



CMA CAM-I 2007 Second Annual Summit

Cost Management Techniques as Strategic Tools

Dave McGarva, MBA, CMC
Partner, Acton Consulting Ltd.



Synopsis of Presentation

- ❖ Porter's Strategic Positioning
- ❖ Current Canadian Issues
- ❖ Impacts on Strategic Positions
- ❖ Cost Management Techniques
- ❖ Examples
- ❖ What does the future hold?



Porter's Strategic Positioning Model

- ❖ Essentially, there are two types of competitive advantage:
 - ❖ low cost
 - ❖ product differentiation
- ❖ Porter derives three strategies:
 - ❖ Cost Leadership, in which a company aims to produce products at the lowest possible cost,
 - ❖ Differentiation, in which a company produces unique products or services,
 - ❖ and Focus, in which a company aims to serve a narrow market segment.



Porter's Strategic Positioning Model

Porter's generic strategies are used to derive the most effective one of four strategic positions:

- ❖ Cost Focus aims to keep costs low and focus on a narrow market segment (very difficult to actualize).
- ❖ Cost Leadership also aims to keep costs low but for a broad market.
- ❖ Differentiation Focus has a narrow focus with high product (or service) differentiation.
- ❖ Differentiation has a broad market with high product (or service) differentiation.



Porter's Strategic Positioning Model

Competitive Advantage

Lower Cost Differentiation

**Competitive
Scope**

**Broad
Target**

**Cost
Leadership**

Differentiation

**Narrow
Target**

Cost Focus

**Differentiation
Focus**



Current Canadian Issues

- ❖ Limited base of skilled workers
 - ❖ (or in Alberta, any workers!)
- ❖ Construction escalation
 - ❖ (caused in large part by Alberta!)
- ❖ Rising Canadian dollar
 - ❖ (mainly attributed to global rise in energy prices, yep Alberta again!)

Impacts on Strategic Positions

	Lower Cost	Differentiation
Broad Target	<u>Cost Leadership</u> <ul style="list-style-type: none">• Higher labour costs• Higher input/start up costs• Reduced int'l margins	<u>Differentiation</u> <ul style="list-style-type: none">• Reduced int'l competitiveness
Narrow Target	<u>Cost Focus</u> <ul style="list-style-type: none">• Higher labour costs• Higher input/start up costs• Reduced int'l margins DEATH SPIRAL!	<u>Differentiation Focus</u> <ul style="list-style-type: none">• Reduced int'l competitiveness

Cost Management Techniques

	Lower Cost	Differentiation
Broad Target	<u>Cost Leadership</u> <ul style="list-style-type: none">• Target Costing	<u>Differentiation</u> <ul style="list-style-type: none">• Off-shoring
Narrow Target	<u>Cost Focus</u> <ul style="list-style-type: none">• Try to get a good price!!!	<u>Differentiation Focus</u> <ul style="list-style-type: none">• Hedging

Cost Management Techniques

- Target Costing

What is Target Costing?

- ❖ “Target costing is a fundamentally different way to look at the relationship of prices and costs. The basic target equation of “Price-Profit Margin = Cost” means that prices are driven and set either by competitive market forces or by the firm as it aggressively lowers its prices to increase market penetration; that profit margins are established such that the firm can make money; and that allowable costs are derived from price and margin.”

(AICPA definition)

Cost Management Techniques

- Target Costing (2)

- ❖ Target costing is based on three premises:
 - ❖ market-driven pricing
 - ❖ treating product cost as an independent variable
 - ❖ proactively working to achieve target cost during product and process development.

Cost Management Techniques

- Target Costing (3)

Success Factors

- ❖ Top management support is a critical success factor in implementing target costing.
- ❖ Target costing is part of a company's culture.
 - ❖ Targets are taken seriously and have reporting structures for monitoring progress against targets.
 - ❖ Targets are never ignored or explained away.
- ❖ There is no unique implementation path.



Cost Management Techniques

- Target Costing (4)

- ❖ Best practice companies:
 - ❖ tie target costing to strategy and profit planning and have a high level of accountability and monitoring of target cost achievement.
 - ❖ have close supplier relations.
 - ❖ use independent and empowered cross-functional teams to acquire resources from functions, but don't tie to supportive performance measures, rewards, training and information systems.
 - ❖ use of sophisticated cost estimation models to make costs visible and understandable to product designers and engineers through internal training and education.
 - ❖ use the capital budgeting process to invest when technology is a limiting factor.



