



INTRODUCTION TO STRATEGIC COST MANAGEMENT

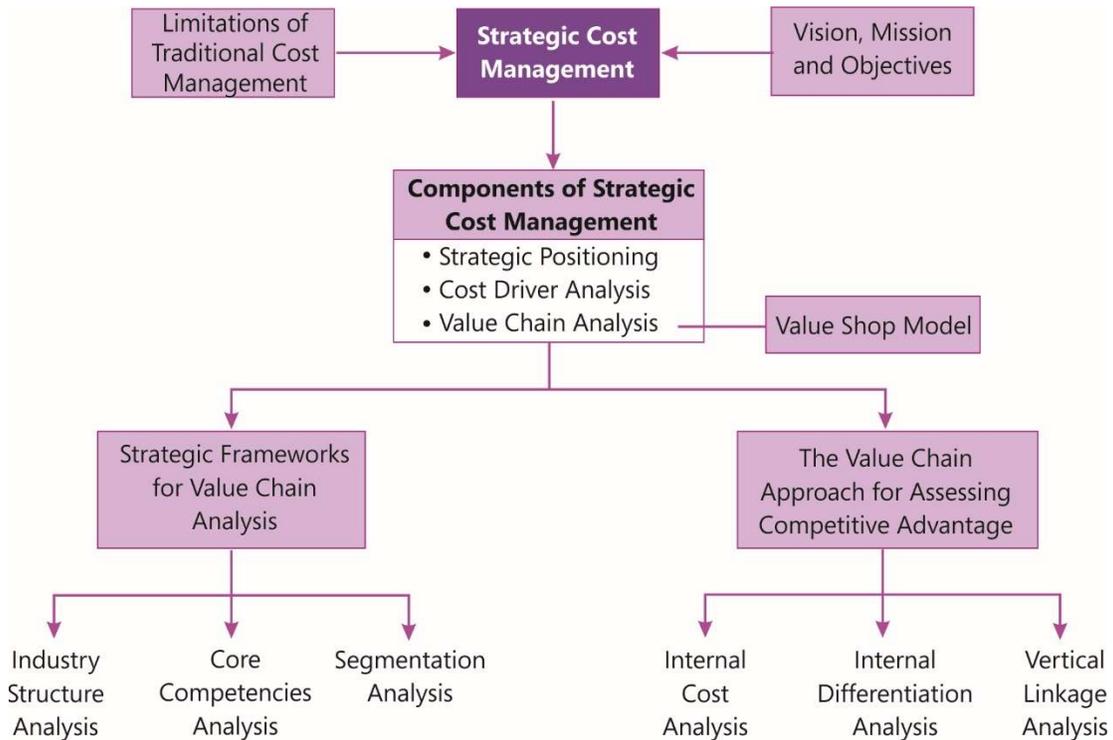


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ **Explain** the role of Strategic Cost Management in supporting Strategy Development and the Day-to-Day Operations of an organization
- ❑ **Distinguish** Strategic Cost Management with Traditional Cost Management

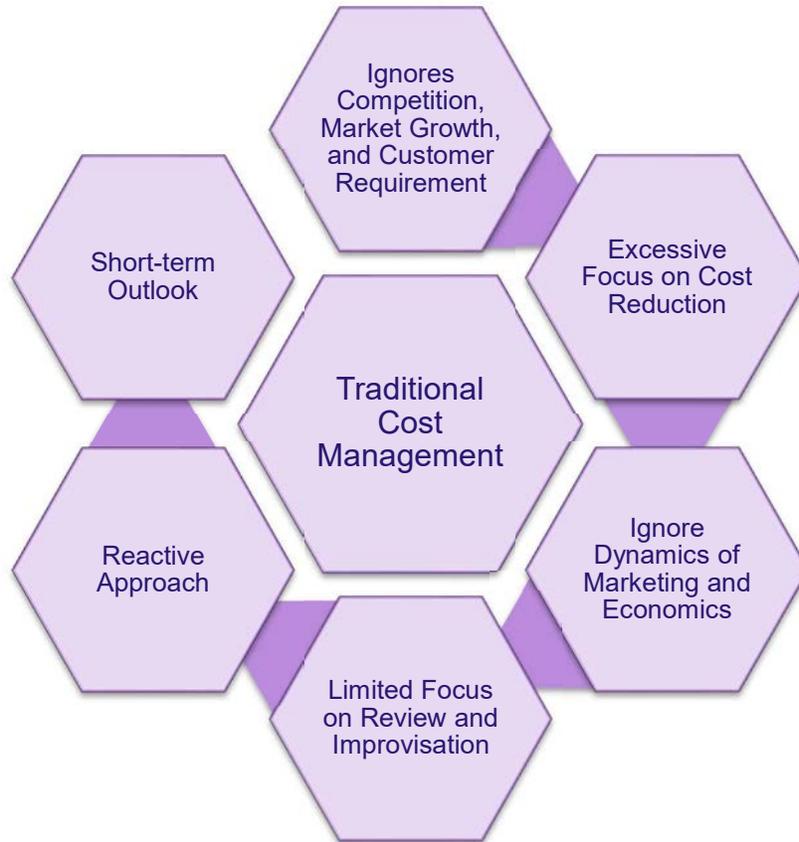
CHAPTER OVERVIEW



TRADITIONAL COST MANAGEMENT

Traditional cost management system involves allocation of costs and overheads to the production and focusses largely on cost control and cost reduction. The underlying assumption was that with reduced costs (direct) and overheads a firm could earn better profits. It involves comparing actual results with the standard expectations (typically budget or standard costs) and analysing the difference. This process is also known as variance analysis. A corrective action would be taken to ensure future outcomes are within the budgeted outcomes.

A traditional cost management system suffers from the following limitations:



- The focus is on cost control and reduction. However, a broad cost reduction programme doesn't work effectively in today's business environment. If a company targets to reduce the marketing spend by, say, 20% across the all product categories, it is likely that the sales of profitable products is also impacted.
- Traditional cost management system has internal focus and does not look at the external factors of competition, market growth, customer requirement etc.
- A broad-based cost reduction could lead to inferior quality of products & services which might drive away customers resulting in lower sales and profitability.
- The expectations of modern customer are quite different. An excessive focus on cost reduction could impact the quality of product and services and alienate the customers.
- Traditional cost accounting systems rely on accounting data which can be misleading at times. Financial statements can be a great reporting tool but might not be able to assist in strategic decision making. It does not consider dynamics of marketing and economics.
- There is a limited focus on review and improvisation of existing processes and activities.
- Traditional cost management is a reactive approach to cost management.
- It has a short-term outlook. E.g. saving costs on an annual basis.

STRATEGIC COST MANAGEMENT

In the modern business environment, it is not sufficient to control costs and a business must focus to manage cost *strategically*. The businesses today operate in an environment with stiff competition, increasing consumer demands for quality products and technology revolution. The ultimate objective of a business is to earn better profits and create value for shareholders. This can be achieved by superior performance as compared to the competitors which results in distinctive competitive advantages.

A **strategy** is a set of actions taken by managers of a company to increase the company's performance.

Strategic cost management is the application of cost management techniques so that they improve the strategic position of a business as well as control costs. It also involves integrating cost information with the decision-making framework to support the overall organisational strategy. It is not limited to controlling costs but using cost information for management decision making. The cost management techniques should be such that they improve the strategic position of a business apart from focussing on controlling costs. The basic aim of Strategic Cost Management is to help the organisation to achieve the *sustainable competitive advantage* through *product differentiation* and *cost leadership*.

