Date: 17 Jan 06
Mr Mahesh Bhandari

Books – Strategic Financial Management By Mr Jakhotia
Strategic Cost Management By Govind Rajan & Shanks

Tele: (Off) 56658881

This class would be shared by Mr Mahesh Bhandari and Mr Jakhotia.

This is a comparatively new subject and has developed in Japan and West. Most of the theories are still under experimentation and validation. As the name suggests, it is strategic decision making regarding cost management of a product. To be more precise, “how much expenditure to allocate to which activity?” Whether to invest in quality improvement or new features or marketing or simply in methods to reduce production costs. It is not a definitive subject and primarily a subjective evaluation of business climate and allocation of costs accordingly. Therefore, unlike other costing topics, it does not involve much of arithmetic work.

The subject was born out of the feeling that the prevailing cost accounting system and practices did not give timely and adequate insight into the rapidly evolving business climate for effective decision making.

Current accounting practices, primarily the balance sheet and profit and loss statement tell what has happened in the company in the past (and even that can be successfully padded up to reflect the desired result) but give no clue about “WHY” it happened. More importantly, it gives no clue as to what can be expected in the near future.

Final cost of the product includes raw material costs, production costs, admin overheads, development costs, advertising/marketing costs, cost of capital, etc. “How much cost to incur on which head” largely depends on the nature of product, market conditions, competition, etc.

Take for instance ROLEX/RADO watches. These watches are reputed for their extra ordinary accuracy and longevity. They are handed down from one generation to other in flawless condition. But their real claim to fame is not their longevity or even accuracy but the style statement they make and status they accord to their wearer. These watches are owned less for time keeping sake and more for the status symbol that they signify. Thus, while maintaining quality is no doubt very important for the management, marketing is even more important. The niche customer segment that these watches rule has to be safeguarded. The production cost of such life style products is very small portion of the total cost. Any savings achieved in production costs will have little impact on profitability. Again, life style products are not for price sensitive segment of the market. Such products, if priced low, would lose their appeal.
Now let us take the case of Sugar. It is a commodity with balanced demand supply condition. It is a perfect commodity. Sugar of one company can not be distinguished from other company’. The customer base for such products is very large and most of the customers are very price sensitive about such products. Company has to sell the product at prevailing market price irrespective of its own cost of sales. Further, profit margins in such products are also wafer thin due to almost perfect market conditions existing. Any extra profits can be generated only through cost management. In commodity items, production cost is largest chunk of total cost. Thus, production costs assume highest significance here.

**Survival Triangle**

![Survival Triangle Diagram](image)

In order to survive in the market, it is necessary that a company leads its competitors at least in one of the above three attributes. Take for example Topaz blade Vs Gillette. While Gillette is leader in quality and even functionality, Topaz is still surviving in the market due to its low price. Similarly, V-John brand of shaving products are barbers’ first preference due to their extremely low prices. Therefore, it is necessary for any company to know why do the customers prefer its products over other companies’ products. Such reasons become the USP of that company and the company needs to protect that turf more vigorously than any other. A product which sells to price sensitive segment, like V-John and Topaz blade, will have to ensure that its selling price remains low compared to its competitors. The day V-John raises its product prices too high, even though it may have improved its quality to better Gillette, it will disappear from the market. It will lose the existing customer segment (Barbers) and will not penetrate into the new one.

**Target Costing:** It is a system where in the cost of the final product is fixed before putting the product on the drawing board. Thereafter, the raw material, production processes, functionality (Features), quality, etc are selected to meet the cost objective. This system is relevant for products made for extremely price sensitive segment.

In case of drugs, the most profitable phase is first 17 years from launch when product and process patents are valid. Thereafter, the drug is relegated to generic drug category and any one free to manufacture the same. At such times prices of drugs fall up to 90%. Therefore, future profitability of a drug company is assessed on the basis of number and balance life of patented drugs and number of drugs under advanced stage of development like clinical trials.
**Balanced Scorecard** – Balanced Scorecard gives more information than routine accounting ledgers. It gives the status of various vital parameters like manpower (attrition rate, comparative worth of various key employees), product life cycle, status of competition, technological movement, opportunities and risks, etc.

As can be seen, it doesn’t only account for tangible financial numbers but also considers the intangibles. Thus, it goes not only into what happened but also why it happened and what could happen in near future.
Activity Based Costing

Activity Based Costing (ABC) is a superior alternative to Traditional Costing methods.

Let us examine as to why we need to do the costing in the first place. Besides host of reasons, some major and others minor, the most compelling reason is correct PRICING OF PRODUCTS.

In a monopolistic market, products are priced based on the market’s capacity to pay, with little or no regard to cost of sales. In such cases, often profit margins are in multiples of production cost and therefore absence of accurate knowledge of product cost does not affect business model. But in a competitive market, or in markets like rural India, where customers are extremely price sensitive, and therefore margins are wafer thin, correct pricing of product is vital for survival. A product priced higher than competitor without any distinctive USP (Unique Selling Proposition) would lose its market share. And a product erroneously priced too low would affect earnings and in some cases might cause losses also. Thus, accurate knowledge of product cost is essential for right pricing decision. Inflated or deflated cost data would lead to incorrect pricing and losses. *(Knowing true cost does not mean pricing to recover full cost every time. The price may still be kept below cost as a part of long term strategy of management. But knowing the correct effect of under pricing on the bottom line is essential for effective decision making)*

Any business involves a variety of costs, some direct and a host of others, indirect. While there is rarely a dispute regarding direct costs like raw material and labour, apportionment of indirect costs or overheads is not always correct. If we see the cost patterns of businesses, we find that in most cases, indirect costs are substantially higher than direct costs. Thus, incorrect apportionment of indirect costs/overheads leads to distorted cost picture and wrong pricing. ABC attempts to accurately identify the product or group responsible for each expense and allocate it to same rather than arbitrarily apportioning all costs on random basis.

