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Strategic Cost Management: The Future of Management Accounting

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STRATEGIC COST MANAGEMENT: 
The Future of Management Accounting

Presented as partial fulfillment for the Requirement of Graduation With Honors to 
the Department of Accounting Business, and Economics at Carroll College, 
Helena, Montana.

John Winship Herr, III 
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Department of Accounting, Business, and Economics.

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Management accounting has undergone various changes throughout the last forty years, and it is certain that it will continue to change even more in the future. Businesses can no longer rely solely, on traditional management accounting practices to stay competitive in today’s global marketplace. If companies hope to be successful they must implement the concepts of strategic cost management. The purpose of this paper is to look at the history of strategic cost management, to see how it is being implemented today, and to show that its importance to the future of management accounting and to businesses as a whole.

TRADITIONAL MANAGEMENT ACCOUNTING

To begin, this paper will discuss briefly, traditional management accounting. Credit for the original concepts of management accounting belongs to men like Robert Anthony, Gordon Shillinglaw, and Charles Horngren. Their ideas that were first expressed in the late 1950’s and early 1960’s taught us the importance of cost analysis to business. Their contributions to accounting were numerous and we owe a great deal to their work. They taught us how to analyze costs, gave us three main objectives of cost analysis, and taught us how to understand cost behavior.
Traditional management accounting uses an internal focus to analyze costs. It looks at what can be done within the business to most effectively manage costs. To do this, it analyzes costs in terms of its products, its customers, and its functions. Traditional management accounting does not concern itself with factors outside of the business, as these things are much more difficult to control. The value added concept is very important to cost analysis using the traditional management accounting approach. Costs can be justified by the amount of value that they add to a product.

According to traditional management accounting, there are three very important objectives that apply to cost analysis. These three objectives are score keeping, attention directing, and problem solving. These objectives are still very important today as long as they are analyzed within the framework of the company's overall strategy.

Traditional management accounting tells us that cost is primarily a function of output volume. To analyze costs you must look at variable costs, fixed costs, step costs, and mixed costs. A very effective approach to analyzing cost behavior, according to management accounting, is to use contribution margin analysis.

The main weakness of traditional management accounting is that it fails to recognize the importance of aligning accounting decisions with overall business strategies. Its focus is essentially too narrow and concerned with short-term results. Accounting departments need to take into account the overall value chain in which their companies operate, the strategic positioning of the firm, and move
toward a focus on structural and executional cost drivers as opposed to using contribution margin analysis.

STRATEGIC COST MANAGEMENT

According to Tony Grundy, the idea of strategic cost management began simultaneously in Europe and the United States. (Grundy, p. 58) In the United States, John Shank and Vijay Govindarajan, of the Amos Tuck School of Business Administration at Dartmouth College, were the first to introduce strategic cost management (or otherwise known as SCM). At the same time, strategic cost management was being developed in the United Kingdom at the Cranfield School of Management. Shank and Govindarajan’s 1993 book, Strategic Cost Management: The New Tool for Competitive Advantage, clearly laid out the concepts of strategic cost management and explained how they should be used. Since then the concepts of SCM have been developed and expanded upon by authors such as Tony Grundy, Shahid Ansari, Jan Bell, Robin Cooper and Regine Slagmulder. They have reiterated the importance of Shank and Govindarajan’s ideas as well as expanding on them and showing how the concepts of SCM can be used by businesses today.

According to Shank and Govindarajan, the central theme of their book was as follows; “accounting exists within a business primarily to facilitate the development and implementation of business strategy. Under this view, business management is a continuously cycling process of (1) formulating strategies, (2)
communicating those strategies throughout the organization, (3) developing and carrying out tactics to implement the strategies, and (4) developing and implementing controls to monitor the success of the implementation steps and hence the success in meeting the strategic objectives.” (Shank and Govindarajan, p. 6)

Information that the firm receives from its accounting department plays a roll in each stage of the cycle that Shank and Govindarajan describe. At stage one, the financial feasibility and financial return of a strategy is evaluated. At stage two, accounting reports focus attention on the factors that are critical for the adoption of the strategy. These reports are relied on to communicate the strategy throughout the organization. At stage three, accounting contributes to the financial analysis that is used to decide which tactical programs to pursue. Finally, at stage four, accounting information such as standard costs expense budgets, and annual profit plans help to control and monitor the success of a strategy.

