CHAPTER 1: Strategic Cost Management - Introduction

Broad Contents of the Chapter are:

1. Traditional Cost management and its Limitations
2. Strategic Cost Management

Traditional Cost Management and its limitations:

Traditional Cost Management deals with Cost Allocation and Overheads absorption and focuses mainly on cost control and cost reduction. This involves comparing actuals with standards and monitoring variances and taking corrective actions to ensure actuals are in line with standards.

Limitations of Traditional Cost Management:

A. Emphasis is more on cost control and cost reduction. In today's dynamic environment, over emphasis on cost reduction may result in dangerous results. For instance large cutting down on advertising or preventive maintenance may be suicidal.
B. Focuses more on internal operations and does not consider external competition, customer expectation etc.
C. Over emphasis on cost reduction may result in quality compromising which in turn may drive away customers.
D. Traditional cost management is mostly historical and based on financial data which at times may mislead while taking strategic decisions.
E. Traditional cost management is reactive in nature.
F. Traditional cost management has short term outlook like month, quarter, year etc.
G. Traditional cost management has limited focus on improving existing operations and processes.

Strategic Cost Management:

In the current dynamic business scenario, it is not just sufficient to control costs. It is also required to manage costs strategically to ensure continuous profits to the business inspite of stiff competition and increasing consumer demands.
Strategic cost management may be defined as the managerial use of cost information at one or more stages of strategic management. Strategic management has 4 stages, viz.

A. Formulation of Strategies;

B. Communication of strategies in the entire organisation;
C. Implementing strategies; and
D. Developing and installing controls to monitor the success of strategies.

Strategic cost management is the application of cost management techniques to improve the strategic position of the business to attain and retain sustained competitive advantage apart from controlling costs.

Strategic cost management is an integral part of value chain. It lays more focus on continuous improvement to deliver superior quality products to customers. It percolates through all the stages of design, development, procurement, production, delivery, service etc.

Traditional Cost Mgmt. (TCM) Vs. Strategic Cost Mgmt. (SCM)

Feature	T C M	S C M
Time Span	Short Term	Long Term
Focus	Mostly Internal	Internal & External
Cost Driver Concept	Based on volume of the product	Each value activity has a separate cost driver. So, cost is related to volume of cost drivers of different activities rather than just the volume of the product
Objective	Problem solving and attention directing	Cost leadership or Product differentiation
Cost Reduction	Primary objective	Primary objective is cost containment, i.e. cost reduction and value improvement at the same time.
Approach	Risk averse	Risk taking and ability to adapt to changing environment.

Components of Strategic Cost Management:
Strategic Cost Management has 3 components. Viz.

A. **Strategic Positioning Analysis:** Strategic Positioning reflects the choices a company makes to create value and how this creation of value differs from others in the same industry. Value creation by a company depends on following 3 factors
   a. Organisational values, culture and systems;
   b. Internal environment - Resources and Competencies; and

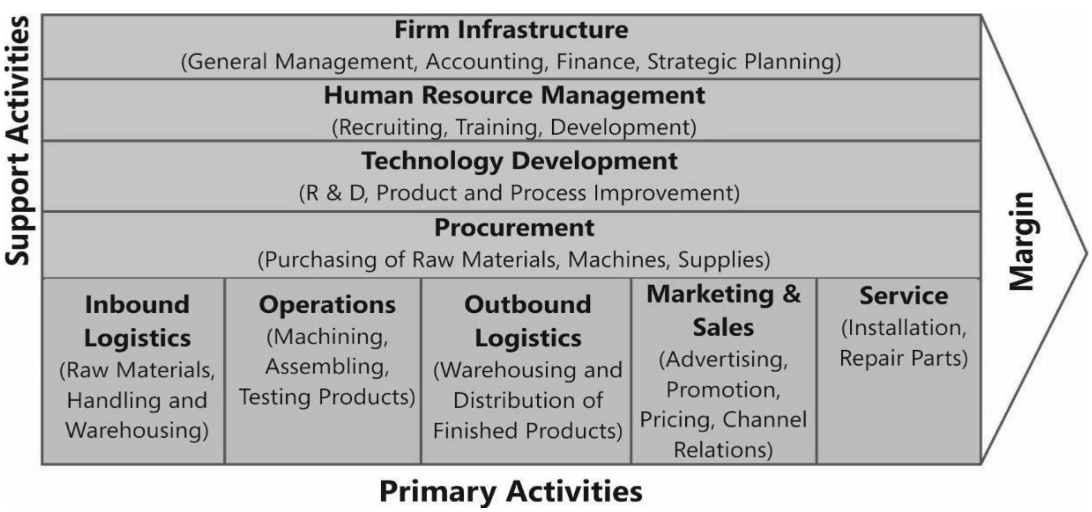
c. External environment. External environment can be analysed through **PESTEL** (Political, Economic, Social, Technological, Environmental and Legal)

