process that an organisation performs, and each process in the chain should focus on improving customer value. The complete value chain includes the following processes:

- Research and development
- Design
- Supply. Extended value chain: encompasses the ways companies obtain their resources and distribute their products and services, possibly using the services of other organisations.
- Production
- Marketing
- Distribution
- Customer service
- Support services



Outsourcing: The acquiring goods or services from an outside provider.

Organisations can find competitive advantages either by
1) creating new knowledge, which relies on supporting human innovation and experimentation, or
2) imitating others' ideas and implementing them in a superior way.

Michael Porter identified three basic ways to use resources, processes and value chains to create competitive advantages based on:
1) low-cost production,
2) product differentiation or
3) market focus.

Michael Porter identifies five competitive forces that describe the sources of threats of competitive advantages. These forces determine how long a competitive advantage can last.

- The combined basis, intensity, breadth and competence of existing competitors, who vie for the same customers and market share.
- The difficulty and likelihood of entry to the market by new competitors, who are attracted by success and high profits.
- The demand and stability of customers, whose needs and financial stability also are affected by competitive forces and can change overnight.
- The reliability, quality and breadth of suppliers, who also face competitive forces and can change their focus or experience difficulties.
- The availability and likelihood of substitute or complementary products, technologies and services that can render current advantages obsolete.

Kotter has identified elements in a process for implementing change.

1. **Identify a need for change.** Sometimes external threats force organisations to change, and at times unforeseen opportunities make change attractive. A performance measure is an indicator that allows a person to determine the level of performance according to a critical attribute (for example, profit, quality) and to compare performance to expectations.
2. **Create a team to lead and manage the change.** Most successful organisations have learned to create cross-functional, diverse teams that are more likely to be innovative in their solutions and discovery of opportunities.
3. **Create a vision of the change and a strategy for achieving the vision.** Make it natural for employees to question and debate whether new products and processes are consistent with the company's overall strategy.
4. **Communicate the vision and strategy for change and have the change team be a role model.** An important behaviour to model is to fearlessly compare planned and actual outcomes, which encourages learning and improved decision making.
5. **Encourage innovation and remove obstacles to change.** Diverse teams almost guarantee innovations. Give authority to the diverse teams to develop new product opportunities.
6. **Ensure that short-term achievements are frequent and obvious.** Approach a new product development by breaking its large problems into smaller ones that teams can analyse and solve in a short amount of time. Even projects that do not meet their original objectives are treated as successes because the company learns why something did not work.
7. **Use successes to create opportunities for improvement in the entire organisation**. By making sequential parts of the process visible, the company can point to many examples of employee contributions to significant improvements in products and processes.
8. **Reinforce a culture of more improvement, better leadership, and more effective management.** Employees should know that opportunities for improvement always exist and that managers take their recommendations seriously. Treating occasional failures as opportunities for learning rather than reasons for assigning blame is important for motivating team members to be creative and honest in their appraisals.

LO 4: Apply benefit-cost and variance analysis to help evaluate an organisation's strategic plans.

Two levels of analysis are important to evaluating the success or failure of a plan. The first level is operational performance analysis, which measures whether the performance of current operations is consistent with expectations. The second level is strategic performance analysis, which measures whether a strategic decision has met expectations.

Generally, operational performance analysis considers performance measures within relatively short time periods, but strategic performance analysis can consider years of performance.

Another distinction between operational and strategic performance is the level of the results that are analysed. For example, an operation performance measure could reflect the quality of parts made in a particular department, but a strategic performance measure could reflect the reputation of quality for an entire product line or company.

Benefit-cost analysis: Measures the effects of a plan by comparing its expected benefits and costs, which can be quantitative and qualitative.

Variances: The differences between a plan's actual and expected quantities.

LO 5: Understand the importance of ethical behaviour and decision making, and identify measures taken to maintain such behaviour.

Unethical behaviour can lead to wasted resources, lost time, ruined reputations and perhaps legal penalties for all involved. Individuals can be pressured to misstate information or results regarding strategic decisions because of:

- Bias from personal commitment to a decision.
- Fear of loss of prestige, position, or compensation from a failed strategy.
- Greed and intentional behaviour to defraud an organisation or its stakeholders.

Ethical codes: describe approved and prohibited practices. These ethical codes educate and support employees who want to behave ethically but either would not know what to do or might be pressured to act unethically.

Although many organisations have ethical codes, cost management analysts also can subscribe to the code of ethics developed by professional organisations.

Sarbanes-Oxley Act (SOX): A regulatory response to widespread unethical behaviour. Two parts of this law are particularly important for cost management:

1. The CEO and CFO are responsible for signing off on their company's financial statements and indicating that the financial statements do not omit material information.
2. The CEO and CFO must indicate that they are responsible for the company's system of internal controls over financial reporting.

Internal control: Is a process designed to provide reasonable assurance that an organisation will achieve its objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.

In practice, internal controls are detailed methods of protecting assets and ensuring that information is reliable. One of the key internal controls is separation of duties, which means no one person has control over the entire transaction. Companies use many types of internal controls in addition to separation of duties. Some examples:

- Selling limits on the amount of expenditures
- Requiring management authorisation for the use of a company's assets
- Reconciling various sets of books
- Prohibiting particular behaviours
- Rotating personnel and requiring employees to take vacations

Internal auditors generally play either or both of two roles in companies: consultants and/or watchdogs.
As consultants, internal auditors learn best practices from their work in various parts of their company and bring that information to the attention of managers in other parts of the company.
As watchdogs, internal auditors check whether employees follow good internal control procedures and look for fraud.
Internal auditors usually report to top management and have access to the audit committee of the board of directors. It is important for internal auditors to report to a level higher than the controller much of their audit work examines accounting systems for which controllers are responsible. If internal auditors reported to the controller, they would be auditing their own boss.

LO 6: Include sustainability and environmental concerns in strategic decisions.

Sustainability: Means that an organisation should not affect the environment such that that there are long-term negative economic, ecological or social consequences.

Legislators intervene in different ways.
First, they directly influence conditions for transactions, for example by imposing rules of pollution levels.
Second, they influence market prices by giving subsidies on investments in low-pollution technology, or by implementing a policy of guaranteed prices, also called a feed-in tariff.
Third, legislators create markets for externalities, such as tradable emission rights.