Strategic cost management lays a greater focus on continuous improvement to deliver superior quality product to the customers. Strategic cost management must be an integral part of the value chain. It needs to include all aspects of the production, purchase, design, manufacturing, delivery and service. It is important that strategic cost management is involved at early stages of a product development cycle to avoid heavy costs of failure.

Example

The following information is extracted from the financial statements of a company producing products A & B. If the company stops producing product B, the sale of A would fall down by 25%.

₹ lacs

| Particulars | A | B |
|---------------------|-----------|-----------|
| Revenue | 60 | 35 |
| Cost of Sales | 35 | 25 |
| Gross Profit | 25 | 10 |
| Overheads | 5 | 12 |
| Net Profit | 20 | -2 |

Analysis

If the information provided above is approached using a traditional cost management technique, the company might decide to stop production of B because it has a very overhead cost and also results in a loss of ₹ 2 lacs. It thus appears to be prudent to close down the production of B.

However, with additional information that sale of product A would fall down by 25% if B is not sold the decision might change. The company would lose ₹ 5 lacs (25% of 20 lacs) because of reduced sales of A. The net loss for the company if it decides to stop production of B is ₹ 3 lacs (2 lacs of savings from B and 5 lacs of loss of profits from A). Hence the decision to stop of production B is not prudent.

Case 1

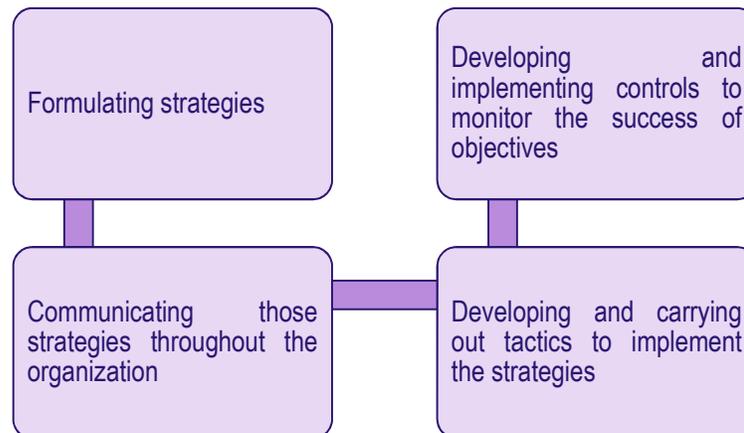
A manufacturing company does not carry out preventive maintenance of its machineries on a regular basis to save costs. Repairs of machinery is carried out as and when a machinery breaks down. This is a traditional approach to cost management where the focus is on cost reduction and cost saving. This is a short- term approach to manage costs.

When machinery breaks down, the company loses more in terms of loss time production and idle labour time. Lack of regular preventive maintenance and planned shutdown time also reduces the life of the machinery and has a longer- term impact. If the loss of production is significant, the company might lose market share to its competitors. Hence, it is important to look at cost management with a strategic focus.

Case 2

A telecom company closed down some of its customer service centres as a cost cutting measure. This led to overcrowding of customers at other centres and longer waiting time for the customers. The volume of work at other centres increased impacting the performance of employees. Both the customers and employees, two of the key stakeholders, were not happy with the company's decision. This type of business decision can impact the reputation and brand image of the company and impact the sales and profitability in the longer run.

Strategic cost management can be referred to as “the managerial use of cost information explicitly directed at one or more of the four stages of strategic management”:



Necessity of Strategic Cost Management

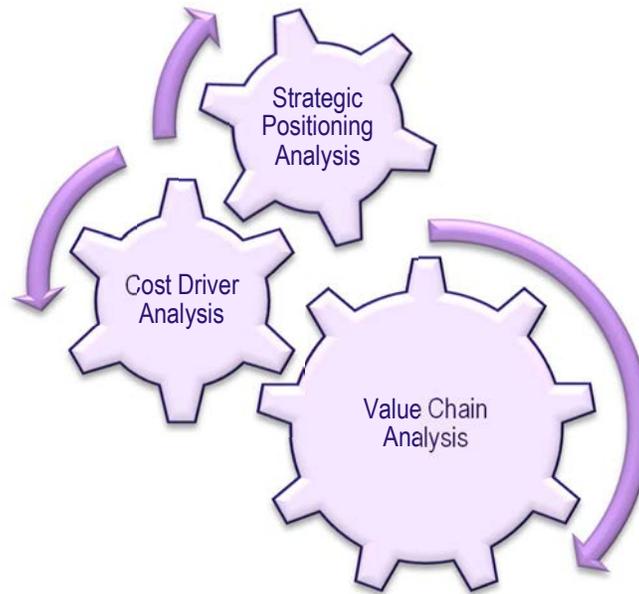
- It is cost analysis in a broader context where the strategic elements become more explicit and formal strengthening the strategic position of the company.
- Cost data is analysed and used strategically to develop alternate measures to gaining sustainable competitive advantages.
- SCM gives a clear understanding of the company's cost structure in search of sustainable competitive advantage.
- SCM is the managerial use of cost information explicitly directed to the four stages of strategic management – formulation, communication, implementation and control.
- SCM helps in overall recognition of cost relationships among the activities in the value chain and the process of managing these relationships to the company's competitive advantage.

Traditional vs. Strategic Cost Management

| | Traditional Cost Management | Strategic Cost Management |
|----------------------------|---|---|
| Time Span | Short term concept | Long term concept |
| Focus | Internal | Both internal and external |
| Cost Driver Concept | Based on volume of the product. | Each value activity has a separate cost driver. So, not based on volume but on activities associated with the manufacturing of the product. |
| Objective | Score keeping, attention directing and problem solving. | Cost leadership or product differentiation. |
| Cost Reduction | Primary objective is cost reduction. | Primary objective is cost containment – cost reduction and value improvement at the same time. |
| Approach | Risk – averse. | Risk taking and ability to adapt itself with changing environment. |

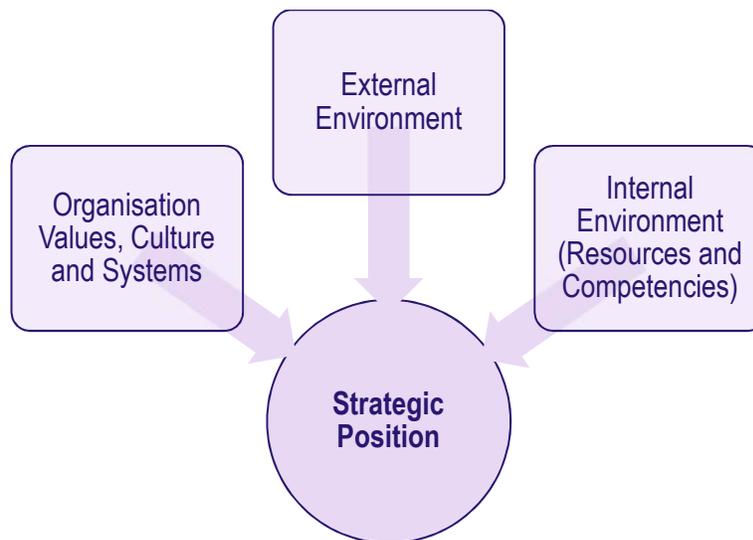
Components of Strategic Cost Management

Strategic Cost Management primary revolves around three business themes - Value Chain analysis, Cost driver analysis and Strategic positioning analysis.



