STRATEGIC COST MANAGEMENT: A CONCEPTUAL FRAMEWORK

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ABSTRACT

Strategic cost management is a framework for incorporating cost information in to decision made in support of an organization's strategic plan. SCM has a long run orientation, focusing on structural cost drivers or organizational cost drivers. SCM integrate strategy and cost system in a meaningful way. Mainly in traditional cost management failed due to using board cost cutting; fail to recognize the difference in customers; information may be misleading for strategic plan, etc. SCM is required to be implemented due to channel proliferation, now customers have sufficient knowledge regarding market, pressure from financial market and emergence of product category killers. The value chain and activity based costing are main tools and techniques of SCM. Under value chain system costs are identified and analyzed for value producing activities and non-value producing activities are eliminated for cost reduction. Under activity based costing activity cost drivers are identified for assigning cost of activities to cost objectives and unnecessary activities are eliminated to reduce the cost of production /service. SCM can be applied for product costing, make or buy decisions, marketing channel decisions, product design decision and activity analysis. But for successful application of SCM proper methodology should be used, like where you need to be, deploy cost and resources to maximize customer's value and move with a bias of action, etc. The article is followed by a case study of ABC Limited (A Hypothetical bank) in which decision of closing the bank branch is changed due to using SCM instead of traditional cost accounting method. This is because under SCM an analysis of different segment of Bank's customer's and value has been followed.

Key Words: Cost, Management, Product, Service, Strategic.

INTRODUCTION

In competitive environments, managers should make a fundamental decision concerning their organization's goal for positioning itself in comparison to competitors. This goal is referred to as the organization's strategic position. Much of the organization's strategy depends on this strategic positioning goal. Michael Porter, a highly regarded authority on business strategy, has identified three possible strategic positions that lead to business success.

1. Cost Leadership
2. Product or service differentiation
3. Market niche.

According to Porter, firms that don't set one of these competitive strategies as a goal or that try to be all things to all people are doomed to be " struck in the middle ". Unable to effectively compete on the basis of price or differentiation in the market as a whole or in a particular market niche, firms struck in the middle are doomed to low profitability.

Deciding to achieve a market position of cost leadership might be part of an organization's strategic plan. In this case management is less concerned with designing innovative new products or services than with the process changes needed for cost reductions, with an alternative strategy of product differentiation, management must balance the concern for low cost against the need to develop and introduce distinctive products on a timely basis.

Whatever an organization’s strategic plan, management needs cost information and an appropriate cost-evaluation framework to achieve its goals. This has developed a new term called as “Strategic Cost Management”.

Strategic Cost Management is a framework for incorporating cost information into decision made in support of an organization’s strategic plan. SCM can be defined as making decisions concerning specific cost drivers within the context of an organization’s business strategy, its internal value chain, and its place in a longer value chain stretching from the development and use of resources to the final consumer. Strategic Cost Management has a long run orientation, focusing on structured cost drivers (such as the location & size of a bank) or an organizational cost driver (such as designing processes for billing credit for billing credit card customers.)

TRADITIONAL COST MANAGEMENT

Managers who recognize that their current business model is outmoded & are intent of change are frequently frustrated with traditional cost management approaches. The factors, which lead to failure of Traditional Cost Management are:.

1. **Across the Board Cuts Seldom Work:** Board cost reduction programmes, accompanied by sweeping goals such as ‘reduce cost by 20% are seldom successful. This is so because such a programmes generally followed by reduction, they fail to recognize in work force for cost reduction & difference in customer value & behavior. It may be that a small percentage of customers say 5 to 15 % account for majority of customer value or profitability for a company. But traditional cost management fail to recognize a company’s most valuable customers, moderate valuable customers & low valuable customer& therefore due to board cost reduction programmes, services towards all the customers affected in the same way. And resulted in decreases in profitability as those highly revaluable customers leave the company for other suppliers those proved themselves more willing to cater to their specific needs.
2. **Customers are Very Different:** Traditional cost management frequently results in operational changes that can negatively impact the customer experience. This is so because the economics and profitability of different customer segments vary as dramatically as does customer preference for different channels and customer service requirements. Traditional cost management fails to recognize these differences will destroy value either by alienating a company’s most valuable customer or by failing to rationalize the resources devoted to marginal or unprofitable customers.
3. **Accounting Tools can be misleading:** Manager frequently rely upon tools and methodologies based on traditional accounting rules and paradigms- but these_seldom incorporate the ways in which value is actually created in the organisation. While GAAP and traditional accounting rules are useful and appropriate for financial reporting purposes, when used as a decision support tool, they can lead to decision that destroy rather than create value.

