# Strategic Cost Management for Sustained Growth - A Study of SME's in India

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**Abstract**

*Indian economy is projected to develop as one of the top economies in the world and is expected to become a $ 5 trillion economy by 2025. In this context, it is good to note that Small and Medium Enterprises (SMEs) of India have been contributing significantly to the growth of Indian economy. It is said that SMEs contribute nearly 45% to the GDP of the economy. It is prudent to ask to what extent the SMEs can continue to contribute towards this projection because, it is reported that sustenance of SMEs has been a major source of concern for the last few years.*

*According to the one of the surveys conducted by IFC, it is learnt that nearly 24% of SMEs close shop in two years of their inception and nearly 53% of them go out of the market totally in about four years for various reasons like poor cost management, bankruptcy and business loss. A report of a National Research Study (2013) opines that SMEs fail to survive on account of lack of competency in cost management and failure to forecast rising cost. Hence, managing the cost of their products or services in SMEs with a strategic focus becomes very important to respond to the challenging economic times faced by business today.*

*The present paper is an attempt to discuss growth of SMEs in India, analyze the current cost management practices adopted by SMEs with specific emphasis on Strategic Cost Management (SCM) Practices adopted and how these practices impact their Business performance.*

**Keywords:** Cost Management, Strategic Cost Management (SCM), Small and Medium Enterprises (SMEs), Business Performance.

**Role of SMEs in Economy**

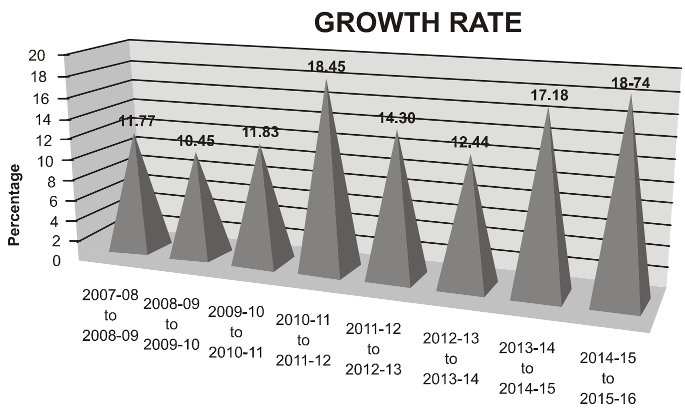
It is well known that SMEs contribute over 90% of business enterprises and 50-60% of total employment to world economy. In Europe, Japan and the USA, 99% of the enterprises belong to the small business segment. Employment generated through Small businesses is more than 50% in the EU and approximately 40% in the USA.

Over the last 50 years, Indian SMEs segment has become prominent, highly progressive and active part of Indian economy. As ancillary units, they support large industries and contribute a great deal to the socio-economic growth of the country. As per the Government of India MSME Report (2016-17), the SME sector consists of approximately 3.6 crore units currently and provide employment to over 8 Crores. It is also good to highlight here that the SMEs constitute 45% of the manufacturing output and 40% of the exports. Thus one can infer the importance of SMEs for the growth of Indian economy.

In a nutshell one can certainly say that the SMEs form a vital component for development of economy. They go a long way in strengthening the productive sector, generating employment, promoting innovation and creating a suitable environment for entrepreneurship.

It has already been stated that by 2025, India is likely to become a 5 trillion -dollar economy and its GDP is expected to grow at 8.5%. It is heartening to note that MSME at a Glance 2016 Report foresees an increase in MSME's contribution to GDP from 8% to 15% by 2020. Secondly, the report states that the MSMEs contribution to overall employment will be 50% and as a result there will be 100% increase in the current MSME workforce of 106 million across agricultural, manufacturing and services sectors. Furthermore, in this way, the MSME will enable the economy to fulfill the growing domestic as well as export demand. They will also pave way for indigenization and import substitution.

It is also important to note that the MSMEs have registered a constant growth as reported by the MSME Annual Report 2015-16 of Government India. The report says that a constant growth rate of 11% till the financial year 2010-11 has been observed. Secondly, the highest growth rate of 18.45% was recorded during the financial year 2011-12 whereas the growth rate came down to 14% during the year 2012-13 and to 12% during 2013-14, though the growth rate again rose to 17% in 2014-15. These figures have been illustrated in the graph given below.