Cost Management Techniques

- Target Costing (5)

Challenges

- ❖ Mistaking partial applications of target costing for a fully implemented system
- ❖ Insufficient supply chain involvement
- ❖ Immaturity of process
- ❖ Organizational structures which do not support cross-functional teams
- ❖ Poor adherence to planned targets
- ❖ Lack of appropriate performance monitoring systems.



Cost Management Techniques

- Target Costing (6) – Metal Fab.

- ❖ Competitive market (tight margins)
- ❖ Consistent, reoccurring work.
- ❖ Invested in capital automation to cut and fabricate industrial pieces.
- ❖ Results:
 - ❖ Higher gross margins (2% – 3% increase)
 - ❖ Retained competitive position by being able to deliver.
 - ❖ Leveraged equipment to win additional business.



Cost Management Techniques

- Off-Shoring

- ❖ “The relocation of business activity to a location in another country with lower costs”
- ❖ Off-Shoring is not just about manufacturing
- ❖ Goldman Sachs estimates that off-shoring has accounted for roughly half a million U.S. layoffs from 2001 – 2004.
- ❖ Forrester, an information technology consulting firm, which expects the number of U.S. jobs outsourced to grow from about 400,000 in 2004 to 3.3 million by 2015.

Cost Management Techniques

- Off-Shoring (2)

Why is this happening?

- ❖ The digitization of information and expanded bandwidth abroad are enabling companies to outsource to low-wage countries services ranging from routine call center work to higher-value software programming, medical diagnosis, and research and analytical activities.
 - ❖ closely related to technological advance
 - ❖ both are driven by competitive pressures to reduce costs
- ❖ Online brokerages add credibility and value to the search and execution processes.

Cost Management Techniques

- Off-Shoring (3) - Acton Consulting Ltd.

- ❖ Low margin work in a consultancy?
 - ❖ Data entry
 - ❖ Data manipulation
 - ❖ Document formatting
- ❖ Used digital pictures of facilitation material and scanned hard copies of workbooks.
- ❖ Emailed to India on Friday afternoon returned Monday morning.
- ❖ Results:
 - ❖ Error rates similar to in-house staff (<2%)
 - ❖ Less than \$US300 compared to \$7200 staff cost

Cost Management Techniques

- Off-Shoring (4)

- ❖ Our experience:
 - ❖ www.elance.com
 - ❖ Founded in 1999, Elance was established to help small businesses easily and efficiently hire freelance talent.
 - ❖ allows businesses to easily find, hire, manage and pay highly qualified professionals – for exactly what they need, when they need it.





Cost Management Techniques

- Hedging

- ❖ “Method of transferring Risk to permit the Risk Bearer to assume two offsetting positions at the same time so that, regardless of the outcome of an event, the risk bearer is left in a no win/no lose position.”
- ❖ Being in business implies taking risks.
- ❖ Some risks are considered to be "natural" to specific businesses, such as the risk of oil prices increasing or decreasing is natural to oil drilling and refining firms.
- ❖ Most common form of hedging, insurance.



Cost Management Techniques

- Hedging (2) – Typical Scenario

- ❖ Manufacturing goods in another country
 - ❖ Cost in one currency (CDN) revenue in another (USD)
 - ❖ Inherent risk that changes in the values of each currency will reduce profit or produce a loss.

Cost Management Techniques

- Hedging (3) - Examples

Potential Strategies

- ❖ Link expenses to the desired currency.
 - ❖ open a production facility in that market to match its expected sales revenue
 - ❖ Match debt payments to expected revenues in the local currency
 - ❖ pay bonuses to employees in revenue currency.
- ❖ Buy futures contract on the currency to mitigate impact



What does the future hold?

- ❖ Uncertainty in currency markets will continue.
- ❖ Bank of Canada will be faced with some difficult decisions.
 - ❖ Increase interest rates to cool down regional inflation
 - ❖ Decrease interest rates to cool down CDN dollar
- ❖ Regardless effective cost management will continue to be critical.