Strategic Positioning Analysis

Strategic Positioning Analysis is a company's relative position within its industry matters for performance. Strategic positioning reflects choices a company makes about the kind of value it will create and how that value will be created differently than rivals. Strategic Positioning Analysis is concerned with impact of external and internal environment on the overall strategy of a company. It is important to take account of the future and to assess whether the current strategy is a suitable fit with the strategic position. The following factors affect the strategic position of a company –



External environment can be analysed using models like **PESTEL** (Political, Economic, Social, Technological, Environmental and Legal factors) and **Porter's 5 forces**.

Cost Driver Analysis

Cost is caused or driven by various factors which are interrelated. Cost is not a simple function of volume or output as considered by traditional cost accounting systems. Cost driver concept is explained in two broad ways in strategic cost management parlance - Structural cost drivers and Executional cost drivers.

Structural cost drivers are the organisational factors which affect the costs of a firm's product. These factors drive costs of a organisation in varied ways. The scale and scope of operation of a company will impact the costs. A larger scale of operations is likely to give an advantage of economies of scale. The usage of technology and complexity of operations also determine the costs of various activities within a firm. The *experience or learning curve* also impacts the costs being incurred by a firm. The product development process could be costlier earlier and cheaper in later stages of a lifecycle. A simple volume based cost allocation would not be appropriate in such cases.

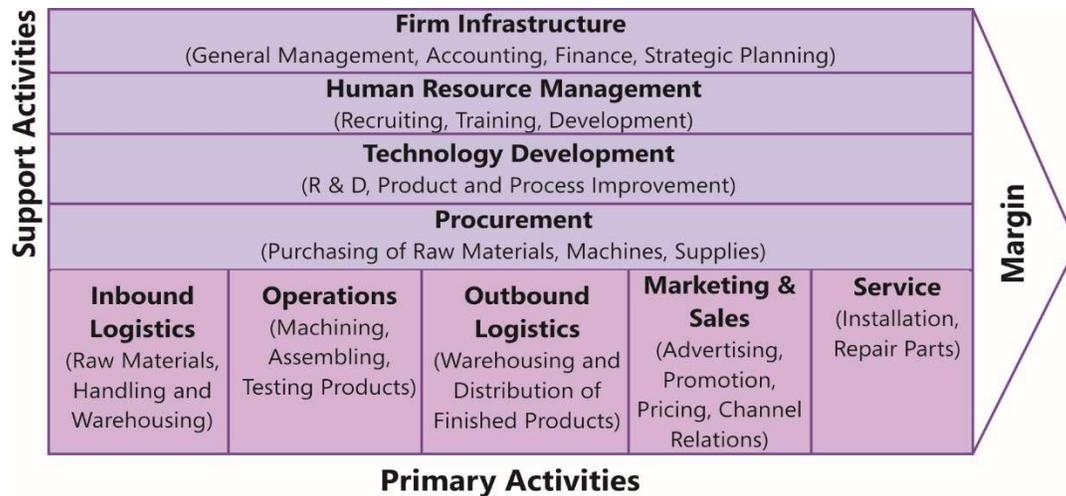
Executional cost drivers are based on firm's operational decision on how the various resources are employed to achieve the goals and objectives. These cost drivers are determined by management style and policy. The participation of workforce towards continuous improvement, importance of total quality management, efficiency of plant layout etc. are examples of executional cost drivers.

In case of a strategic analysis, volume is not the most appropriate way to explain costs. It is more relevant to explain costs based on strategic choices and executional skills. All costs drivers might not be important at all times. A company must focus on those cost drivers which is of strategic importance.

Value Chain Analysis

Value-chain analysis is a process by which a firm identifies & analyses various activities that add value to the final product. The idea is to identify those activities which do not add value to the final product/service and eliminate such non-value adding activities. The analysis of value chain helps a firm obtain cost leadership or improve product differentiation. Resources must be deployed in those activities that are capable of producing products valued by customers.

The idea of a value chain was first suggested by Michael Porter (1985) to depict how customer value accumulates along a chain of activities that lead to an end product or service.



Porter describes the 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.*”

The concepts, tools and techniques of value chain analysis apply to all those organisations which produce and sell a product or provide a service.

The various activities undertaken by a firm can be broadly classified into Primary activities and Secondary activities. Primary activities are those which are directly involved in transforming of inputs (Raw Material) into outputs (Finished Products) or in provision of service. Secondary activities (also known as support activities) support the primary activities. Though, secondary activities are not directly involved in creation of product, it doesn't mean that they are of less importance as compared to primary activities.

Primary Activities include:

- *Inbound Logistics*: These are activities concerned with receiving, storing, and distributing the inputs (raw materials) to the production process. The relationship with suppliers is a key component in this process.
- *Operations*: These activities involve transforming inputs into final product. Activities such as machining, packaging, testing and equipment maintenance form part of Operations.
- *Outbound Logistics*: These activities involve collecting, storing and distributing the products from the factory line to end consumers. This may include finished goods warehousing, delivery vehicle operation, order processing and scheduling.
- *Marketing and Sales*: Marketing and Sales provide the means by which the customers are made aware of the product. The activities include advertising, promotion, distribution channel selection, sales force management and pricing policy.
- *Service*: This includes activities related to after sales service like Installation, repair and parts replacement.

Support Activities include:

- *Procurement* involves purchasing of raw material, supplies and other consumables required as inputs for the primary activities.
- *Technological Development* includes technical knowledge, equipment, hardware, software and any other knowledge which is used in the transformation of inputs to outputs.
- *Human Resource Management* includes activities around selection, recruitment, placement, training, appraisal, rewards and promotion; management development; and labour/ employee relations.
- *Firm Infrastructure* consists of activities such as planning, finance, accounting, legal, government affairs and quality management.

A Value Chain gives managers a deeper understanding of what the organisation does and helps them identify key processes of the business. The various processes can be analysed to identify those activities which do not add value to consumers. Such non-value activity can be eliminated to add to the margins of the business as a whole.

Case Scenario

ABC Ltd. is engaged in business of manufacturing branded readymade garments. It has a single manufacturing facility at Ludhiana. Raw material is supplied by various suppliers.

Majority of its revenue comes from export to Euro Zone and US. To strengthen its position further in the Global Market, it is planning to enhance quality and provide assurance through long term warranty.

For the coming years company has set objective to reduce the quality costs in each of the primary activities in its value chain.

Required

STATE the primary activities as per Porter's Value Chain Analysis in the value chain of ABC Ltd with brief description.