What is an Activity?

In costing, activity is defined as a process that consumes resources (and therefore costs money) and adds value to the product. If either of the two, cost or value, is absent, it is a non-activity. Usage of machine is an “Activity” because it consumes electrical power, man hours (operator), maintenance, depreciation and investment costs while adding value to the material being worked upon. But if a process does not cost the company or does not add value, it is called a “Non-Activity”. Take for instance use of sunlight to dry a product. Using sunlight here is a non-activity because it does not involve any cost even though it is adding value to the product. But if we use electrical heater for the same purpose, it is an activity. Similarly, take a hypothetical case of a firm purchasing its merchandise from Pune, bringing to a warehouse in Chembur and a few days later transporting it to its store in
Crawford market. There are costs involved in unloading at Chembur and then hiring another truck and loading it for transportation to Crawford Market. But there is no value added in the process. Therefore, this is also a non activity.

By identifying non activities, attempts can be made to minimize or completely eliminate them and thus reduce costs. JIT (Just In Time concept tries to achieve just that. Warehouse functions are “Non-Activity” because they do not add any value to the product. By implementing JIT, a large number of unproductive costs, like handling, storing, damages, pilferage, internal transportation, warehouse rent, material handling equipment, salaries of personnel, etc, are eliminated).

But why is ABC required? What competitive advantages does it offer over the traditional costing method?

While knowing the accurate cost of the product for pricing decisions is one prime incentive for adopting ABC approach, identifying “Activity” and “Non Activity” in a business process is other key benefit of ABC approach. The third advantage it offers is in terms of responsibility accounting – Who was responsible for a particular loss or excess costs incurred by the company.

A classic case of advantages of ABC quoted above is over projection of sales. Production schedules are set as per sales forecasts. When sales forecasts are not met, there is unsold inventory of finished goods. This inventory leads to various excess costs like inventory carrying costs, working capital costs blocked by it, and damages/discounts offered to clear it.

In the traditional accounting method, these costs are apportioned to production department and profitability of product is calculated after reducing these costs from sales. Low profits thus reported lead to either price increase affecting competitiveness of the product, or in some cases cut back in sales thrust or discontinuance of the product itself.

But in ABC, above costs are tracked to failure of Sales Department to correctly forecast market demand and allocated to it (Responsibility Accounting). Thus, on one hand, Sales Department does not go scot free after goofing up in forecasting sales, on the other hand, product’s profitability at current price is correctly ascertained (Pricing Decision).

ABC does not stop at just costing of product. It actually goes a lot further. It goes on to cost even the customers and suppliers. How does it do it?

A business deals with all kinds of customers. On one side there are customers like some of the Govt Deptts who accept literally any quality supplied at higher than market price but will take their own time to release payment after continuous tracking and often on payment of bribes. On the other extreme, there are companies who would often return a percentage of supplies as substandard or defective. The order servicing cost in both cases are different. Then, there are bulk customers and small value customers, loyal customers and occasional customers, and so on. The cost of servicing each of these customers is different. ABC
Attempts to factor-in all these differential costs and would suggest different price for each individual customer rather than apply a uniform rack-rate.

Similarly, there are suppliers. Some are stable and reliable in terms of quality and schedule, others are erratic and undependable. There is Cost of Poor Quality and also disruption in production schedule. ABC tries to build in these factors into purchase cost.

While ABC is applicable in almost all the industries, it gives more returns in multi-product setups. In case of single product setups like Cement company, its benefits would probably be limited to identification of non-activity. But in a complex set up like HLL, it has been found to be very useful.

Activity Based Costing has a long history in manufacturing sector but not so much in service sector. The primary driver was success of Japanese in manufacturing sector and giving the American’s a run for their money.

One of the first successful application of this concept was by a American Tractor manufacturing company John Deer. Despite being market leader in Tractors, the company was reporting losses and was almost on the verge of facing Liquidation (called Chapter 11 in US business parlance). With the help of ABC, they could restructure their production process by reducing the number of activities in plant 100 to just 40, reduced production costs, rationalized sales price of various spare parts and was back in black once again.

**In ABC application, following questions are addressed:**

1. What activities are being performed by the organization?
2. Why does organization need to perform those activities?
3. How much of each activity is required by each of the products, services and customers?
4. How much does it cost to perform each of those organizational activities?

Traditional costing methods use cost centres/cost pools where as ABC uses cost drivers concept.

**Cost Drivers:** There is often confusion between activity and driver. The two are not one and same. An activity is name of process without any qualifications or precise specifications. Transportation is an activity. It does not specify what to be transported, from where to where, how much to be transported.

In each activity there are one or more factors which increase or decrease the cost. In the above example – if material and quantity are same then distance to be transported will determine the cost. Thus, in this case distance becomes the Cost Driver. Take another example of a simple activity like digging a hole in ground at two places. For same size of hole at both the places, the effort, and therefore cost, would be different depending upon nature of soil. A rocky ground might take four times more effort and money to dig the hole.
Thus, soil nature is the Cost Driver here. Therefore, “Cost Driver” means - what is so different between two instances of execution of seemingly same activity which causes variability in costs.