It is important to note that the success of the strategy is the key reason for making accounting decisions. Currently the focus on the strategy sometimes tends to get lost in the importance of maximizing current earnings and presenting the best possible current financial picture to the public. While this focus on the short-term may lead to higher current stock prices, focus on strategy will lead to long-term success for the business.

Shank and Govindarajan also provide three key questions that should be analyzed before any accounting ideas are implemented. (Shank and Govindarajan,
First, "Does the idea serve an identifiable business objective?" Second, "For the objective it is designed to serve, does the accounting idea enhance the chances of obtaining the objective?" Third, "Does the objective whose attainment is facilitated by the accounting idea fit strategically with the overall thrust of the business?" According to Shank and Govindarajan the answer to all three of these questions must be, "yes," for an accounting idea to be useful for a particular purpose.

Now that we know the role that accounting should play in a business using strategic cost management and the questions that must be answered affirmatively for an idea to be useful, I will look at the three key themes of strategic cost management. These themes are value chain analysis, strategic positioning analysis and cost driver analysis. The blending of these three key themes give us the basis of strategic cost management.

**VALUE CHAIN ANALYSIS**

The value chain concept is the first theme of strategic cost management. Shank and Govindarajan state that "in the SCM framework, managing costs effectively requires a broad focus, external to the firm." (Shank and Govindarajan, p. 48) Michael Porter first called this focus the value chain, in 1985. (Shank and Govindarajan, p. 48) The traditional notion of a firm’s value chain had a distinctly internal focus. It looked only at a firm’s purchases, its processes, its functions, its products, and its customers. The strategic cost management
perspective of the value chain has a much more external focus. It focuses on an overall value chain of which a particular business may be only a small part. Here the value chain begins with the basic raw material sources for component suppliers and extends to the final useable product that ends up in the hands of the ultimate consumer. When making strategic decisions, businesses should consider the effect the decisions will have on the entire value chain in which it operates.

In the past management accounting has focused on a firm's internal value chain and used a valued added approach to making decisions. When it is viewed in the SCM perspective the value-added approach has two major flaws. These flaws are that it begins too late and it ends too soon. By only looking internally, a firm misses all the chances it has to capitalize on linkages with its suppliers and its customers. Firms need to look at the overall value chain so that they can more effectively make strategic decisions.

According to Shank and Govindarajan, “value chain analysis is essential to determine exactly where in the chain customer value can be enhanced or cost lowered. Ignoring linkages upstream from the firm as well as downstream is too restrictive a perspective.” (Shank and Govindarajan, p. 50) This means that businesses must look externally when determining their value chain as no firm spans the entire value chain in which it operates.

Each company operates within its own unique value chain. No two firms compete in the exact same market having both the same suppliers and customers in all cases. Therefore each company must evaluate their own unique value chain. Shank and Govindarajan insist that, “gaining and sustaining a competitive
advantage requires that a firm understand the entire value delivery system, not just the portion of the value chain in which it participates. Suppliers and customers and suppliers’ suppliers and customers’ customers have profit margins that are important to identify in understanding a firm’s cost/differentiation positioning, because the end-use customers ultimately pay for all the profit margins along the entire value chain.” (Shank and Govindarajan, p. 51) Using this perspective it is clear that a firm should never limit its analysis to its own internal value chain.

This type of value chain analysis goes well beyond the traditional concept of a firm’s value chain that represents the collection of activities that the firm performs in the different functional areas. The traditional value chain only took into account the firm’s activities from design to distribution. Even though analysis of the overall value chain is clearly the superior approach, colleges and universities today are still focusing on the traditional approach. Perhaps the reason they focus on the traditional approach is that the aspects of a firm’s internal value chain are easier to understand and work with, since firms have control over them. Using the SCM value chain approach would be more complex and possibly beyond the scope of many management accounting courses.