OBJECTIVES OF THE STUDY

The study has been undertaken with the aim to highlight the need of strategic Cost Management in the today's competitive era.

RESEARCH METHODOLOGY

The study is of descriptive type and hence the information required has been collected through secondary source like reference books, journals and online data base. No particular tools has been used for analysis being the research paper is of conceptual nature

STRATEGIC COST MANAGEMENT

Manager today operates in a dynamic environment that reflects the convergence of profound technological, competitive and behavioral changes. These forces of changes are compelling executives to changes the most fundamental operational and economic assumption of their business. For this purpose strategic management process is used. But again strategic management process may fail unless it is not integrated with cost management. It has developed a new approach, which is called as Strategic Cost Management. The following factors have forced the management to adopt strategic cost management.

1. **Channel Proliferation**: New channels are reshaping the competitive landscape in a multitude of business. As customer become familiar with and adopts new channels, the economics of existing business models come under tremendous pressure and becomes less relevant to competitive success. For example in Insurance industry there are two types of insurance companies, the first "direct" Insurance companies & the second those rely upon "traditional agent / brokers". The difference in commission & cost levels between these two types of insurance companies provides a striking economic advantage to lower cost direct players, which they have been able to leverage into market share gains.

2. **Consumer in the Know**: Consumer are becoming more knowledgeable both about products / service and channel offerings. As a result of this customer always try to get the best service at minimum cost and this lead to competition among product /service providers. For example in financial service industry, consumers are now less loyal. They are much more likely today to re-evaluate their existing credit cards, mortgage, insurance and investments whenever they are offered new solutions. This results in increased "switching" between providers and will create significant cost pressure for the financial services community. Financial service providers will need to spend more to retain their most valuable customers & they will have to spend more on marketing and acquisition to replace those that do defect.

3. **Pressure from Financial Markets:** Business is now under "real time" scrutiny by thousands of analysts who monitor, review and analyze myriad operating statistics for publicly traded companies on a daily & weekly basis. Financial markets award higher valuation to those companies that demonstrate grater levels of productivity and efficiency.

4. **Emergence of Product Category Killers:** The growth of companies that focus on a single product has also created a new set of economics pressures for established multi product/services companies. These "category killers" build their operating model with single – minded focus, often resulting in a lower cost position within their chosen market segment. The superior preferment's captured by many category killers demonstrate that short of