B. **Cost Driver Analysis:** Costs of a product are driven by both Structural Cost Drivers and Executional Cost Drivers. Structural cost drivers are based on the structure of the organisation and Executional cost drivers are based on the utilisation of different resources by a company to achieve its objectives and goals.

C. **Value Chain Analysis (VCA):** Value Chain Analysis is a process by which an organisation identifies and analyses the various activities that add value to the product. Intention is to eliminate or minimize Non-Value added activities.

The concept of Value Chain was propounded by Michael Porter in 1985 who says Value Chain as "*Internal processes or activities a company performs to design, produce, market, deliver and support its product*." He further stated that "*a firm's value chain and the way it performs individual activities are a reflection of its history, its strategy, its approach of implementing its strategy, and the underlying economics of the activities themselves.*"

Porter further classified the activities of an organisation into Primary activities and Support activities as per the following diagram:



Primary activities are those activities which are directly involved in conversion of inputs to outputs and Secondary (or Support) activities are those which support primary activities.

Framework of V C A:

Value Chain Analysis is done both internally (i.e. within the organisation) and externally (i.e. within the industry). Internal V C A requires internal information and external V C A requires industry information. Strategic framework of V C A consists of:

A. Industry Structure Analysis;
B. Core Competencies Analysis; and
C. Segmentation Analysis

Industry Structure Analysis is studied through Porter's 5 forces which are:

a. Bargaining power of buyers,
b. Bargaining power of sellers,
c. Threat of Substitute products or services,
d. Threat of new entrants,
e. Intensity of competition among rival firms.

Core Competencies arise through resources or capabilities. They can be through unique skill sets of people, or through technical knowhow, or through cost leadership, or through product differentiation, or the assets of the organisation etc.

Core competencies are to be validated from time to time. Validation is done through 3 tests

a. Access to wide variety of markets,
b. End product benefits to customer, and
c. Difficult for competitors to imitate.

(Example is Google's Search engine.)

Loss of core competencies may prove disastrous for the organisation.
(Example is Nokia feature phone)

Core competencies are used to leverage the Value Chain of current business or even new business. A cement industry with good logistics and dealer network can have steel products also. Similarly a bank with good customer base can have insurance business as well.

Segmentation Analysis leads to the identification of segments where the organisation is doing well and where it is not. For this analysis following steps are to be followed:

a. Segment variables and categories are to be identified. Segment variables may be products, type of customers, Geographical areas, etc. etc.
b. Construction of segment matrix
c. Analysing attractiveness of segment
d. Identification of key factors of each segment
e. Exploiting respective segments for overall benefit of the organisation.

Superior Performance and Competitive Advantage
In order to survive and prosper, organisations should:

a. Supply what customers desire and
b. Survive competition

Firm's competitive advantage is the difference between the sale value it realises from customers and the cost it incurs to create such value. The competencies can be achieved by an organisation through:

a. **Product differentiation** (eg. Apple products, Gillette razor etc.) Differentiation arises when products quality is superior, Superior innovation of the product, Superior response from customers etc.

and / or

b. Through **Low Cost Advantage** (eg. Jio). In this case, firm has 2 options. Either to increase the market share at the cost of higher profits or go for higher profits with less concern about market share.