From the strategic perspective, value chain analysis highlights four profit-improving areas. (Shank and Govindarajan, p. 54) The first, is a firm’s linkages with its suppliers. These linkages can not be used effectively if the firm does not look at its external value chain. However, exploiting these linkages can be very beneficial to the firm. Finding ways to improve its strategic position relative to its
suppliers will enable a firm to lower its overall costs. The second, is a firm’s linkages with its customers. Relying on the value-added approach of traditional management accounting stops the analysis too soon. It does not take into account linkages that exist with customers. Recognizing and capitalizing on these linkages can be beneficial to both the company and its customers. The third area of improvement is developing process linkages within the value chain of a business unit. Value chain analysis explicitly recognizes that value activities within a firm are interdependent. Shank and Govindarajan have observed that “Conventional management accounting approaches tend to emphasize across-the-board cost reductions. However by recognizing inter-linkages, the value chain analysis admits to the possibility that deliberately increasing cost in one value activity can bring about a reduction in total costs.” (Shank and Govindarajan, p. 56) The fourth area of improvement is developing linkages across business unit value chains within the firm. Using value chain analysis to exploit linkages among value activities across business units produces the potential for significant profits. Cooper and Slagmulder list three ways that a firm can improve these internal linkages. (Cooper and Slagmulder, April, 98, p. 16) These include establishing systems to help streamline transactions between departments, devising transfer pricing systems, and creating pseudo profit centers.

Shank and Govindarajan developed a three-step methodology for constructing and using a value chain. (Shank and Govindarajan, p. 58) The first step is to, “Identify the industry’s value chain and assign costs, revenues and assets to value activities.” The second is to, “Diagnose the cost drivers regulating
to each value activity.” The third step is to, “Develop a sustainable competitive advantage, either through controlling cost drivers better that competitors or by reconfiguring the value chain.”

Calculating a firm’s value chain, while not an easy task, is very necessary for all firms. The process of constructing the value chain alone, can be very useful to the business, as it forces managers to step back and look at how their activity adds value to the chain of customers who use their products. It also causes them to take a good look at how their cost structure compares with those of their competitors.

Shank and Govindarajan list three final reasons why the value chain analysis is superior to the value-added approach. (Shank and Govindarajan, p. 89) The first is, “it arbitrarily distinguishes between raw materials and many other purchased inputs. Purchased services such as maintenance or professional consulting services are treated differently than raw materials purchased.” Second, “Value-added does not point out the potential to exploit the linkages between a firm and its suppliers or between a firm and its customers with a view to reducing costs or enhancing differentiation.” Third, “Competitive advantage cannot be fully explored without considering the interaction between purchased raw materials and other cost elements (e.g., purchasing higher-quality, higher-priced raw material could reduce scrap significantly and thus lower the total cost).” Since value chain analysis views each firm in the overall context of the environment in which it operates, it avoids these problems and it is relevant for all firms.
STRATEGIC POSITIONING ANALYSIS

The next theme of strategic cost management is the use of the strategic positioning analysis. There are two main ways that a firm can gain a competitive advantage over its competitors. (Shank and Govindarajan, p. 95) It can either compete on the basis of cost leadership or product differentiation. Each strategy involves a different mindset and new ideas should be evaluated as to how they fit the strategy that the firm has chosen. A firm following a cost leadership strategy should obviously make different decisions than a firm following a differentiation strategy.

Traditional management accounting does not effectively consider the importance strategy has on accounting decisions. Traditionally the essence of management accounting has been to perform the functions of score keeping, problem solving, and attention directing. These three functions are discussed in most management accounting texts today. The problem with the use of these three ideas is that they do not vary according to the strategic context of a firm. Therefore, traditional management accounting does not effectively take into account strategic positioning analysis.

Since strategies are different for different types of organizations, controls should be tailored to the requirements of specific strategies. Shank and Govindarajan used the following line of thinking to establish their logic behind linking controls to strategy. First, "For effective execution, different strategies
require different task priorities; different key success factors; and different skills, perspectives and behaviors.” Second, “Control systems are measurement systems that influence the behavior of those people whose activities are being measured.” This leads us to the conclusion that, “a continuing concern in the design of control systems should be whether the behavior induced by the system is the one that is consistent with the strategy.” (Shank and Govindarajan, p. 93)

Strategy is dependent upon two aspects, a company’s mission and the competitive advantage that it pursues. A firm can adopt one of three different types of missions. (Shank and Govindarajan, p. 94) The first type is a build mission. The goal of a build mission is increased market share at the expense of short-term earnings and cash flow. The second type of mission is a hold mission. The goal of a hold mission is to protect the firm’s market share and competitive position. The third type of mission is a harvest mission. The goal of a harvest mission is to maximize short-term earnings and cash flow, even if this means sacrificing market share. It is important to note that firms usually do not adopt a pure form of one of these missions, but instead their mission leans toward one of the ends of a continuum that places a pure build strategy on one side and a pure harvest strategy on the other.