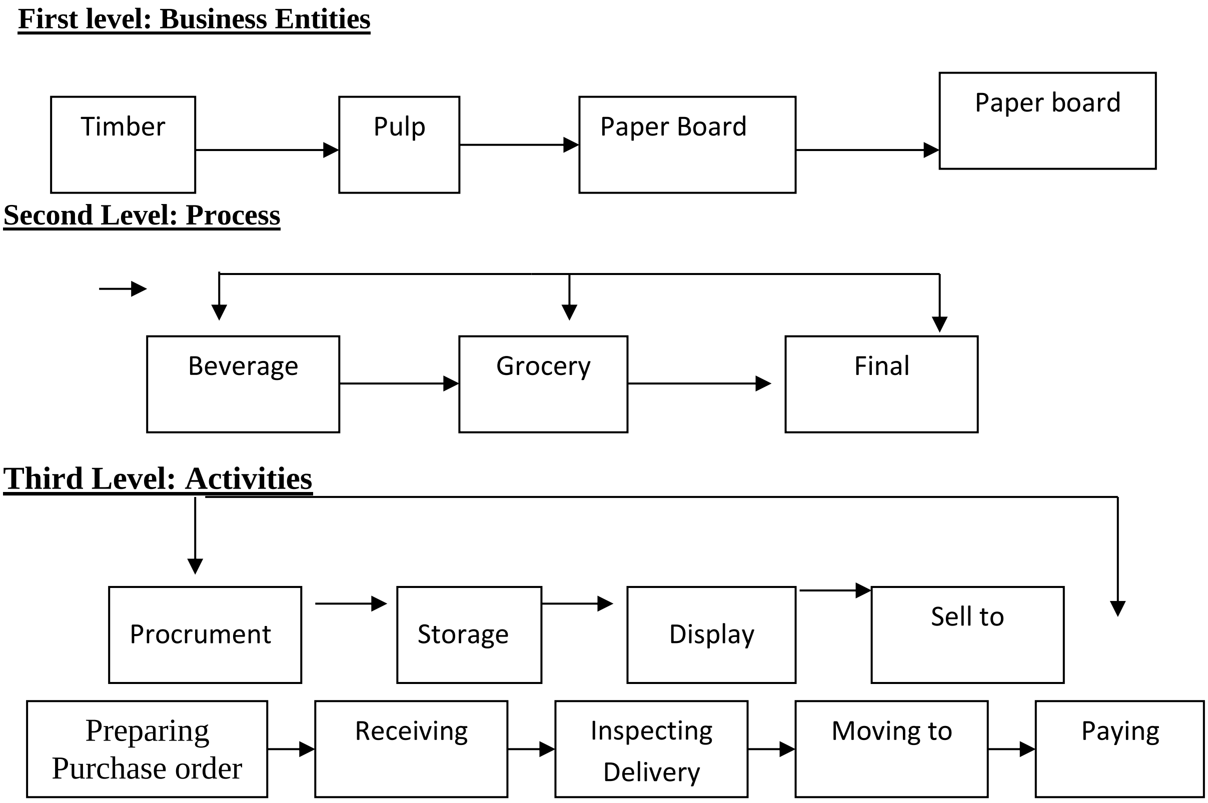
rethinking their entire business design and core competencies. Multi products /service providers and traditional products/service providers will be at an increasing disadvantage in terms of costs, profitability and market place valuation.

SCM TOOLS AND TECHNIQUES

For better application of SCM mainly the following tools & techniques are used:-

1. **The Value Chain**: The value chain for a product or service is the set of value producing activities that stretches from basic raw-materials to the final consumer. Each product or service has distinct value chain and all entities along the value chain depend on the final customer's perception of the value and cost of product or service. It is the final customer's perception of the value and cost of a product or service. It is the final customer who ultimately pays all cost and provides all profits to all organization along the entire value chain. Consequently, the goal of every organization should be to maximize the value while minimizing the cost of a product or service to final customer depending on the need of management, value chains are developed at varying levels of details. Exhibit-I: presents the value chain for the paperboard cartons used to package beverages, such as Coca-Cola, Pepsi, etc. The value chain is presented at three levels, with each successive level containing additional details.

Exhibit –1: Elements of a Value Chain for a Beverage Packaging Product



To better understand how business entities within the chain add value and incur costs, management might further refine the value chain into processes, collection of related activities intended to achieve a common purpose (as explained in Exhibit I)

The goal of maximizing final customer value while minimizing final customer costs leads organizations to examine internal and external links in the value chain rather than the departments, processes or activities independently. From a value chain perspective, it is total costs across the entire value chain, not the cost of individual business, departments, processes or activities that is most important.

Exploiting cost reduction & value enhancing opportunities in the value chain has led many buyers and suppliers to view each other as partners rather than as adversaries. Company such as Hewlett- Packard & Ford now involves suppliers in design, development and manufacturing decisions. Using value chain concepts, relationships with suppliers often begin to represent an extended family, allowing companies to focus on core competencies, this capability provides distinct competitive advantage.