Source: MSME Report 2015-16

Though the report mentioned above shows a rosy picture of the performance of SMEs in India, the IFC report (IFC 2010) on the contrary says that these SMEs are very unlikely to sustain the growth of Indian economy over a long period of time as estimated in the MSME Annual report of Government of India.

According to the IFC Report, SMEs appear to have a short span of life- 23.7% of them close down within 2 years of inception and another 52.7% of them completely go out of business in about 4 years. Some of the reasons can be negative returns on the investments, bankruptcy and so on. The reasons seem to be quite obvious like failure to manage costs or foreseeing rising cost of goods or services. A report of a National Research Study (2013) opines that SMEs fail to survive on account of lack of competency in cost management and failure to forecast rising cost. The report states that 61% of SME operators close businesses on account of poor management, 50% SMEs fail because of lack of experience in management. The other reasons are inadequate capital, ineffective marketing, and lack of time for accounting. Thus one can conclude that Inability to manage and anticipate cost will result in reduced profitability and continued reduction in profitability will finally result in SMEs exit.

From the foregoing discussions, it becomes clear that though the SMEs in India show great potential for contributing to the growth of Indian economy as visualized by the Govt of India MSME report, it is also true that SMEs are very unlikely to stay in operations for a longer period of time so as to contribute to the growth of Indian economy for various reasons like poor cost management practices, failure to forecast rising cost, inadequate investments etc.

Having discussed the growth potential of SMEs in India, in this paper an attempt has been made to present a strategic approach to cost management.

**Cost Management : A Paradigm Shift**

**Traditional Cost Management**

Cost management was relatively simple when the production was targeted at one or a homogenous range of products. According to Berliner and Brimson(Berliner and Brimson1988:86) "Traditional cost management was developed during this time when business environment was moderate. Production was an important competition factor and cost structures were more flexible and easy to influence. Major focus of cost system was recording and reporting the past events relating to costs and profits. Key objective of Cost system was determining the cost of goods produced and cost of inventory". "Determination of manufacturing cost consumed much effort and the preparation of cost data took a great amount of time as well as personal and financial resources" states Hansen and Mowen (Hansen and Mowen 2000:2). There are many studies what state that as the business environment became more and more complex, the traditional cost management practices fail to provide solution for addressing problems of cost and profitability management.

Eiler et al. (1982:133ff.), state that the existing cost management systems are operationally expensive and there is great delay in disseminating information. "Traditional Cost Systems fail to produce accurate, useful and timely information and most importantly they do not reflect the new competitive environment" argued Johnson and Kaplan (Johnson and Kaplan (1991:1)).

Turney (1996:1) opines that the existing cost management systems do not focus on the right problems and right priorities, consequently, leading the companies to wrong markets and customers.

In their study, Shank and Govindarajan (1989:5) express the need devising an accounting system which is quite different from traditional record keeping. They further state that "It will be a right assumption to expect traditional costing systems to support current information requirements arising out of complex business environment such as information relating to the customer profitability, customer orientation, sales channels, support new technology techniques, facilitating the development of a successful business strategy".

This opinion is further supported by Johnson and Kaplan (1991:234) also. They opine that the existing cost management system should estimate long term production cost which include designing cost, development cost, as well as engineering costs and many others like marketing, distribution, services cost etc. They hold that knowledge of these costs is very essential for planning, improvement, quality management, enhancing productivity etc.

Kammlade et al. (1989:6) opine that there has been a change in the attention paid to direct labour and overhead cost has changed over last 150 years. The Research shows that the growth of overhead portion of the total cost is growing along with the manufacturing Overhead, Manufacturing overhead contributes to more than 30% of the total manufacturing cost of a typical company and administrative overheads accounting for additional thirty to fifty percent.

Kaplan (1984:96)opines that labour cost are very likely to become fixed and sunk costs. Thus, the focus has shifted from direct cost towards overheads (Turney 1996:34).

There are several situations that can result in distortion of cost such as complexity and diversity, volume of production, diversity of material, setup (Cooper (1988:49)). "Hidden Costs" or costs which originates from complexity in overhead cost allocation of the company, that cannot be explained with the output emerges. There is a genuine need to understand these hidden costs. In this context, it is good to know what Johnson and Kaplan (1991:237) say. They state that there is a need to understand the role played primary cost drivers which traditional cost management system have failed.

**Strategic Cost Management (SCM)**

There is a paradigm shift in approach to cost management. Prof. Bala Balachandran of Kellogg's School of Management argues that the business equation has changed from

"Sales = Cost + Profit to Profit = Sales - Cost". It is the cost that drives the profit and not the sales price.