The second aspect upon which a firm’s strategy depends is its competitive advantage. There are two main types of competitive advantages that a firm can pursue, low cost and differentiation. (Shank and Govindarajan, p. 94) The primary objective of a low cost strategy is to achieve low costs relative to competitors. Grundy explains that in order for a low cost strategy to be successful
the expectations of buyers in the industry must be relatively uniform. (Shank and Govindarajan, p. 105) The primary objective of a differentiation strategy is to differentiate its product so that it creates something that its customers perceive to be unique. A differentiation strategy works well in a market where variations in products can lead to different buying habits by consumers.

Many variables affect a firm's choice of mission and competitive advantage. Some of the things a firm might look at when determining its mission are the importance of strategic planning in its industry, its capital expenditure evaluation criteria, its hurdle rates, and its capital investment analysis. A major factor a firm should consider when choosing its competitive advantage is the changing environment in which it operates. If a firm's environment changes, then it will probably be necessary for it to change its strategy.

**COST DRIVER ANALYSIS**

The third theme of strategic cost management is cost driver analysis. According to strategic cost management, cost is driven by many interrelated factors. In traditional management accounting the main cost driver is output volume. In SCM, output volume is not seen as a very important cost driver. Using volume as the firm's most important cost driver leads to breakeven analysis, which can be very useful. However, the distinction between fixed costs and variable costs is not always important since, in the big picture of things, all costs are essentially variable costs.
Shank and Govindarajan refer to Daniel Riley who breaks cost drivers into two categories, structural and executional cost drivers. (Shank and Govindarajan, p. 20) Grundy defines structural cost drivers as, “those cost drivers which reflect the fundamental design of the business—operationally, technologically, and in terms of market focus and scope.” (Grundy, p. 62) Structural cost drivers can be broken into five groups dealing with scale, scope, experience, technology, and complexity. Shank and Govindarajan note that, “Of the structural drivers, scale, scope and experience have received a large amount of attention from economists and strategists over the years. Of these three, only experience has drawn much interest from management accountants.” (Shank and Govindarajan, p. 21) This attention is witnessed with the recognition of the existence and importance of a learning curve. The learning or experience curve can be an important strategic cost driver. Grundy has documented cases where certain United Kingdom accounting firms have been able to dominate certain service niches by focusing on their experience curves. As a result, Grundy noted that these firms were able to “reduce initial marketing and sales costs, achieve much greater operational efficiencies, secure more referred or follow-on work, and add more value in the same time, or the same value in less time and with less cost relative to the mid-range players.” (Grundy, p. 59) More recently, the rise of activity based costing (ABC) has placed some emphasis on complexity as a structural cost driver. The importance of ABC to strategic cost management will be further discussed later.

According to Shank and Govindarajan, executional cost drivers are “those determinants of a firm’s cost position that hinge on its ability to execute
While in the case of structural cost drivers, more is not always better; with executional cost drivers more is always better. At minimum, a list of executional drivers includes work force involvement, total quality management, capacity utilization, plant layout efficiency, product configuration, and exploiting linkages with suppliers and/or customers.

One particular executional cost driver is quality. Analysis of this cost driver leads us to the topic of total quality management (TQM). There are four main schools of quality management in their discussion of TQM. These schools are the Juran, Demming, Crosby and Japanese approaches. While all four schools have their differences they are very similar in that they all believe that firms should strive to produce that best quality available and that in the end this will reduce costs. The adoption of TQM fits well within the framework of strategic cost management.

**RELATED ISSUES**

Next, the strategic cost management perspective will be used to discuss a few related topics. The topics to be covered include profit variance analysis, the use of non-financial measures for a company, and activity based costing.

The strategic cost management perspective of profit variance analysis views profit variance analysis as most meaningful when it is tied to strategic analysis. Performance evaluation needs to be tailored to the strategy being
followed by the business units of a company. Favorable variances and favorable performance do not necessarily go hand in hand. The same is also true for unfavorable variances. Traditional profit variance analysis simply compares a company’s results to a set budget. How can a company be assured that the budget they are using is an accurate measure of their success? Variances need to be evaluated in the proper strategic perspective to be meaningful.