Further value chain perspective focus on process, not departments because processes often cross the boundaries of departments within an organization. It is difficult to control costs by focusing on a department when processes require activities in several departments. Looking at the activities within a process, management might determine that certain activities could be combined, eliminated or replaced by lower cost alternatives. As a long-run approach to profit enhancing cost reduction, it is better to eliminate or reduce activities that drive cost than to merely cut budgets.

Developing a diagram of a value chain is a subjective art rather than an objective science. Cost drivers play an important role in this process. **Cost drivers that influence cost can be classified into three main categories:**

a) **Structural Cost Drivers:** Determining activities available to respond to customer needs like location, scale, scope, technology, etc.
b) **Organizational Cost Drivers:** Selecting activities used to respond to customer's needs like work force involvement, plant layout efficiency, total quality management etc.
c) **Activity Cost Drivers:** Performing units of work (activities) to serve customer needs.

Once the major processes performed to serve customer needs have been identified, the next step is to determine the activities involved in each process. For this purpose map or process flow chart can be prepared. Understanding a company's processes through process mapping is the launching pad for improvement and redesign of those processes. It has become more powerful concept of improving process performance with the advent of activity based costing.

2. Activity Based Costing: ABC involves determining the cost of activities and tracing their costs to cost objectives. On the basis of the cost objective's utilization of units of activity. A cost objective is any object to which costs are assigned; it is typically a product or service provided to a customer.

The most widely used approach to activity based costing involves the use of a two stage model. In the first stage costs are assigned to activities. In the second stage, costs are assigned from activities to cost objectives on the basis of the cost objectives use of activities. ABC requires the following steps:-

- Identifying activities.
- Assigning costs to activities.
- Determining the basis (activity cost Driver) for assigning the, cost of activities to cost objectives.
- Determining the cost per unit of activity.
- Reassigning costs from the activity to the cost objectives on the basis of cost objective's volume of consumption of activities.

3. Some other Tools & Techniques: - For assisting in strategic cost management, the following some techniques are also used:-

- Target costing
- Total quality management
- Bench marking
- Business process Re-engineering
- Just in time Inventory
- Implementing process management
- Redesigning the finance function

SCM: APPLICATION & METHODOLOGY

Professor Narayana Swamy has mentioned that SCM has great scope for application in Indian companies but so for attempts made are minimal. The following are the potential applications of SCM with promise of significant benefits to the organization:

1. **Product Costing:** In many companies product cost information available is deficient. It is important to capture the activities that are attributable to each product or to more product groups and determine the pricing and other policies of the company that are appropriate. In most of the cases product costs have turned out to be incorrect.
2. **Make or Buy Decisions:** Make or buy decisions should be made on strategic considerations. Even so, cost considerations are important. For example, the decisions to out source a component could result in a number of activities causing additional overhead. A sophisticated understanding of costs would enable manager to out source only parts that are not strategically significant or are easy for outsiders to manufacture.
3. **Marketing Channel Decisions:** These decisions could benefit from the SCM approach. The decision to sell to specific customers through specific channels is one possibility.
4. **Product Design:** Designers, generally do not have cost information and therefore, are likely to come up with designs that may not be cost efficient. A few companies have started forming teams consisting of designers. Manufacturing engineer, cost accountants and marketing managers as part of their new product development efforts. However most companies do not pay attention to product design with the result that product cost is high and frequent design changes are necessary.
5. **Activity Analysis:** It is important to identify activities that add cost but not value to the customers such activities are called not valued activities and must be eliminated from the business to remain competitive. Non-value added activities include inspection, internal movements & waiting for next operation. Non Value added activities result in unnecessary expense and increase manufacturing or service lead time. As a result, a business that has a large number of non-value added activities would be unable to introduce new products rapidly and in time & within acceptable cost units.

SCM: METHODOLOGY

1. **Determine Where You Need to be:** There is an old usage saying that "if you don't know where are you going, any road will get you there". Therefore it is important to define at a high level the cost targets and expected economic and operating environment a business needs to compete in if it is to be successful. These cost targets are similar in nature to those tracked by financial analysts. Moreover, the experience of other industries can be very useful in helping managers define and confront the challenges facing the business.