Solution

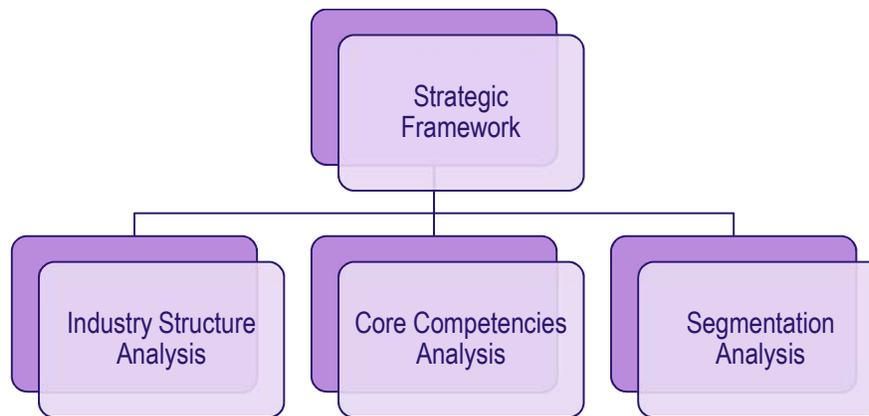
Primary activities are the activities that are directly involved in transforming inputs into outputs and delivery and after-sales support to output. Following are the primary activities in the value chain of ABC Ltd.:-

- (i) **Inbound Logistics:** These activities are related to the material handling and warehousing. It also covers transporting raw material (yarn or fabric) from the supplier to the place of processing inside the factory at ludhiana.
- (ii) **Operations:** These activities are directly responsible for the transformation of yarn or fabric into final readymade garments for the delivery to the consumers.

- (iii) **Outbound Logistics:** These activities are involved in movement of readymade garments to the point of sales. Order processing and distribution are major part of these activities.
- (iv) **Marketing and Sales:** These activities are performed for demand creation and customer solicitation. Communication, pricing and channel management are major part of these activities.
- (v) **Service:** These activities are performed after selling the goods to the consumers. Installation, repair and parts replacement are some examples of these activities.

STRATEGIC FRAMEWORKS FOR VALUE CHAIN ANALYSIS

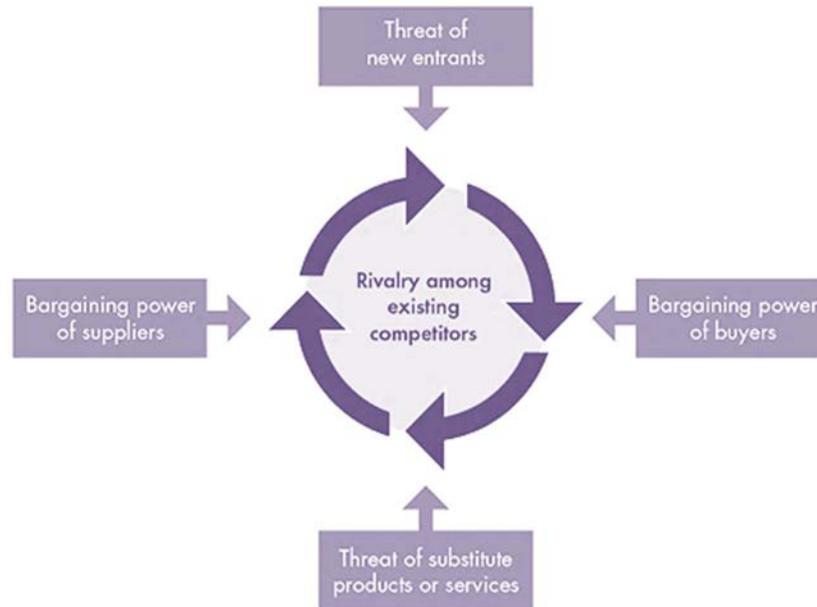
Value Chain analysis requires internal information (for internal value chain) and external information (for industry value chain). The Value Chain analysis requires strategic framework for organising varied information. The following three are generally accepted strategic framework for Value Chain analysis.



Industry Structure Analysis (Porter's 5 forces analysis)

An industry might not yield high profits just because the industry is large or growing. The five forces suggested by Porter's play an important role in determining profit potential of the firms in an industry. Michael Porter developed a five factors model as a way to organise information about an industry structure to evaluate its potential attractiveness.

Factors which influence profitability are:



- **Bargaining power of buyers:** The bargaining power of buyers generally determines the ability of buyer to push the price down. This happens when the buyers are concentrated or when the volume purchased by buyers is very high. In other words, when the bargaining power of buyers is high, they would be in a position to dictate terms to the firm. A buyer also has higher bargaining power if the cost of switching suppliers is very low. A higher bargaining power results in lower profitability. Large companies have a high bargaining power when they buy from small suppliers.
- **Bargaining power of suppliers:** The bargaining power of supplier is relatively higher when the input is important to the buying firm or when there are very few suppliers of the input. The suppliers could also dictate terms if the input supplied is not replaceable or when an alternate input is not available. Microsoft dominates the operating system business of computers and laptops and can dictate terms to its buyers as buyers do not have multiple options to choose from. The profitability of companies can shrink if the suppliers have a higher bargaining power.
- **Threat of substitute products or services:** When multiple and close substitutes are available in the market for a particular product, customers are likely to switch suppliers easily. A firm in such a case must resort to competitive pricing to retain its customers. When few substitutes exist for a product, consumers are willing to pay a potentially high price. If close substitutes for a product exist, then there is a limit to what price customers are willing to pay. The problem becomes severe if substitutes are available at much cheaper price (case of launch of Reliance Jio). A company should strive to build its brand and customer loyalty to thwart the threat of substitutes.

Substitutes could be from within the industry or from a different industry. The paper industry faces threats from e-book market. When more people switch to public transport as trains, the demand for vehicles comes down.

- **Threat of new entrants:** The threat of new entrants largely depends on the barrier to entry and perceived profitability in an industry. If an industry is profitable and the barriers to entry are low, new firms could enter the industry leading to excess supplies and reduced prices. Some examples of barriers to entry are intensive capital requirement, sophisticated technology, legal factors, limited access to raw material & labour etc.

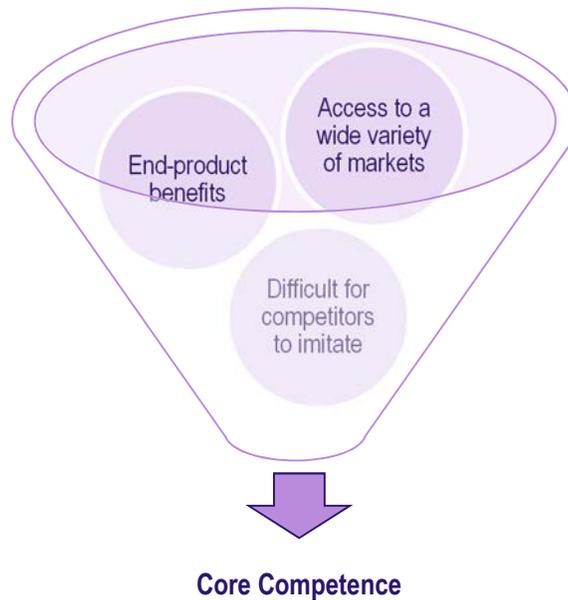
Industries which require huge amount of capital or sophisticated technical knowhow might not have a high threat of new firms entering into the industry. Airline industry is a case where very few new firms enter the business because of the capital requirements. Another barrier to entry could be legislation which restricts newer firms to start the business, like in the case of defense industry. Certain industries (for example medicines) are largely driven by patents and new firms might find it difficult to enter the industry. An industry where threat of new entrants is low is more profitable than an industry where new entrants can easily enter the industry.