**All activity drivers have been divided into four broad groups:**

1. Transaction/Resources – Same activity requiring different resources at different instances.
2. Duration – Duration of activity may vary at different times
3. Intensity – A mechanical press requiring different pressures (and energy) to compress the aluminium and iron pieces into same shape.
4. Complexity – The three drivers above assumed that there was only one variable element determining variability of cost. But there could be more than one variable working simultaneously to affect cost of the activity.

**Hierarchy of activities –**

1. Unit
2. Batch
3. Product
4. Facility

Let us take example of a soap factory manufacturing 4 different brands of soaps for explaining this hierarchical level. In a soap factory, by unit we mean - single unit of soap bar. Batch indicates all the soaps of a particular brand produced today. Product signifies particular brand of soap, and then facility level means whole factory.

ABC attempts to go down to the unit level but this may not be necessary every time or even possible. In case of wrapper and raw material, it is worthwhile to go to unit level. But when QC test is done, it is done for the whole batch. Advertisement costs are for the product and security is for whole factory. Any further subdivision of these costs may not be feasible or even worthwhile. Similarly Brand Building costs and Corporate costs are Product and Facility costs respectively.
Cost Drivers Contd…..

The cost drivers can be classified into three categories

1. Primary Cost Drivers – The ones which can be related to unit directly

2. Secondary Cost Drivers – Those drivers which are indirectly and approximately related to unit.

3. Tertiary (Not mentioned in books) – These are remotely connected to the activity.

Measurement of machine hours per unit production is relatively easy. Thus Machine Hrs for every unit of production is primary cost driver.

However, calculating electricity consumed in each unit of production by measuring from the power meter (which may be a combined one for many machines) is a difficult and cumbersome process. But same can be calculated indirectly by finding power of machine and machine hrs required for each unit. This machine hr is a secondary cost driver for power consumption in this case.

Who is to be allocated the cost?

This is a million dollar question and has no simple answer. Correct answer is entirely situation based. Thus, unless complete facts of the case are not known, apportioning/allocation of cost to any particular cost centre would be improper.

Take the case of prolonged down time of a production facility for maintenance/repairs. Who is to be apportioned the cost of this down time?

In this case, even before attempting to answer the question, it is necessary that some additional information about downtime be obtained from the concerned people. Like,

(a) Is it a planned maintenance? Or is it a break down maintenance.

(b) If it was a breakdown, what were the reasons for breakdown? Was it because of over flogging of machine to meet a particularly severe deadline?

(c) Or, did it happen due to arson?

(d) Or, was negligence of machine operator the cause of failure?

(e) Or, did it happen due to some accident?
(f) Or, did it just happened without any apparent cause?

(g) Did the repairs/maintenance complete in scheduled time or took more time.

In each of the above cases, the cost centre which is to be allocated the cost of this down time is different. If it was a planned maintenance, down time costs are already built into the cost of machine hr. Thus, no further apportioning is required. But if maintenance is taking more than planned time, this extra time would be apportioned to maintenance department.

Over-flogging of machine to meet the company’s commitment would be apportioned to Corporate.

Thus, we see above that there is no thumb rule to quote as to who should be apportioned a particular overhead. Each case is different and the real responsibility center which had caused the cost, is to be carefully identified depending on facts of the case. Adequate knowledge of case is thus very important.

ABC method is cost intensive method. Method consumes lot of effort and money in collecting relevant data. Therefore, prior to opting for ABC method, it is necessary that Cost Benefit Analysis be carried out. Measurement of cost to be incurred in “cost measurement” is an important criteria in choosing to apply this concept. Careful analysis of end use of cost measured is also necessary. In case the cost is relatively small compared to the total cost of product, investing too much resources in the process is not justified.

This method should ideally be applied to large overhead cost centres. Multi-product situations are other ideal application areas for ABC and offer great opportunity for deriving benefits.

But such knit picking of costs is beneficial only in intensely competitive and cost sensitive market situations where margins are thin. In a monopolistic sellers’ market with demand supply gap, ABC concept has little relevance.
Balanced Scorecard

What is the problem with traditional methods of business analysis? Why do we need another method now?

- **Past Focussed. No Hint of Future** - Traditionally, tools used for business analysis are Balance Sheet and Profit and Loss Statement. These statements are like a post mortem report. You can only draw some lessons from it. It only tells you what happened, There is just no clue as to why it happened, what could have happened or what could happen later. Nor do they carry any hint of business strategy.

Take the case of Kellogs cereals launch in India or Coke and Pepsi binge in USSR, or even the Telecom and TV companies. All these companies have recorded huge losses in initial years of operations because they deliberately underpriced their products in respective territories to achieve market penetration/share. TV companies offered free to air services in the beginning but later most of them went “Pay Channel” way to rake in obscene profits. But the initial years’ balance sheet showed only losses and carried no hint of such profits in years to come.

- **Lagging Indicators of Business** - In financial jargon, they are lagging indicators of the business (presence of police in front of a house is a lagging indicator which tells us that some untoward incident has happened in the house). But what a business manager requires is a leading indicator. (leading indicator are those which change before occurrence of an event and act as warning signals. Presence of police bandobast on road is a leading indicator warning us about traffic congestion on that road. Liberal allocation to Highways project is a leading indicator for cement and steel companies growth).