There are several studies which provide insights on Strategic Cost Management. Cooper and Slagmulder (1998a:14) defined SCM as the application of cost management techniques to "simultaneously improve the strategic position of a firm and reduce costs".

Three types of cost management initiatives are suggested based on their impact on the organization's competitive position whether it is positive, negative or neutral. To cite an example let us imagine that an airline company of good repute has only two desks for selling tickets. As a result, there is a long queue and a great delay for the busy airline customer which will finally result in customer dissatisfaction and bad reputation. It will also reduce sale of tickets when compared to other airlines. One might argue that making available only two desks will make it cost effective, it will undoubtedly bring down the sales for the company in the long run. In this situation, a strategic approach to cost management could be invest on Information Technology that is online ticketing system that can bring up customer satisfaction and company growth.

Cooper (1995a:89) is of the opinion that SCMs have to consider all aspects of design, production and delivery besides purchase of accessories. One can infer here that, SCM should include every component needed for life cycle of a product. Welfie and Keltyka (2000:33) opine that SCM goes a long way in strengthening a strategic position of an organization and also reducing the cost. Similarly, Seal: (1989:117) also says that SCM must enable an organization to become competitive in cost, quality, and customer services and cost reduction. Shank and Govindarajan (1993:6ff.) stress that there is a need for clarity in understanding the cost structure of an organization in order to sustain their competitive advantage.

Michael E Porter(1998a) has also contributed to the understanding of the concept of SCM. Porter states three generic strategies for a firm to achieve competitive advantage. They are cost leadership, differentiation, and focus. While undertaking strategic cost analysis, the organization must identify its value chain which comprises five primary activities - in-bound logistics, operations, out-bound logistics, marketing and sales and services. These activities are supported by the infrastructure, human resources, technology and procurement. In this value chain, each activity is assigned cost and the behavior pattern of each activity is regulated by many factors which are termed as "cost drivers" by Porter (1998a). These cost drivers operate in an interactive way and it is management's success in coping with them that determines the cost structure.

Porter suggests that the value chain must be reconfigured or better control must be exercised over the cost drivers making use of cost driver information. The reconfiguration of value chain involves deciding on those areas of the value chain where the firm has a comparative advantage. It also need to be noted that Strategic approach to cost management should take into account "value systems, beliefs, and projections of employees; changes in business processes".

According to McIlhattan (1992: M1-1), "strategic cost management is the skillful handling or directing of costs". Horngren et al. (2000:3) state that cost management should become one of the important component general management strategies and should not be implanted in isolation. Howell and Sakurai (1992:29) equate cost management with cost down mentality. Kato (1993:37) opines that it is a good strategy to grab every possible cost reduction opportunity in the current volatile business environment, they also caution that cost reduction strategies should also have regard for "quality functions and characteristics of the product, from the customers' point of view".

The term strategic cost management has a broad focus. It is far more concerned with management's use of cost information for decision-making and not confined to the continuous reduction of costs and controlling of costs. In the opinion of Hilton et al (2001:8) who state that "SCM is a philosophy, an attitude, and a set of techniques to contribute in shaping the future of the company". SCM embodies a proactive attitude towards business in which "all the costs of the products and services result from management decisions within the company and with customers and suppliers" (Hilton et all 2001:8). Thus, this proactive attitude requires that strategic cost management must have the following attributes:1)Market orientation, 2)Holistic overview and 3)Anticipatory approach.

Hilton et all also opine that strategic cost management is a set of reliable techniques which work together to achieve goals of the organization. They term these SCM techniques as "strategic cost-management system". Thus it can be concluded that SCM system will work as a key element helping the organizations to achieve and sustain strategic competitive advantage.

**Techniques of SCM**

Review of research literature reveals that the following techniques have been used as instruments to study SCM:

- Target Costing (Seidenschwarz 1993 and Ansari et al. 1997b)
- Activity Based Costing and Activity Based Management ((Turney 1996 and Cooper and Kaplan 1998 and 1999)
- Benchmarking (Hoffjan 1997, Götze 2004 and Wage ner 2006)
- Lifecycle Costing Shields and Young 1991, Coenenberg et al. 1997, Hans en and Mowen 2000 and Götze 2004)
- Target costing refers to the process of determining the target cost by deducting the desired profit margin from the competitive market price.
- Activity-based costing (ABC) makes use of activity cost as related to outputs called cost drivers.
- Activity-based management (ABM) involves identification and evaluation of activities performed by businesses so as to make a value chain analysis.
- Benchmarking which is also known as process benchmarking which evaluates various aspects of businesses and in relation to the best practices within their own sector.
- Life Cycle Costing (LCC) refers to the technique of comparing initial investment options and identifying least cost alternatives for the life of the product.

