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Too many students offer weak generalisations when they're required to explain a particular technique or system. It's essential to focus on the distinguishing features of the subject at hand

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In recent years a large proportion of candidates have scored low marks when asked to describe the characteristics of various business methods and their associated costing systems. Each approach has unique characteristics that you need to cover in your answers rather than giving a generic response that mentions issues that may be common to several topics. Consider one such system, Kaizen costing, for example. A good answer in this case will define the term; introduce the theory and its practical application; and explain how it relates to target costing, total life-cycle costing and standard costing.

As an introduction to the theory and practical application of Kaizen costing, let me explain my first encounter with it in a business setting. During my years as a management accountant in the telecoms industry I experienced several business processes, including just-in-time production, benchmarking and flexible manufacturing, along with their associated costing systems. My employer at the time, a global telephone manufacturer, needed to embrace any business technique that would help it to stay

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competitive – and total quality management (TQM) was a technique that attracted a lot of its attention.

When I left to become a university lecturer I retained many of the documents that my firm had circulated when introducing TQM, especially those written by the consultancy that had helped it to implement the method. These documents repeatedly mention three specific TQM concepts: "getting it right first time", the removal of waste and continuous improvement. The last of these, continuous improvement, relates directly to Kaizen costing. As its name suggests, it's an ongoing process that strives to reduce costs by making improvements and removing waste. Successful continuous improvement requires full commitment from senior managers, along with effective, well-documented policies and procedures designed to log, examine and develop all new ideas.

Kaizen costing and target costing

The cost-plus method is one of the most traditional and common pricing techniques. In fact, virtually all companies in the UK used cost-plus pricing until they started to realise that they were operating in price-competitive markets. Until then, they had naively assumed that consumers would be willing to pay whatever price they arrived at by adding a percentage to the estimated cost of the product or service. This cost-plus approach has gradually been replaced by target costing. This addresses the pricing issue from the other direction. It must be accepted that in a competitive market a company has little influence over the selling price of its product.

Organisations use market research to establish the number of units they are likely to sell and the unit price that customers are willing to pay for the product. From this selling price, a company subtracts the profit required to meet its profit objective, arriving at a target cost. In most cases this cost will be lower than the current cost, especially if the product is subject to the learning-curve phenomenon, which

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would result in a “cost gap”. The firm’s objective is to bridge this gap – ie, to cut the cost by using tools such as value analysis and functional analysis. Achieving the target cost requires a concerted effort from the whole company. Some firms choose a team of managers from all the main departments, whose main aim is to examine every aspect of the product and the manufacturing process to remove unnecessary costs and anything that does not add value, while maintaining quality and functionality. In some cases this may lead to a complete product redesign.

Once the design has been approved, production can begin, which is where Kaizen costing starts. The method can be defined as a focus on obtaining small, incremental cost reductions (rather than big changes at longer intervals) during the production phase of the product’s life cycle. Kaizen costing is based on the belief that nothing is ever perfect, so improvements and reductions in the variable costs are always possible. Like its big brother TQM, it becomes part of the culture, involving all members of the organisation. Everyone is encouraged to offer ideas that, however small, could lead to a reduction in variable costs, which could in turn lead to a reduction in the selling price and, hopefully, a growth in sales. Alternatively, the price could be maintained and the resulting increase in profits could be used to reward the shareholders or be reinvested in other projects. It’s easy to see how Kaizen costing is aligned closely with lean manufacturing, whose main aim is to cut waste through continuous improvement. This is achieved by identifying the best resources and most efficient processes to remove waste from production.

Kaizen costing and total life-cycle costing

Although most management accounting techniques assess performance on a yearly basis and normally focus on the production phase, it’s accepted that a product starts incurring costs long before it comes to the market. It incurs them from the time the initial idea is conceived until the last unit is sold, the unsold stock is scrapped and all other product-related run-down activities cease. The product’s total life-cycle costs include:

- Design and legal costs – eg, patenting.
- Research, development and testing.
- Recruitment and training.

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- Manufacturing, which would include any learning-curve effect.
- Marketing, sales and distribution.
- Inventory, storage, obsolescence etc.
- Retirement and disposal.

So, while target costing relates to planning and Kaizen costing covers manufacturing, total life-cycle costing is relevant to all stages of a product’s life.

Kaizen costing and standard costing

CIMA defines standard costing as “a control technique that reports variances by comparing actual costs to preset standards facilitating action through management by exception”. The main aim of this cost-control tool is to avoid adverse variances, based on the assumption that manufacturing conditions will not change. Standards are usually set before the year to which they relate and do not change for the whole period, unless a major cost or change in circumstances renders them obsolete. Kaizen cost targets, on the other hand, are usually set monthly.

One of the main criticisms of standard costing is that, as long as adverse variances are avoided, no attempt is made to seek further cost savings. Kaizen costing is a more proactive approach that assumes improvements can always be made – it promotes a culture in which all employees are constantly seeking to reduce production costs. So, if the standard cost of a product is set at, say, £9 and its actual cost is found to be £8.90, no cost-cutting action is even considered under the standard costing approach, because there is a favourable variance. But a Kaizen user will examine ways of cutting this figure to £8.80, £8.70 and so on.

KAIZEN COSTING BECOMES PART OF THE PACKAGE

At the start of 2002 a UK company called Kappa Packaging (now part of the Smurfit Kappa Group) had a factory in Greater Manchester that made, among other products, cartons to hold bottles of drink. That year the firm introduced a new approach to cutting the amount of waste paper and cardboard it was producing, which stood at 14.6 per cent of the raw materials consumed. The new approach included the following initiatives:

- † Making employees more aware of how much waste was being produced.
- † Requiring them to monitor the amount of waste for which they were individually responsible.
- † Establishing a Kaizen team to find ways of reducing waste.

As a result, Kappa was able to reduce waste from 14.6 per cent to 13.1 per cent of raw materials used by the end of 2002 and down to 11 per cent in 2003. Each percentage-point saving was worth an estimated £110,000 a year.

Source: “Accurate measurement of process waste leads to reduced costs”, www.envirowise.gov.uk, 2003.