- **Intensity of competition/ rivalry amongst firms:** Some markets are more competitive than others. In highly competitive industries, firms resort to cut-throat competition to win more customers. The competitive rivalry is higher when an industry has high number of firms and is lower when there are few large players dominating the market. The intensity of competition is higher:
 - When firms are of more or less equal size.
 - Extra capacity exists in the industry
 - Difficulty in differentiation in the products.
 - High exit barriers - This is a case where the exit costs are high and hence firms must continue in the industry despite excess capacity at industry level.
 - Higher fixed costs - Firms would want to produce as much as possible to keep the unit costs low leading to surplus capacity.

Since these five forces are ever-changing, Porter's framework needs to be employed as a *dynamic analytical tool*. This is because competition is a dynamic process; equilibrium is never reached and industry structures are constantly being reformed. The five forces analysis helps a firm to better understand the industry value chain and its competitive environment.

Core Competencies Analysis

Core Competency is a distinctive or unique skill or technological knowhow that creates distinctive customer value. The core competency of Google is its capability to deliver excellent search results which could not be imitated by its competitors. The core competencies are a function of the collective skillset of people, organisation structure resources & technological knowhow. A core competency is the primary source of an organisation's competitive advantage. The competitive advantage could result from *cost leadership* or *product differentiation*. There are three tests useful for identifying a core competence.



The loss of core competencies could be disaster for firms. Nokia was a leader in the feature phones segment till smart phones were introduced. The changing dynamics of industry meant that Nokia lost the top position in mobile phone industry and led to sale of the business to Microsoft. Bajaj Auto, who had core competency in the scooter segment, lost traction when motorbikes were introduced. It is thus important that the firms continuously evolve their core competencies and remain relevant in the ever-changing business environment.

Core competencies stem from two sources:

Resources: Resources are factors that enable a company to create value for customers. They can be tangible (land, buildings, inventory, machinery, money etc) or intangible (employee's skills, brand, patent, technology etc.). The more difficult a resource is to imitate, the more valuable is the resource for the company. The algorithms used by Google to deliver search results are not easily imitated by competition. Similarly, the secret formula of concentrates used by soft drinks manufacturers like Coca Cola are hard to copy.

Capabilities: Capabilities refer to the company's ability to co-ordinate resources and put them to productive use. Availability of resources by themselves does not guarantee core competency and success. Capabilities stem from organisational structure, processes and control systems.

Applying the value chain approach to core competencies for competitive advantage includes the following steps:

- **Validate core competencies in current businesses:** Core competencies must lead to a competitive advantage to the business and the existence of core competencies be validated continuously.

- **Leverage competencies to the value chains of other existing businesses:** A core competency in one segment of business can be used in another existing/new business. An excellent distribution network in one business can be used to launch another product. Example - If a bank has wide network of branches in its banking business, the same network can be used to launch and sell insurance products.
- **Use core competencies to reconfigure the value chains of existing businesses:** While firms may manage their existing value chains better than their competitors, sophisticated firms work harder on using their core competencies to reconfigure the value chain to improve payoffs. Otherwise, competitors may exploit opportunities.

How IKEA Reconfigured the Furniture Industry?

| Value Chain | Major Choice |
|---------------------|--|
| Design | Simple, high quality, designed to lower cost |
| Parts | Standard & common, global supplier network |
| Assembly | By the customer |
| Transport/ Stocking | Computerized system for suppliers & warehouses |
| Marketing | Scandinavian image |
| Display | Focus on designs, not pieces, to create value |
| Home delivery | By the customer |

Source: Normann and Ramirez, 1993

How Tetra-Pak Reconfigured the Value Chain?

Filling

Make container on site

Tetra - Pak specialised equipment

Transport

No refrigerated trucks

No wastage space in filling & packing

Retail Display

Low store handling

No need to refrigerate & less space is required

Customers

Longer shelf life

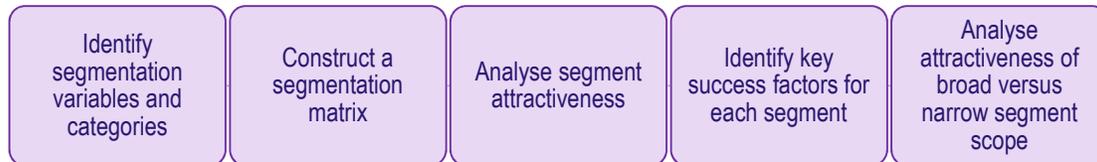
No need to refrigerate & less space is required

- **Use core competencies to create new value chains:** With strong core competencies in its existing businesses, an organisation can seek new customers by developing new value chains. For example, FedEx transferred its expertise in the delivery of small packages to contract new business with L.L. Bean for overnight distribution. Disney has exported its people-moving skills to urban mass transit for Oakland, California.

Segmentation Analysis

A single industry might be a collection of different market segments. Motor vehicle industry, for example, can be seen as a composite of tyre, glass, battery, metals etc. Not all firms in an industry participate in all segments. The structural characteristics of different industry segments need to be examined.

This analysis will reveal the competitive advantages or disadvantages of different segments. A firm may use this information to decide to exit the segment, to enter a segment, reconfigure one or more segments, or embark on cost reduction/ differentiation programs.



- **Identify segmentation variables and categories:** An industry might be divided into multiple segments depending upon the nature and complexity of the industry. The segmentation could be based on the nature of products or geographies or customers.
- **Construct a segmentation matrix:** After the segments are identified, a segmentation matrix (generally two way) can be created. ITC could create a matrix based on the nature of products (Cigarettes, Hotels, Textile, Paper etc) and geographies (North, East, West and South). Another way could be to create a matrix using products and distribution channel (wholesale, retail, direct).
- **Analyse segment attractiveness:** The segmentation matrix could be used to evaluate profitability and performance of each of the segment. The interrelationship between various segments (say distribution channels, similar products) must also be considered while analysing segmental attractiveness.
- **Identify key success factors for each segment:** Each segment identified must be assessed with a relevant measure of performance. It could be quality of product, service, timeliness of delivery etc. A single performance measure across all segments is not advisable. A measure which suits the service segment will not suit the manufacturing segment.
- **Analyse attractiveness of broad versus narrow segment scope:** The company must identify whether it wants to be in a broad segment or a narrow one. Narrower segments could be risky for business as a single segment could be vulnerable to the competition. Multiple segments help a company to spread costs across the various segments. The company might also be in a position to use the competency of one segment in other segments. Some firms might abandon certain segments because of lack of profitability. The competitive advantage of each segment may be identified in terms of low cost and/or differentiation.

SUPERIOR PERFORMANCE & COMPETITIVE ADVANTAGE

The ultimate objective of a for-profit company is to achieve superior performance in comparison to their competitors. A company which attains superior performance gets a definitive competitive advantage. The company's profitability is improved with superior performance which leads to the maximisation of shareholder's wealth.

In order to survive and prosper in an industry, firms must meet two criteria:

- They must supply what customers want to buy and
- They must survive competition.

A firm's overall competitive advantage derives from the difference between the value it offers to customers and its cost of creating that customer value.

In order to attain superior performance and attain competitive advantage, a firm must have distinctive competencies. Distinctive competencies can take any of the following two forms:

- An offering or ***differentiation advantage***. If customers perceive a product or service as superior, they become more willing to pay a premium price relative to the price they will have to pay for competing offerings. Example: Customers of Apple pay a higher price for its products.
- Relative ***low-cost advantage***, under which customers gain when a company's total costs undercut those of its average competitor. Example: A company which can provide similar products at much lower costs.