**Cost Management Practices in Indian SMEs**

Based on the study it is learnt that in the Indian SMEs cost is taken as a given factor. Both employees and managers focus more on the output side and do not look beyond the routine processes of output production. There is hardly any discussion on cost control. For the SMEs in India, cost cutting is synonym for resource cutting, which impacts a great deal on the mindset of the employees. The employees eventually get demotivated leading degradation in the qualitative output. Secondly even such cost saving exercises are not systematic.

On the other hand, it is now realized that cost control has to be planned and a continuous process Controlling cost need not mean cutting resources. A company can choose its raw material taking in to account better logistical feasibilities instead of substituting inferior and cheaper raw material in place of original good quality raw material.

This study has also revealed that most SMEs in India lack an effective costing system which can accurately measure the cost. The existing costing system appears to be vogue and illogical. It is also found that though direct cost is linked to the final output, the method of linking direct cost and overheads is inappropriate which results in arriving at wrong cost per unit. Furthermore, there is also a mistake in accounting for indirect costs. They are brought under one aggregate item of expenditure and is spread across various products. Naturally, this unscientific way of measuring and reporting of cost leads to wrong decision making.

**An Investment**

From the foregoing discussions, it becomes clear that implementing a strategic approach to cost management becomes imperative in the current business scenario, if Indian SMEs have to contribute duly to the growth of the Indian economy. In this direction, it is imperative for us to build or establish a culture of cost consciousness in the SMEs. Experts opine that Business Owners should consider initiating a costing system in their enterprise as an 'investment' and not as an expenditure. This investment will certainly yield good returns over a long period of time. The right step in initiating a change in cost management is creating an awareness about cost control among employees. Managers need to be trained in dealing with cost data so that they develop the right outlook towards cost management.

Review meetings must be held with discussions around how and what goes into product costs. Every section or department of the company must be made aware about the impact of their respective actions on overall cost of production. Suggestions and ideas must be welcomed across the organization in order to make the system of costing fully robust.

Bottom-up communication should be encouraged rather than top-down unidirectional communication which lacks creative interaction.

**Linking Performance with Management Control**

Finally, to develop a cost conscious culture in a SME, the performance of the employees must be linked to cost management process. Management control systems like budgeting and variance analysis should be defined to measure and manage the contribution of managers towards cost consciousness. Without linking rewards to performance, the possibility of continuing with a systematic approach for cost management remains low. Hence there should be standard operating procedures for achieving targets set for cost management and control.

All the functions from manufacturing to sales should be given equal importance and weights. Cost effectiveness is not the responsibility of shop floor alone. Only when it becomes part of the entire organizational culture it finds meaningful acceptance across the enterprise.

**Strategic Cost Management (SCM) application for Indian SMEs:**

SCM has great scope for application in SMES in India. What has been attempted by enterprises so far is minimal. Following are some of the areas where SCM can be applied:

- SCM can be applied to Product Costing in order to address the deficiency in product cost information. This can be achieved using the "Cost Driver" concept of SCM.
- Sophisticated Cost information using SCMs will help to make appropriate make or buy decisions.
- Marketing channel decisions could benefit from the SCM approach. The decision to sell to specific customers through specific channels is one possibility.
- Identification and elimination of non-value adding activities has become increasingly important through Activity Analysis process.

**Conclusion**

In the current global scenario, unless the Indian SMEs make a sincere attempt to invest time and energy on evolving a suitable strategic approach to cost management, the SMEs are not likely to contribute their might for the substance of the Indian economy and also to realize the goals as projected by MSME Report of the Government of India. There is ample evidence in research studies that developing SCM is the need of the hour for Indian SMEs especially in the context of the programs like Make in India, Start up India, Skill India, Revised Public Procurement Policy, Pradhan Mantri MUDRA Yojana, and encouragement to SMEs by way of reduced corporate tax rate as announced in the latest budget.

It is hoped that studies like the present one need to be taken up on a large scale across the country so as to gather relevant local area specific data in order to arrive an indigenous model of Strategic Cost Management for Indian SMEs.

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