Summing up - These financial statements record only what has happened. But there is no knowing as to what more could have been achieved or what can happen in future. Even as a historical recording, they have only a limited use, because there is no hint of lost opportunity. There is no warning of what dangers are lurking ahead or what opportunities might unfold in future. They also fail to reflect the strategies.

- **No Early Warnings** - Balanced Scorecard is like an early warning system. It provides us with tools which, if correctly applied, will forecast opportunities and dangers in business.

- **Do not Measure Non Financial Parameters of Business** – Financial performance can be successfully dressed up by smart people in the short and medium term. To show better profit in current year, long term investments, like Marketing, R&D, Capital, Technology, Training, etc can always be scaled back without being evident in tradition way of business analysis. But these short term profitability window-dressing measures will have serious long term consequences.
This approach to strategic management was developed in the early 1990's by Drs. Robert Kaplan (Harvard Business School) and David Norton.

This approach works on the premise that – “What you measure is what you get”. To cite an example, a company with accurate time keeping system will have a better record of timely attendance of employees than the company without it. Thus, the balanced scorecard approach provides a clear prescription as to what companies should measure in order to achieve its goals.

It is to be re-emphasised that the balanced scorecard is a future oriented management system (not a measurement system). Even though it seemingly works through measurements, real thrust is not on measurement but strategy. Measurements are just the prodders to push people towards concentrating their energies for performance in key areas. It helps organizations to first formulate their vision and strategy and then to translate them into action. It provides feedback around both the internal business processes and external outcomes in order to continuously improve strategic performance and results.

Kaplan and Norton describe the innovation of the balanced scorecard as follows:

"The balanced scorecard retains traditional financial measures. But financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology, and innovation."

The balanced scorecard suggests that we view the organization from four perspectives, and to develop metrics, collect data and analyze it relative to each of these perspectives:
1. The Financial Perspective
2. The Customer Perspective
3. The Business Process Perspective
4. The Learning and Growth Perspective

However, these four perspectives are not sacrosanct. Depending on the need, more perspectives may be added.

1. **Financial Perspective** - Measures which reflect financial performance, for example, number of debtors, cash flow or return on investment. Financial performance of an organization is fundamental to its success. Even non-profit organizations must make the books balance. Financial figures suffer from two major drawbacks:

   (a) They are historical. Whilst they tell us what has happened to the organization they may not tell us what is currently happening, or be a good indicator of future performance.

   (b) It is common for the current market value of an organization to exceed the market value of its assets. Tobin's-q measures the ratio of the value of a company's assets to its market value. The excess value can be thought of as...
intangible assets. These figures are not measured by normal financial reporting.

Financial perspective becomes useful when our figures are benchmarked against competitors’ and segment/industry leader’s figures. Such comparison throws questions like, why is our credit period higher than our competitors. It gives us a clue as to what we are not doing as on date and what can be done in future.

2. **Customer Perspective** - Measures having a direct impact on customers, for example time taken to process a phone call, results of customer surveys, number of complaints or competitive rankings. There is an increasing realization of the importance of customer focus and customer satisfaction in every business. These are leading indicators: if customers are not satisfied, they will eventually find other suppliers who will meet their needs. Poor performance from this perspective is thus a leading indicator of future decline, even though the current financial picture may look good.

In developing metrics for satisfaction, customers should be analyzed in terms of kinds of customers. If percentage of repeat orders or business from existing customer is declining, it is a sign of dissatisfaction among the customers and a warning of business moving downhill in near future.

3. **Business Process Perspective** - Measures which reflect the performance of key business processes, for example the time spent prospecting (searching, analysing), number of units that required rework or process cost. In simple terms, it is analysis of the core business performance like quality of product, cost, availability, etc.

4. **Learning and Growth Perspective** - Measures describing the companies’ learning curve, for example number of employee suggestions or total hours spent on staff training, in-house process improvements, etc.

The specific measures within each of the perspectives will be chosen to reflect the drivers of the particular business. Ideally, there should be about 3 goals/measures in each of the perspectives for a single year. Even when there are 10 goals, only 3 should be chosen in a year. Often there is a spill over effect of improvement in those three areas on to other desired areas. For example, we might find that the internal business objective of improving in-house communication through installation of a new telephone system can help the customer objective of reducing response time to telephone calls, leading to increased sales from repeat business.

These goals should be benchmarked with leaders in the industry.

In many senses, the objectives chosen are leading indicators of future performance. Effort we make today is reflected in the future profits of the company. In this way, current expenditure can be viewed as investment in the future of the company.
Purpose of Balanced Scorecard

(a) Clarify and update strategy
(b) Identify and align strategic initiatives
(c) Link strategic objectives to long term targets and annual budgets
(d) Communicate strategy throughout the company
(e) Align unit and individual goals with strategy
(f) Conduct periodic performance reviews to learn about and improve strategy

Advantages

1. Focus from generalities to specifics
2. Focus on few critical parameters
3. It shifts focus from finance and accounts to entire operations
4. It guards against sub-optimisation
5. Looks at complete picture rather than parts of it in isolation.
6. It is not control oriented but goal oriented.
7. It assumes that what you measure is what you get.
8. It promotes cross functional management
9. It establishes partnership models
10. It is team oriented and not individual oriented
11. It helps understand interdependencies and intra-relations

Implementation Steps

1. Draw commitment of the top management
2. Draw a clear vision and strategy
3. Define business objectives
4. Identify performance measures
5. Test the hypothesis
6. Fine tune the model
7. Create a feedback loop up to Board level
8. Institute a reliable performance measurement and reward mechanism (Very Very important)
Entrepreneurial Approach to Cost Management

How do you define Entrepreneur?