Differentiation Advantage (Product Differentiation)

It occurs when customers perceive that a business unit's product offering is of higher quality, involves fewer risks and/or outperforms products offered by competitors. In other words, customers perceive the product or service offered by a business to be superior. For example, differentiation may include a firm's ability to deliver goods and services in a timely manner, to produce better quality, to offer the customer a wider range of goods and services, and other factors that provide unique customer value.

A differentiation advantage can be achieved by adopting the following techniques:

- Superior Quality: The customers are offered a better-quality product in the similar price range. The quality of product or service offering is such that the company becomes a preferred choice of its customers.
- Superior Innovation: The company continuously offers innovative products ahead of its competition.
- Superior Customer Responsiveness: The company produces products or provides services which are aligned with customer's expectation. The company also focusses on overall customer service and works towards parameters like reducing waiting time, on time delivery etc.

Once a company has successfully differentiated its offering, management may exploit the advantage in one of two ways viz., either; increase price until it just offsets the cost of improvement in customer benefits, thus maintaining current market share; or price below the “full premium” level in order to build market share. Companies like Apple charge premium prices from its customers because customers perceive Apple’s product to be different from others.

*Value chain analysis can identify the points at which **Differentiation Advantage** can be achieved by:*

- Producing products which are superior to competitors by virtue of design, knowhow, performance, etc.
- Offering superior after-sales service by outstanding distribution.
- Expanding the product range
- Superior packaging of the product.
- Making brand strength.

Low-Cost Advantage (Cost Leadership)

A firm enjoys a relative cost advantage if its total costs are lower than those of its competitors. This relative cost advantage enables a business to do one of the following:

- Charge a lower price than its competitors for its product or services in order to gain market share and still maintain current profitability; or
- Match with the price of competing products or services and increase its profitability.

A company must choose a strategy in which it can lower its cost and thereby gain a competitive advantage. Many sources of cost advantage exist - access to low-cost raw materials; innovative process technology; low-cost access to distribution channels or customers; and superior operating management. A company might also gain a relative cost advantage by exploiting economies of scale in some markets.

Example - A refinery which has superior technology can process low grade crude to produce oil. Since low grade crude is cheaper than what the competitors pay for high grade crude, the company might be in a position to charge lower price & gain additional market share or charge higher price and earn better profits.

A disadvantage of this strategy is that competitors might find way to lower their costs as well. Hence, a company which pursues a cost leadership strategy must continuously improve its cost structure. Another risk associated with cost leadership strategy is that managers might try to lower costs by compromising the quality of products.

*Value chain analysis is central to identifying where cost savings can be made at various stages in the value chain. Value chain analysis can identify the points at which **Low Cost Advantage** can be achieved:*

- Reduce costs by copying rather than creating designs, using cheaper materials and other cheaper resources, reducing labour costs and increasing labour productivity.

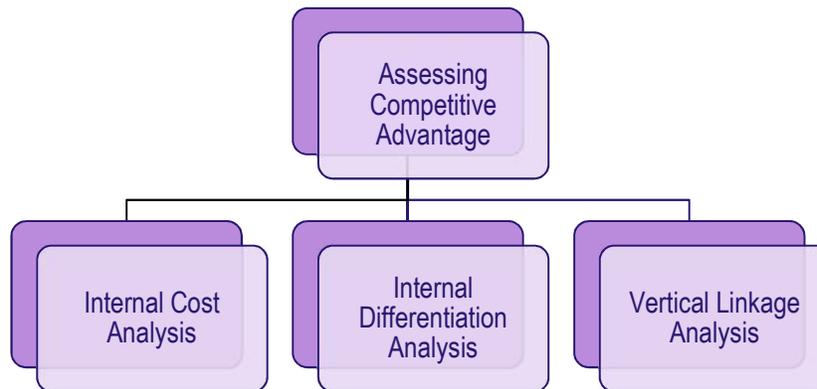
- Attaining economies of scale by high-volume sales.
- Use high-volume purchasing to get discounts for bulk purchase.
- Locating in areas where cost advantage exists or government support is possible.
- Gaining learning and experience curve benefits.

The company must look at its **value chain**, which consists of all of its functions – production, marketing, R&D, customer service, information systems, materials management, human resources – to determine each one's role in lowering the cost structure and/ or increasing customers' perceived utility through differentiation of its product or service.



THE VALUE CHAIN APPROACH FOR ASSESSING COMPETITIVE ADVANTAGE

The value chain model can be used by business to assess the competitive advantage. Companies must not only focus on the end product/ service but also on the *process/ activities* involved in creation of these products/ services. The value chain approach can be used to better understand the competitive advantage in the following areas:



Internal Cost Analysis

Organisations can use the value chain analysis to understand the cost of processes and activities and identify the source of profitability. The following steps are generally used to carry out an internal cost analysis.

- **Identify the firm's value-creating processes:** This is the first step in which a firm identifies its value-creating processes. Traditionally, businesses organise themselves into various cost, revenue and profit centres. The businesses are also organised on a functional structure with different layers of hierarchy. These types of classification or organisation does not help firm understand the contribution of each activity.

The key is to classify activities to understand their true contribution to the firm's competitive advantage. Example - firms might have distinctive advantage in their procurement process or inbound logistics.

- **Determine the portion of the total cost of the product or service attributable to each value creating process:** The next step is to trace or assign costs and assets to each value-creating process identified. A company might use estimates to assign costs to the value creating activities. The costs of support activities must also be allocated to get a full picture of costs. Example: A new ERP system might reduce the inbound logistics costs with proper inventory management but would increase the cost on IT front. Unless such costs are identified and allocated, the analysis would not give a clear picture. Many of the processes identified may be instrumental for achieving competitive advantage.
- **Identify the cost drivers for each process:** The company identifies the factors which drive costs. A change in cost driver leads to a change in the overall cost. The next step of internal cost analysis is to identify the factor or cost determinants for each value-creating process. Once the factors driving costs are identified, business can assign priority in its cost management activities.

Management accounting systems may not reveal the causes or factors for the significant individual costs. The use of a single output or volume measures to assign costs can also be misleading at times. *Multiple cost drivers usually provide more useful information and analysis. The companies are using activity based costing to gain a better understanding of the resources consumed and costs incurred for a certain activity.*

- **Identify the links between processes:** The value chain analysis considers individual value activities as separate and discrete. However, the individual activities are not independent and are not expected to function in silos. Most activities within a value chain are interdependent and the linkages between the various activities might impact the total cost. The cost improvement programs in one value chain may lower or increase cost in other processes. An increase in automation might reduce the manpower cost but would also increase the technology cost.
- **Evaluate the opportunities for achieving relative cost advantage:** Traditionally firms and businesses have adopted across the board cost reduction. Such an approach (E.g. reduce costs under all heads by 15%) does not solve the actual problem as the costs are not reduced strategically. Such an approach might lead to forceful reduction of costs in certain areas like marketing which might impact the sales.

Certain activities might provide a larger opportunity for reducing costs while other activities might require that costs are incurred at current level or may be even at higher levels. *Using the value chain approach, a company goes beyond simple across-the-board cuts and attempts to lower cost and improve efficiency within each value-creating process.*

Reducing process input costs often means negotiating lower wages or moving production to countries with cheaper labour costs. Suppliers might be willing to drop their prices if the company negotiates long-term contracts. Companies also use buyer-seller partnerships to gain advantages in cost, quality, time, flexibility, delivery and technology.