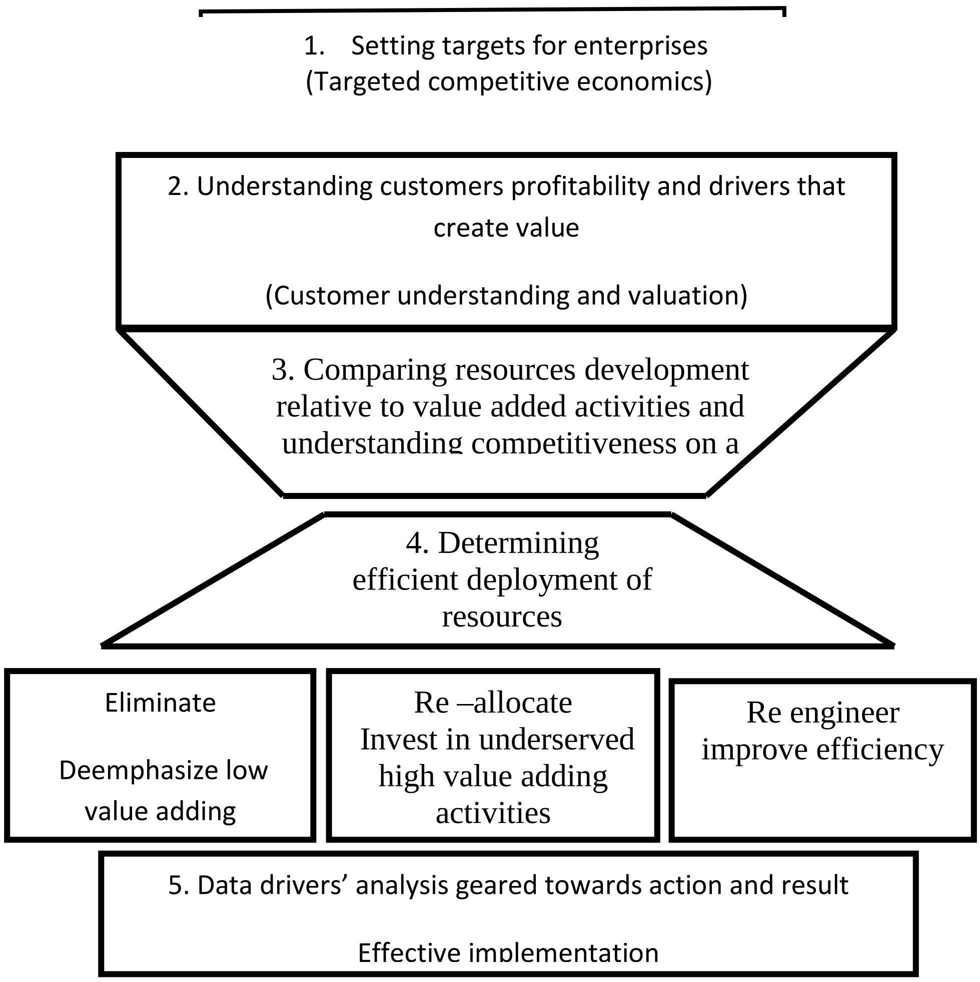
2. **Deploy Costs & Resources to Maximize Customer's Value:** The next step is to understand the company's customer base and the distribution of value or profitability with in that base. For this purpose, customer can be typically identified and classified on the basis of various segments likes profitability and product, channels and resources they use. After such a classification of customers the following significant questions can be analyzed:

   - What product and services does business most attractive customer's value and how effective and efficient is business in delivering them?
   - What percentage of business resources is devoted to customer segments of Marginal attractiveness? How can business reduce that percentage?
   - What non-strategic services should business outsource to more efficient providers!
   - What product, customer segment or channel areas should business exit entirely?

3. **Move with a Bias for Action:** Programme implementation requires concrete senior management support. Too many change projects falls into a death spiral of "analysis Paralysis" – action cannot happen until just one more piece of research taken.