The term entrepreneur applies to someone who establishes a new business entity to offer a new or existing product or service into a new or existing market, and are willing to accept a high level of personal, professional or financial risk to pursue the perceived opportunity. Establishing a new business entity involves arranging finances and taking certain risks.

Entrepreneurial approach to cost management works through minimising cost of intermediation. Between the entrepreneur and the customer are various other factors of production and each has a cost, whether it is capital invested, or the human capital, or raw material, or infrastructure for production and marketing. This intermediation is the entire set up between the entrepreneur and the customer.

Entrepreneurial Approach to costing involves following:

1. Core Competencies
2. Strategic Advantages
3. Long Term perspective of cost management

Cost Management is a function of following three functions:

(a) Competitive Environment
(b) Maturing of Product
(c) Length of the product cycle

Competitive Environment – In a competitive environment, cost management assumes very high significance. High competition level leads to shrinking of operating margins and
therefore, the profit is dependent on cost management. Conversely, in a monopolistic situation, cost management loses its relevance.

**Maturing of Product** – As the product matures, avenues for cost cutting also disappear. All possibilities of cost cutting would have already been explored over the period and therefore finding a new dimension for effecting any significant cutting becomes a challenge.

**Length of Product Cycle** – A product with a fairly long life give ample opportunities to invest in R&D and find methods for cost cutting. But products where life cycle is short, like electronic products where often life is not more than a year or two, much investment in cost management may not yield desired returns.

**Micro Profit Centre Approach** – As per this approach, entire operations of business are broken down into micro profit centres. It, as the name suggests, is about bringing down the profit and loss calculation to lowest level possible. These small centres of activities could be even providing internal support services and therefore may not have any direct link with company’s profits. Yet, this concept believes in finding the means to measure their contribution to the organisation’s profit margin at shortest possible units of time internal (if possible on per person and per day basis). Remember the adage – **“What you measure is what you get”**. So, as per this concept, each employee is converted into a micro profit centre. Once profitability is directly attributed to individual, it leads to rewards and empowerment.

This approach has following advantages:

(a) Takes away bureaucracy  
(b) Harnesses entrepreneurial spirit  
(c) Leads to equitable profit sharing and reward system

Micro Profit Centre Approach can be divided into two streams:

(a) **Real Micro Profit Centre** – Where it is practically possible to link and measure the employee’s contribution to company’s profitability  

(b) **Pseudo Micro Profit Centres** – In most cases, it may not be possible to link and measure the contribution to company’s profitability. What with the units which are providing services and even intermediate production process, like packaging. When these jobs are converted into profit centres, it is called pseudo micro profit centres.

Let us examine the case of HR Deptt in any company. It is a pure service department. How do we convert it into a profit centre and measure its productivity and profitability.

If we recall the functions of Personnel Deptt, it is planning, recruiting, selection/hiring, induction, training& development, appraisal, etc of employees. Today, most of these
functions can be outsourced. Fix the benchmark of performance with the cost of outsourcing vis a vis cost to the company for maintaining the department internally. Like, most recruitment companies charge one month’s salary for hiring an employee. This cost and the training costs are amortised over a period of five years. In case an employee quits midway through, balance costs are apportioned equally to HR Department and production department. *(He may have quit the company because of a bad boss. So, how can you blame his exit on poor selection alone?)* Similarly, other functions of the department can be linked to the cost of outsourcing those functions.

This concept also believes in giving maximum freedom to production managers to source the services they want from anywhere and not shackling them with in-house facilities. Once, each service has been priced and going to factor into his costs, he will only select the most cost efficient one, whether internal or outsourced. That will spur the service departments to maintain high standards of quality. Similarly, various departments should be allowed to sell their excess capacities in market. Personnel Departments of large companies can act as selection centres for smaller companies, either parallelly with their own selection process or even independently. We have seen this happening in past two decades or so in India. If you recall, you can obtain admission in some of the engineering colleges based on your score in IITJEE. Similarly, after some large companies finish their selection process, many candidates get call letters from companies they had never applied to.

*(Today, the two most prominent business risks that companies are encountering are terror and manpower attrition. Terror acts lead to direct and indirect business losses. It could lead to damage of offices and facilities. Or it could lead to loss of market or disruption in supplies)*.

**Empowered Organisations** – As per definition proposed by Institute of TQM, an organisation is empowered if an employee does not have to seek third person’s (read supervisor/boss) intervention for 90% of the routine tasks.

Empowering leads to unleashing of creative energies in the individuals who would find ways to do the things better, faster and cheaper.

**Benefits of Entrepreneurial Approach to Cost Management**

(a) Profit as a performance metric carries positive effect on performance of the enterprise.

(b) It provides management with a mechanism to reward publicly. *(The biggest drawback of any reward policy is that while it motivates the beneficiaries, it de-motivates many others because they wrongly, and some times even rightly, smell favouritism in award of rewards)*.

(c) It helps in reinforcing/changing behaviour that leads to increase in profits.

(d) Profit as universal metric – Each work group/individual can assess own performance relative to others.