Internal Differentiation Analysis

Companies can also use value chain analysis to create and offer superior differentiation to the customers. The focus is on improving the value perceived by customers on the companies' products and service offering. The firms must identify and analyse the value creating process and carry out a differentiation analysis.

- **Identify the customer's value creating processes:** The company must identify various activities in its value chain which are undertaken to deliver products/ services to its customers. Differentiation comes from the way various activities are performed and the way in which value chain is structured.
- **Evaluate differentiation strategies for enhancing customer value:** The company seeks to evaluate various strategies which could enhance the customer value. The strategies which a company can implement to enhance the customer value are:
 - Superior features in product - e.g. Premium cars, Phones etc.
 - Using effective marketing & distribution channels - e.g. on time delivery.
 - Excellent Customer Service - e.g. timeliness of repairs at effective cost, cleanliness at hotels etc.
 - Having a superior brand image - e.g. Apple, Google, Tata
 - Offering better quality product at competitive prices.
- **Determine the best sustainable differentiation strategies:** The activities which could enhance differentiation must be identified. A company must identify those strategies which could create sustainable product/ service differentiation. The selection of strategy must be according to the availability of resources.

Vertical Linkage Analysis

A company generates competitive advantage not only through linkages of internal processes within a firm but also through linkages between a firm's value chain and that of a suppliers or users. A vertical linkage analysis includes all upstream and downstream activities throughout the industry. The analysis encompasses activities beginning at source of raw material and ending at the final delivery of products to the customers. A company must have an understanding of not only its internal value chain but also of the industry value chain.

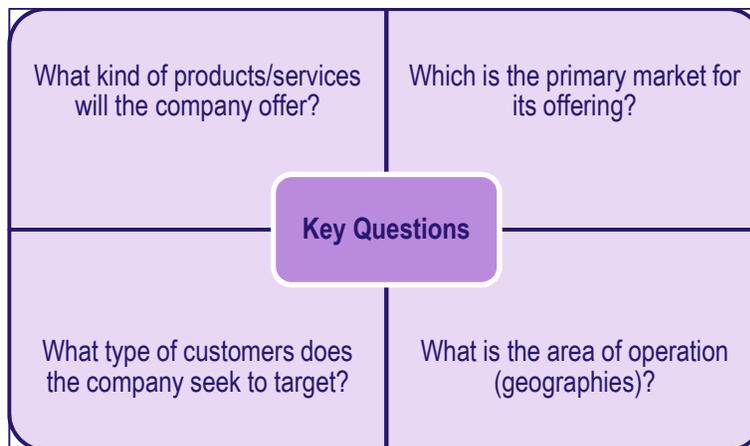
A company might not carry out all activities in the entire value chain of an industry. Hence, it might not be in a position to obtain information relating to costs and revenues for each process being carried out in the industry. However, such information is necessary for a firm to carry out a vertical linkage analysis. A company must identify the cost drivers for each of the process in the value chain of the industry as done in the case of the internal value chain analysis. A company must identify and evaluate the opportunities for sustainable competitive advantages after carrying out a industry value chain analysis.

Example - A company manufactures cars using various components like chassis, steering wheel, tyres, axles etc. The company does not manufacture all the components in-house and are purchased from third party suppliers. The company focusses on assembly line which is its core competency. However, certain parts, which are critical to the car are manufactured in-house. This is a strategic choice to gain a competitive advantage.

In another case, a company could identify that there is virtually no competition in a particular process of the value chain. In such a case, it is less likely that the company might get a competitive price for the components it purchases. If there is only a single battery manufacturer, the car company might end up paying higher price. Such a situation could lead to a competitive disadvantage. A company might also carry out negotiations with its suppliers after an analysis of industry value chain. This generally happens when the company observes that certain section of value chain is charging excessive margin.

VISION, MISSION AND OBJECTIVES & SCM

A company's *mission statement* is a statement of the company's reason to be. It seeks to answer the question - "Why does the company exist?". It is a statement of organisation purpose and helps in addressing the following questions –



It might also include a statement of organisation value and major goals. A company's mission statement must be *customer focused* and not product focused.

A company's *vision* is what the company would like to achieve. A vision statement must be challenging and generally states an ambitious future. A good vision statement must motivate employees and managers to work towards the common organisation goals.

A company's *objective or goal* is a precise and measurable future state that the company wants to achieve. The purpose of objective or goal statement is to specify what needs to be done in order to attain the company's mission or vision. Goals must be specific and measurable as well as challenging and realistic.

The fundamental purpose of strategic planning and management is to align the vision and mission statements. A company's strategy is directed towards achieving a sustained competitive advantage. As discussed earlier, a competitive advantage is achieved by product differentiation and cost leadership. Strategic cost management is hence closely linked to the vision, mission and objectives of the company.

Management accounting draws on simple models of microeconomics and assumes that cost is primarily a function of only one cost driver, namely output/ volume. SCM, on the other hand, builds upon richer models of economics of industrial organisation and acknowledges that cost is driven by multiple factors that are interrelated.

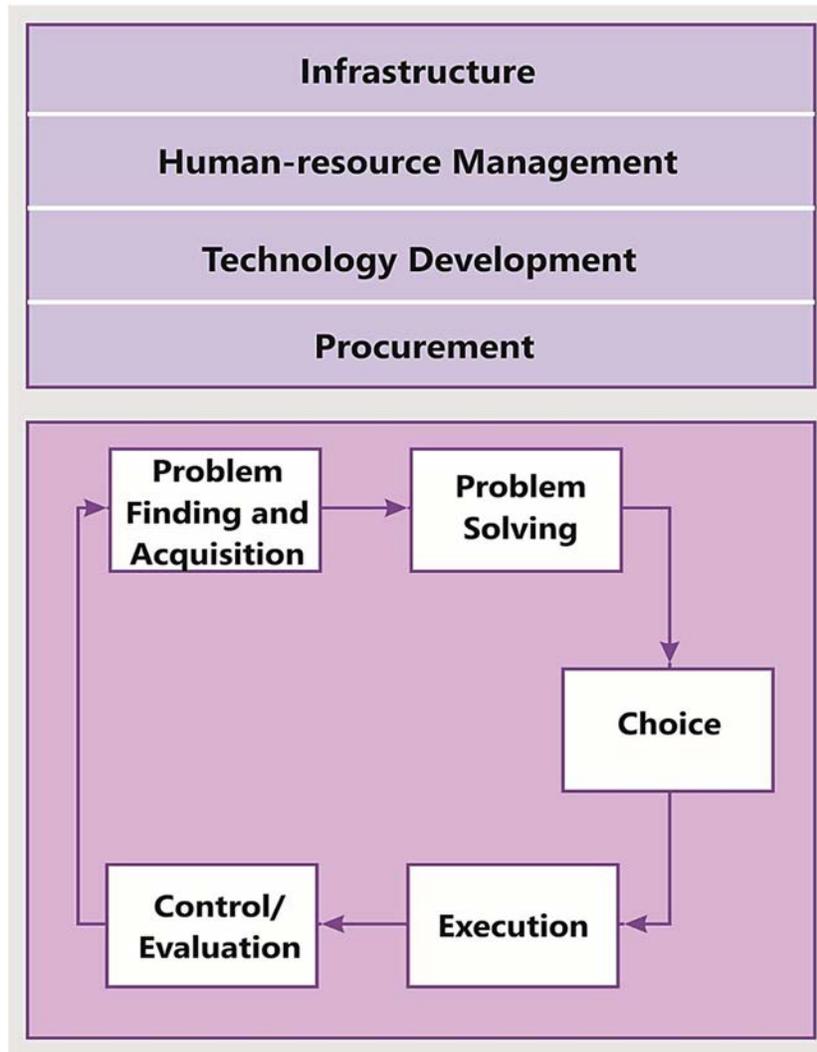
In the SCM frame work, effective cost management involves a broad focus which Porter calls the value chain. It is a strategic tool used to analyse internal firm activities. Its goal is to recognize, which activities are the most valuable (i.e. are the source of cost or differentiation advantage) to the firm and which ones could be improved to provide competitive advantage. Cost leadership can be achieved through techniques like target costing. Product differentiation is directly proportional to market movements and changing business requirements.