The whole methodology is based upon the following principles (See Exhibit No. II)

Exhibit-2: Methodology of SCM



CASE STUDY OF ABC LIMITED (A HYPOTHETICAL BANK)

1. **Background:** The bank ABC limited engaged in the banking business. The bank has opened /established a number of branches for its banking business and particularly for retail banking.
2. **Problem:** The bank has been facing competition in the market and want to reduce its expenses ratio and at the same time to boost earnings through improved productivity and growth. The Bank focused on its retail branch network to achieve these goals. This is so because of the following two reasons: -
    - **a)** Retail network is very important, as it is the most important sales channel i.e. retail banking service channel.
    - **b)** Magnitude of the costs embedded in the branch network.
3. **Steps taken - appointed a team for analysis:** The bank appointed an internal team to analyse the performance of bank's retail distribution network and offer suggestions for improvements.
4. **Tools used by team–traditional costs management:** The appointed team measured the profitability of each & every branch on the basis of: -
    - Aggregate deposits and loan volume.

    - Average margin to balances & comparing the results to operating costs of branches.
5. **Suggestions of team:** The team identified a number of branches that could be closed due to their negative profitability.

6. **Improved solution based on strategic cost management:** This approach is based on the framework of understanding customer's value and behaviour. The following steps are to be taken under this approach: -
   - Estimate customer's lifetime value for each customer taking into account retention, cross sale rates, credit risk and balances.
   - Segmentation of customer on the basis of their value, which shows significant variations in customer value between segments.
   - Understand channel and branch usage by each segments of customer. Wherever appropriate assign a measure of customer value to each branch based on the customer who utilized that branch and their usage pattern.
   - This types of analysis will show that some of the most valuable customers relied heavily upon branches
   - Predict the impact on customer attrition of closing certain branches by considering issues such as proximity to other branches and certain geo- demographic variable viz. Crime rate, per capital income, new housing loan rate, etc. This analysis will recognize differences in customer value and behaviour it will help to depict the impact of different scenarios on the future profitability of branches.
   - This analysis will result in a significantly different perspective regarding branch closing when compared with traditional analysis as under (based on assumed figures)

Table-1: Branch Rationalization Assessment

Traditional – P & L Account (Rs. In Crores 2009-2010)	**SCM customer focused** (Rs. In Crores 2009-10)
Domiciled deposits =10	NPV of customer relationship = 9
Domiciled credit = 15	Impact of closing on customer value
Revenues = 4	(loss of revenue) = (4)
Branch transaction costs = 3	Potential cost saving (fixed and variable) = 3
Branch fixed cost = 2	Impact on value from closing =(1)
Margin =(1)	(loss which can be avoided)
Recommendation: - ***Close the Branch***	Recommendation: - ***Leave Open***

- Senior Management of the Bank will perceive two important benefits by using SCM as under: -
  - It will help them to avoid decision that resulted in losing its most valuable customer.
  - It will help them to avoid making decision upon false or un attainable increases in productivity and cross sell from closing certain branches due to un anticipated customer attrition.

Despite all the attention paid to customer relationship today, few organizations segment their customer sufficiently to identify the most valuable and profitable customer. Without this work as foundation any cost cutting initiative, no matter how well intentioned, is little more than a game of blind man's bluff to 'pin the tail' on the non-value adding parts of the business.

CONCLUSION

Strategic cost management is a framework for incorporating cost information into decision made in support of organisation strategic plans. In today's competitive environment managers of an organisation should decide to achieve a market position of cost leadership because otherwise the other strategies for success may fail. Traditional cost management failed due to using the board cut cost reduction programmes, lack of differentiation in customer and based on traditional approach. Therefore SCM needs to be implemented. Further SCM is also required to be implemented due to channel proliferation, customer have knowledge of market, pressure from financial market & emergence of product category killers. Various tools and techniques can be used for SCM but mainly the value chain & Activity Based Costing techniques are used. But before implementation of the SCM in various types of strategic decisions like, product costing, make or buy decisions, marketing channel decisions, product design, activity analysis etc, a proper methodology should be adopted otherwise the goal of SCM may not be achieved.

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