(e) Creation of profit centres could revitalise the firm’s cost management system.
(f) Small firms or P&L centres are inherently more effective and efficient than large firms or large P&L centres
   (i) Small firms or P&L centres do not have expensive & ineffective bureaucracy.
   (ii) They can react quickly to change in market conditions.

(g) It helps in continuous cost reduction efforts.

Reasons –

(a) This approach makes you think innovatively about BPR and value analysis.

(b) Product innovation and development carried out for customers’ benefit are appreciated by them.

(c) Cost reduction efforts keep employees on guard against inefficiencies and complacencies.

The above makes you to think differently and strategically.

(Nike is not a manufacture of shoes. It does not own any captive shoe manufacturing units. It out-sources its production to independent manufacturers. Designing and material choices are joint efforts of those manufacturers and the Nike. When Nike identifies some new material or design, it allows those manufacturers to use them to bolster their fortunes (of course, under some safeguards) and they reciprocate by sharing with Nike their knowledge of new innovations in the field).

![Competition is out. New mantra is Competition](image)

Apple Mackintosh were the leaders in Software and Hardware for over 20 years before Microsoft entered the market. Initially, Microsoft was decidedly inferior in product quality for many years after the launch. Yet the company got the foothold in the market and left the original leader miles behind. Why did an established brand with superior product lose out to a new entrant with inferior product?

Apple Computers had developed the operating software which was sold only with their own machines. They refused to share their source code with any one or allow any one else to build applications based on their OS. They wanted to control the entire market, upstream and downstream, forward integration and backward integration.

When Microsoft entered the field, it adopted an entirely different business model. It went for a Collaborative Model of Business. It offered to computer manufactures its OS as free supply (for limited period validity on computers) to be bundled with new computers. It not
only offered it but even actively persuaded them. Once habituated to Microsoft OS, few customer has will and energy to invest time in learning a new OS, even if it was some what better. And how many even new that Apple software is better than Microsoft. Most go by the Hardware OEM recommendation or dealers recommendation who were assiduously wooed by Microsoft to promote its product. Company allowed and promoted extensive Microsoft OS based applications (utility softwares) development. Over a time, it created a large base of stakeholders in the growth of Microsoft.

American Express Credit Cards in another firm which went Apple Computers way and eventually lost out to Visa and Master Cards. They ruled the market for 20 years with the exclusivity of their cards before Visa and Master cards went collaborative way with banks and replaced American Express at the Numero Uno position. In the process, they turned that life style product called credit card into a commodity.

**Strategic Concept**

Build     -    Hold     -    Harvest

Business is cyclic in nature. There is a boom in demand followed by a slack and then again boom. This concept is about predicting the boom time, investing in a project to be ready just at short of predicted boom time, holding on to it till arrival of boom time and then harvesting the profits. Correct prediction of boom time is important because “Holding” carries a cost. Profits also tend to decline after a while as the competition and more capacities build.

![Profit Time Curve](image)

If a product is technology intensive, it is necessary to invest in new technology.

Bombay Dyeing was the leader in supply of Polyester raw material, Di-Methyl Terephthalate (DMT), till about 1996. However, it lost much of its business when Reliance
entered the market with a cheaper substitute called Purified Terephthalic Acid (PTA). Today, over 90% of the polyester is manufactured using PTA.

**Scale** – If a product has large overheads, then large base will help. So, increase the capacity.

**Marketing** – Better and newer means to woo customers are continuously required. Gillette won the market by selling razors at low price and then selling expensive blades to them. (By the way, this a most often used strategy in product segment which generates future sale of dependent products. Take the instance of cars. Cars are often under-priced and then spares are priced at Rip-off level to rake in profits. For instance – If a Maruti Baleno is assembled by buying individual spare parts, it will cost...; guess how much? Well a Rolls Royce. Yes, it will cost in the range of Rs 1.4 Crores. Hard to believe, yet true. Even our little Santro will be close to Rs 50 lacs). Off course, Gillette has been coming up with new blade series too every now and then.

Govt policies – We as business administrators have to keep more than an eye on Govt Policies too. Govt policies on a particular product can alter the cost and therefore profitability of a product drastically, more than any other factor of production. Tax policies, Import/Export Policies, Regulatory policies, Monitory policies, Intervention through Administered Price Mechanism in some cases or even controlling market supply through PSUs are some of the tools through which Govt policies can affect the cost and profit of a product.

**Energy Charges** – In many products, like metals, energy is the prime source of cost. In case of Aluminium and Iron manufacturing, plants are invariably located in the ore belt and mines are on long lease for a pittance. Therefore, ore costs are miniscule. But ore melting process is energy intensive and thus, energy contributes to as much as 70% of the total cost of metals. Tisco emerged as the lowest cost producer of steel in the world since it could keep its energy cost low. Similarly, Hindalco focuses only on one area of cost control, ie Energy. It conducts regular energy audits.

---

**But don’t just concentrate on decreasing costs, increase the revenues/profits.**

The basic mantra of management is – Always choose to bet on growth than cost control. There is always a limit to downside. Literally nothing can reduce below zero, (Working Capital can be brought down to even below Zero called Negative Working Capital). But upside is unlimited in most cases. (A Rs 100 share can at the most become a 10 paise share or be delisted from stock exchange, thus capping the maximum loss to Rs 100. However, same share can grow to Rs 10,000 or Rs 1,00,000, like Infosys share has done. So, upside is virtually limitless). Notwithstanding fact that some times cost control itself is the road to growth, concentrate more on growth than controlling costs. There are often better options for growth than just the cost control. Essence of the matter is that cost control should be opted only strategically and not blindly.