The strategic cost management perspective emphasizes the use of non-financial performance measures in addition to financial performance measures. Non-financial measures can be used to evaluate current situations, since financial measures only give us a clear picture of what has already happened. There are six phases involved in implementing the use of non-financial measures. (Shank and Govindarajan, p. 139) Phase one occurs when a company perceives a shock to its operating environment. This shock may come in the form of a new product development by a competitor or a new technological breakthrough in the industry. A company enters phase two when it concludes that its current control system is deficient. Therefore, in order to continue to compete, a change must be made. Phase three takes place when a company attempts to define key success factors that lead to a competitive advantage. When a company attempts to find quantifiable measures of non-financial success factors it is in phase four. Phase five exists when actual implementation of the new system occurs. Finally, in phase six the company uses its new measures to evaluate the new positive and negative outcomes it receives relative to the key success factors it has defined.
Next, the topic of activity based costing (ABC) will be explored.

Traditional costing approaches can misallocate costs among products and activity based costing can be helpful in attaching a truer cost to each product. For example, in the past overhead costs have been spread evenly over various products. This does not always give an accurate cost for each product, since not all products are supported by the same amount of overhead. With ABC, overhead would be attached to each product at its own specific rate. Another area in which traditional costing approaches have failed is in the allocation of costs to services.

Implementing ABC involves three steps. The first step is to identify the key cost drivers of a particular product or service. To do this, a company identifies all the key inputs that lead to an increase in the cost of their products. The second step is to look for ways to simplify or change processes in order to reduce costs or add more value. This step may include comparing the company's processes to those of its competitors or those of successful businesses in other industries. The third step is to devise a new way to monitor costs by measuring the impact of key cost drivers. This step is critical as it gives the company accurate feedback so it can more effectively monitor the results. While ABC is very useful as a strategic tool, it should not be used as an accounting system. Shank and Govindarajan list three major problems with using ABC as an accounting system. (Shank and Govindarajan, p.181-185) The first problem is that, “ABC assigns all of the current manufacturing costs to products without any concern as to whether or not the cost is legitimate in a strategic sense.” The second problem is that, “like all general ledger-based accounting systems, ABC is caught up in the distinction
between costs that will be inventoried and those that will be expensed.” This distinction is no longer useful for managerial purposes. The third problem with ABC is a limitation that exists for all formal accounting systems. ABC involves accounting for today’s strategy and cannot account for what will happen when the strategy is extended into tomorrow.

CURRENT USES OF STRATEGIC COST MANAGEMENT

Strategic cost management programs are being implemented throughout the world. The June 30, 1995, San Antonio Business Journal, discussed how building owners and managers are using SCM to lower their acquisition costs, reduce their position costs and minimize their application costs. Hans Hinterhuber, in his 1997 article, Strategic cost management: preliminary lessons from European companies, explains how European companies are “(1) making core competencies the guiding ideas of their strategies and (2) striving to aggressively increase their value, first by reengineering practices, and second by ‘inventing’ new markets and satisfying all stakeholders, not only shareholders, better and quicker than competitors or other reference companies are able to do. (Hinterhuber, H.H., p. 1)

There are also many current articles being written on the use of strategic cost management. Cooper and Slagmulder write monthly articles on SCM in Management Accounting magazine. They have shown how to apply SCM to
internal markets, to develop a micro-profit center, and even how to use it for financial reporting. Their articles address different issues every month, however the underlying theme that accounting decisions should be based on the strategic goals of the firm is always present.

**FINAL THOUGHTS**

Strategic cost management is clearly an important topic for the future. The January 1997, *Executive Edge Newsletter*, sites as recent survey of the Cost Management Group of the Institute of Management Accountants where 67% of the respondents said strategic cost management is the wave of the future. ("Future Trends," p. 4) More recently an article in the December 1998, issue of *Management Accounting*, listed the eight areas in which entry-level accountants were underprepared. (Continuing Education, p. 72) Strategic cost management was part of that list. It is clear that more importance should be placed on strategic cost management in colleges and universities throughout the United States. The use of strategic cost management may be one of the main keys to competitiveness in the global marketplace of the future and therefore we should prepare ourselves by learning how to use it.
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