Strategic cost management is not a fine science but requires careful analysis of how strategic management concepts provide positive or adverse reactions to each element of value chain, positioning decisions and cost drivers. The art in doing this is working out strategies which have the most preferential cost benefits. There is overlap between these three different types of strategic cost management analysis techniques which can all relate back to executional, structural and organizational costs. Each type of analysis is aimed at establishing where cost benefits can be achieved through strategic choices managers make within the organisation.

VALUE SHOP MODEL OR SERVICE VALUE CHAIN

The concept of value shop came in to lime light holding the hand of Mr. James. D. Thompson in the year of 1967. However, it took more than thirty years to name the concept as 'Value shop'. In 1998 Mr. Charles B. Stabell and Mr. Oystein D. Fjeldstad in their research work properly defined the concept of 'Value Shop'. This concept aims to serve companies from *service sector*. In value shop principle, no value addition takes place. It only deals with the problem, figure-out the main area requires its service and finally comes with the solution. This approach is designed to *solve customer problems rather than creating value by producing output from an input of raw materials*. Value shops mobilizes resources (say: people, knowledge or money) to solve specific problems such as curing an illness or delivering a solution to a business problem. The 'problem' could also be how to exploit an opportunity. The shop process is iterative, involving repeatedly performing a generic set of activities until a solution is reached. This model applies best to telecommunication companies, but also to insurance companies and banks, whose business essentially is mediating between customers with different financial needs. **The model has the same support activities as Porter's Value Chain but the primary activities are described differently.** In the value shop they are:

- Problem finding and acquisition.
- Problem solving.
- Choosing among solutions.
- Execution and control/evaluation.



The management in a value shop focuses on areas like problem and opportunity assessment, resource mobilization, project management, solutions delivery, outcome measurement, and learning.



THE ROLE OF THE MANAGEMENT ACCOUNTANT

The management accountant is traditionally considered the resident expert on cost analysis; cost estimation; cost behaviour; standard costing; profitability analysis by product, customer or distribution channel; profit variance analysis; and financial analysis. Today, management accountants must also bring skills in activity-based costing, benchmarking, re-engineering, target costing, life-cycle costing, economic value analysis, total quality management and value chain analysis. 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 the use of value chain analysis, the management accountant enhances the firm's value and demonstrates the value of the finance staff to the firm's growth and survival.



SUMMARY

- The basic aim of Strategic Cost Management is to help the organisation to achieve the cost leadership to get the sustainable competitive advantage. A well-conceived cost reduction strategy enables the managers to capture maximum value in the form of direct savings. It is an effective way of reducing cost, increasing revenue and facilitating survival in the competitive world.
- Strategic cost management should be inherent to each stage of a product's life cycle, i.e. during the development, manufacturing, distribution and during the service lifetime of a product.
- Strategic cost management can be referred to as "the managerial use of cost information explicitly directed at one or more of the four stages of strategic management" viz Formulating strategies, communicating those strategies throughout the organization, Implementation the strategies, and Implementing controls to monitor the success of objectives.
- Composition of Strategic Cost Management – Cost Driver Analysis, Strategic Positioning Analysis and Value Chain Analysis.
- The Strategic Positioning of an organization includes the devising of the desired future position of the organization on the basis of present and foreseeable developments, and the making of plans to realize that positioning.
- Value Chain Analysis is a strategic tool used to analyse internal firm activities. Its goal is to recognize, which activities are the most valuable (i.e. are the source of cost or differentiation advantage) to the firm and which ones could be improved to provide competitive advantage. Cost leadership can be achieved through techniques like target costing. Product differentiation is directly proportional to market movements and changing business requirements.
- Benefits of Strategic Cost Management – Strategic elements become more explicit, cost data is used to develop alternate measures to gaining sustainable competitive advantages, clear understanding of the company's cost structure, managerial use of cost information explicitly directed to the four stages of strategic management – formulation, communication,

implementation and control, overall recognition of cost relationships among the activities in the value chain.

- Porter describes the 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.”
- Classification of Business Activities for Value Chain Analysis –

Primary Activities: Primary activities are directly involved in transforming inputs into outputs and delivery and after-sales support to output. They include Inbound Logistics, Operations, Outbound Logistics, Marketing & Sales and Post-Purchase Service.

Support Activities: Support Activities are the activities which support primary activities. They are handled by the organisation’s staff functions and include Procurement, Technology Development, Human Resource Management, Firm Infrastructure.
- Differentiation Advantage– It occurs when customers perceive that a business unit’s product offering (defined to include all attributes relevant to the buying decision) is of higher quality, involves fewer risks and/or outperforms competing product offerings.
- Low-Cost Advantage– A firm enjoys a relative cost advantage if its total costs are lower than the market average. This relative cost advantage enables a business to do one of the two things; price its product or services lower than its competitors in order to gain market share and still maintain current profitability; or match with the price of competing products or services and increase its profitability.
- The Value Chain Approach for Assessing Competitive Advantage–

Internal Cost Analysis– to determine the sources of profitability and the relative cost positions of internal value-creating processes;

Internal Differentiation Analysis– to understand the sources of differentiation (including the cost) within internal value-creating processes; and

Vertical Linkage Analysis– to understand the relationships and associated costs among external suppliers and customers in order to maximize the value delivered to customers and to minimize cost.
- Strategic Frameworks for Value Chain Analysis– Value chain analysis requires a strategic framework or focus for organizing internal and external information, for analyzing information, and for summarizing findings and recommendations. Three useful strategic frameworks for value chain analysis are,

Industry Structure Analysis, Core Competencies, and Segmentation Analysis.

- Porter's Five Forces Model– Under this model, the profitability of an industry or market measured by the long-term return on investment of the average firm depends largely on five factors that influence profitability. These are:

Bargaining power of buyers; Bargaining power of suppliers; Threat of substitute products or services; Threat of new entrants; and Intensity of competition/ Degree of rivalry.

- Value Shop Model– This approach is designed to solve customer problems rather than creating value by producing output from an input of raw materials. Value shops mobilizes resources (say: people, knowledge or money) to solve specific problems such as curing an illness or delivering a solution to a business problem.

The model has the same support activities as Porter's Value Chain but the primary activities are described differently as Problem finding and acquisition, Problem solving, Choosing among solutions, Execution and control/evaluation.

The management in a value shop focuses on areas like problem and opportunity assessment, resource mobilization, project management, solutions delivery, outcome measurement, and learning.