That leads us to the topic of Strategic Positioning.
**Strategic Positioning**

Where do you want to position your product?

There are two options before a business. It can choose either to be a

(a) Cost Leader, or use

(b) Differentiation

But whatever be your choice, it should be a well calculated and deliberate choice. Don’t allow the market forces to dictate where you want to be.
Target Costing

Target costing is one where the production cost of the product is decided first and then all the elements of production and costs like, design, production processes, raw materials, etc, are selected to achieve the specified cost. Tata’s dream project, Rs 1,00,000 car, is the most visible and transparent example of Target costing.

Why this sudden emphasis on Target Costing?

Product life cycles are getting shorter and shorter, quite often one or two years, sometimes even less than one year in high-tech industries. With a one-year product life, there is very little scope for achieving any cost control. In any case, once the product is developed and designed and all specifications and processes in place, there is a limit to how much cost cutting companies can do in the manufacturing stage. There is a cost for cost control itself. Therefore, cost management should start up-front at the initial stage to be effective.

This is true even for a product with larger life cycle. As a totally new product and its industry develops, initial sales are based on its novelty, technological superiority, concept, and/or service, with high profit margins. Soon competitors emerge and most of the above USPs are lost. Sale Prices have to be scaled back to remain competitive. To maintain profit margin, companies begin focusing on cost reduction. However, the cost structure for existing facility is largely locked-in in the product design and production process and therefore cost reduction efforts have limited impact. New companies enter with better cost structure and push the leader out of business. Thus, to ensure that a product has longer life cycle, it is essential that costs be rationalized during product development phase itself. This is where Target Costing comes into picture.

Target costing works on fundamentally different approach than traditional costing approach. It is based on three premises:

(a) Orienting products to customer affordability or market-driven pricing rather than designing the product and then finding the capable customers.

(b) Treating product cost as an independent variable during the definition of a product's requirements, and

(c) Proactively working to achieve target cost during product and process development.

How do you calculate the Target cost?

Target cost is often found by backward calculation.

Target Profits (TP) = Target Selling Price (TSP) – Target Costs (TC)

TC = TSP – TP
Now, in the above equation, TSP and TP are both uncontrollable variables. TSP is determined by the market. Irrespective of the quality, larger part of the market will accept certain products only for a certain max price. So, TSP will be dictated by market forces. Similarly, investors expect certain minimum return on their capital. So, the minimum profit (TP) is dictated by the investors. That leaves TC as the only variable that a business manager can control.

### Target Cost Calculation Worksheet

<table>
<thead>
<tr>
<th>Sign</th>
<th>Price/Cost Element</th>
<th>Estimate</th>
<th>% Factor</th>
<th>Per Unit Factor</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>-</td>
<td>Manufacturer's Suggested Retail Price</td>
<td></td>
<td></td>
<td></td>
<td>495.00</td>
</tr>
<tr>
<td>=</td>
<td>Standard Dealer Margin</td>
<td></td>
<td>30%</td>
<td></td>
<td>(148.50)</td>
</tr>
<tr>
<td>=</td>
<td>Cost to Retailer</td>
<td></td>
<td></td>
<td></td>
<td>346.50</td>
</tr>
<tr>
<td>-</td>
<td>Shipping/Distribution Cost to Retailer</td>
<td></td>
<td>0%</td>
<td>15.00</td>
<td>(15.00)</td>
</tr>
<tr>
<td>=</td>
<td>Selling Price to Retailer</td>
<td></td>
<td></td>
<td></td>
<td>331.50</td>
</tr>
<tr>
<td>-</td>
<td>Distribution Cost/Mark-up</td>
<td></td>
<td>15%</td>
<td></td>
<td>(49.73)</td>
</tr>
<tr>
<td>-</td>
<td>Shipping/Logistics Cost to Distribution Center</td>
<td></td>
<td>0%</td>
<td>17.00</td>
<td>(17.00)</td>
</tr>
<tr>
<td>=</td>
<td>Manufacturer's Selling Price</td>
<td></td>
<td></td>
<td></td>
<td>264.78</td>
</tr>
<tr>
<td>-</td>
<td>Profit Margin</td>
<td></td>
<td>8%</td>
<td></td>
<td>(21.18)</td>
</tr>
<tr>
<td>-</td>
<td>Warranty Cost</td>
<td></td>
<td>2%</td>
<td></td>
<td>(5.30)</td>
</tr>
<tr>
<td>-</td>
<td>Corporate Allocations</td>
<td></td>
<td>10%</td>
<td></td>
<td>(26.48)</td>
</tr>
<tr>
<td>-</td>
<td>Business Unit Selling, General &amp; Administrative</td>
<td></td>
<td>12%</td>
<td></td>
<td>(31.77)</td>
</tr>
<tr>
<td>-</td>
<td>Non-Recurring Development Cost</td>
<td>1200000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-</td>
<td>Estimated Production Volume</td>
<td>200000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>=</td>
<td>Allocated Non-Recurring Development Cost</td>
<td></td>
<td></td>
<td>6.00</td>
<td>(6.00)</td>
</tr>
<tr>
<td>=</td>
<td>Business Unit Target Cost</td>
<td></td>
<td></td>
<td></td>
<td>174.05</td>
</tr>
<tr>
<td>-</td>
<td>Overhead</td>
<td></td>
<td>45%</td>
<td></td>
<td>(78.32)</td>
</tr>
<tr>
<td>=</td>
<td>Direct Target Cost (Labor &amp; Material)</td>
<td></td>
<td></td>
<td></td>
<td>95.73</td>
</tr>
</tbody>
</table>
Value Chain Analysis

Three Key Themes:

1. Value Chain Analysis
2. Strategic positioning analysis
3. Cost Driver Analysis

Scale, scope, experience, technology, complexity, etc have all bearing on all the above.