<u>Mission, Vision, Objectives and SCM:</u>
Mission indicates the reason for the existence of an organisation. This answers the question why the organisation should exist? Related issues are:

A. What kind of products or services is it going to offer;
B. What type of customers are targeted;
C. What's the primary market
D. What's the Geographical area of operation etc.

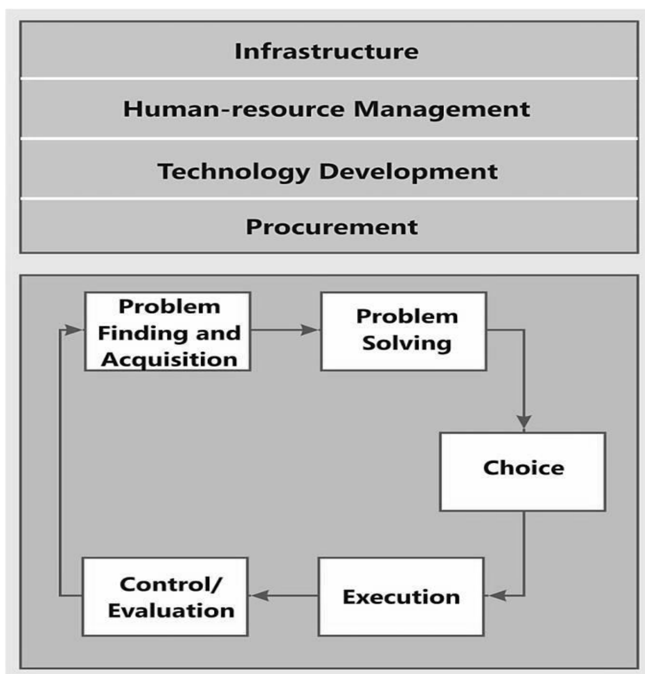
A Mission statement should be **Customer Focused and not Product Focused**
Vision statement indicates what the organisation intends to achieve from its Mission. A Vision statement must be challenging, ambitious and motivate employees to work towards organisational goals. Vision is long term in nature ranging from 3 to 10 years or even more.

Objective or Goal is a precise measurable future state that the organisation intends to achieve. This indicates what needs to be done to meet the vision of the company. Timeframe of Objectives or Goals are short term in nature and range from as short as a day to a quarter, to a year etc.

SCM is required to align the Mission, Vision and Objectives of the organisation and attain Goal Congruence. The organisation must be positioned to attain sustained competitive advantage in the dynamic environment. This is achieved through product differentiation and / or cost leadership. Thus, SCM is closely linked to the organisation's Mission, Vision and Objectives.

Value Shop Model or Service Value Chain:

Value shop mobilises resources (say: people, knowledge or money) to solve specific problems such as curing an illness or delivering a solution to a business problem, or identifying an opportunity etc. This approach is designed to solve customer problems rather than creating Values as in production scenarios. This model is applicable to service sector where as VCA is applicable to production sector. In value shop principle, no value addition takes place. It only deals with the problem, figure-out the main area which requires its service and finally comes with the solution. To arrive at solution it adopts iterative process and simulation till solution is achieved. This model is useful for Banks, Insurance, Telecom etc. companies. The model has the same support activities as Porter's Value Chain but the primary activities are described differently.



Role of Management Accountant:

Management Accountant is traditionally considered as expert on cost analysis; cost estimation; cost behaviour; standard costing; profitability analysis by product, customer or distribution channel; profit variance analysis; financial analysis etc. However, Today Management Accountants must also have skills in activity-based costing, benchmarking, re-engineering, target costing, life-cycle costing, economic value analysis, total quality management, value chain analysis etc. Value chain analysis is a team effort. Management accountants need to collaborate with engineering, production, marketing, distribution and service professionals to focus on the strengths, weaknesses, opportunities and threats identified in the value chain analysis results. By championing VCA, Management Accountant enhances firm's value and demonstrates the value of Management Accountants for the firm's growth and survival.