In order to survive and succeed in the market, a product has to lead its competitor in either of the two fronts:

(a) Product Differentiation
(b) Price.

Superior
Relative
Differentiation Positions

(<1) Differentiation Advantage
(2) Differentiation Advantage Cost Advantage
(3) Low Cost Advantage
(4) ???

Inferior
(High Cost)
Relative Costs
Superior
(Low Cost)

In the above strategic positioning model, if your company enjoys brand value/enjoys differentiation advantage over its competitors or it enjoys cost advantage over its competitors, it will succeed in the market. However, a constant look out would be necessary to ensure that some one else does not overtake you in your USP. But every one wants to be in quadrant (2). A company in this quadrant has little to worry.

Managing Costs Effectively

Broad Focus
External to Firm

Linked set of value creating activities from basic raw materials to end use customers –

Definition of Value Chain by Porter
If we make an arbitrary model of value chain of any B School like JBIMS, we see that it derives its value from above 5 sources. An approximate importance that people place on five value factors is indicated below each. Now when you rate various B schools on each of the above counts, it will tell you as to where does JBIMS stand relative to other business schools. It could be leading most in Teachers/students/Alumni factors while lagging far behind in infrastructure and research. Infrastructure and research are its weaknesses. So, if this institute has to move up the ladder among the B schools in the country, it will have to strengthen its infrastructure and research work.

The benefit of value chain analysis is that it gives you the benchmarks against which you can judge your performance which purely internal assessment does not tell you. It tells you which areas are your strength and which are weaknesses. It tells you which segment of the business are you making good profits and which are laggards. It will be identify for you the value creators and value destroyers.

Value creators are the activities where net operating margins are in plus and value destroyers are the activities which have negative contribution to the company’s profitability (loss making in simple terms). Take the example of a company having a factory and a captive mine. It could be that the company is making good profits on mining operations but incurring losses in factory. Thus, if the company sells the factory and continues with just the mine, it would be more profitable. Thus, here while mine is value creator, factory is value destroyer. Unless there are strategic or regulatory considerations, it would be profitable for the company to sell the plant. But such value destroyers would not be visible unless value chain analysis of entire business is carried out. Thus, value chain is all about breaking business into small segments and then analysing and comparing each of those with other segments of own business as well as similar segments of competitors’ business.

Any value chain analysis requires constructing three value chains:

(a) One for own company
(b) One for the Industry
(c) One for the best and most efficient company.

Comparison of segmental performance with best in the industry tells us the upper limit of performance. It saves us from pegging our expectations/targets too high. Own value chain tells us the performance of various segments.

Now let us examine the value chain of paper industry:
A paper industry involves above six independent stages of production. It is not necessary for any player to be in two or more of the above businesses. In fact, very few companies in paper business own all the six segments of above value chain. Now, suppose during the value chain analysis it is found that our own logging operations are costing more than what company would pay to buy from the local market. Further investigations reveal that the cost is high due to long distance between our forest and pulp plant. The company will have two choices; Reconfigure or sell. Either move the plant near the forest to reduce the transportation cost. *(Transportation cost is big cost centre. To save the cost, tree trunks are often thrown in the river and then collected somewhere down stream near the plant)* or sell the forest and buy your requirement from local market.

Value Chain Analysis gives a mechanism to know where value can be increased or cost can be reduced.

Value chain framework is a method for breaking down business into strategically relevant activities in order to understand the behaviour of cost and sources of differentiation.

Once the business is broken down into strategic activities, each activity is analysed for Revenue, costs, assets, employees, etc and then compared with same activities of competitors’ business. That reveals our strengths and weaknesses.

While segregating business into relevant strategic activities, either segregate them into big cost pools or on the basis of cost behaviour. Find where the competition is treating/dealing the cost differently and the source of differentiation.

Technology has begun to invade the business more and more with time. Situation is grim in technology intensive business. A disruptive technology can invade your business any time. Completely new products and processes reduce the cost and convenience by over half overnight and make an established business unviable. Take the case of Polaroid camera. Advent of digital photography and table top colour printers made the process of instant photography much faster, cheaper and easier. A 100 year old company sank without a trace. Computers have thrown the typewriter companies out of business. Photocopy machines have similarly ousted cyclostyling machine companies out of business. The list of new products replacing old products is rather long.

As a finance manager, it is necessary to watch out for the technological developments and changes in the market place rather than just burying your head in the balance sheet numbers. Financial advice sans market intelligence would be disastrous.
In case of metals, energy consumption is the major cost. In case of aluminum, it could be as much as 70% of the total cost. Therefore, it is important that energy consumption as well as per unit cost, both be kept as low as possible. Hindalco has been so successful because it has own captive hydro power generation source thus keeping the energy cost very low.