Abstract:

According to the latest report from the World Bank, Small and Medium Enterprises (SMEs) have been key players in most of the economies of the world, specifically in developing countries. SMEs contribute nearly 50% of employment and one third of GDPs in the growing economies. Recent estimates predicts that 80% of the formal employment will happen from the SMEs for next fifteen years.

Over last 50 years, Indian SMEs segment has become prominent, highly progressive and active part of Indian economy. These SMEs not only play a very important role in providing high employment avenues at lower investments than large industries, but also support rural areas in industrialization. As ancillary units, they support large industries and provide high contribution towards socio-economic growth of the country. SME sectors consisting of approximately 3.6 crores units currently and providing employment to over 8 Crores persons. This sector has about 8% share in the GDP and growing. Forty-five percent of the manufacturing output and forty percent of the exports comes from these SMEs in India.

Though SMEs have major contribution towards GDP growth across the globe, one of the surveys conducted by IFC (IFC Estimates 2010) shows that “nearly 24% of SMEs exit in two years and nearly 53% of SMEs disappear from the market in four years due to business loss, bankruptcy, or cost management”. According to one of the national research study commissioned April 2013 (Australia) for studying business failures of SMEs identified that absence of competency in managing the cost with strategic focus, forecasting rising costs contribute to 61% of the reasons for business failure of SMEs.

Managing the cost with a strategic focus becomes very important to respond to the challenging economic times faced by business today. Strategic Cost management
(SCM) is an important prerequisite for an enterprise to gain advantages in modern increasingly competitive market.

SCM identifies and removes activities and processes that do not drive business value, sizes the business for remaining tasks, assigns the right people in a purpose-built organization to complete them, and tracks outcomes. It also enables companies to reinvest savings to drive growth.

The present paper is an attempt to analyze Strategic Cost Management (SCM) Practices adopted by SMES in India and how these practices impact their Business performance.

In this paper I have discussed the paradigm shift in cost management leading the Strategic Cost Management in the introductory section followed by SME Growth and their issues with specific emphasis on the cost and profitability management in the second part. Conclusion has been in the third section.

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

1. Cost Management: A Paradigm Shift

1.1 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 Brimson 1988:86) “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).

With the growing complexity of business environment, many studies argued that “traditional cost management systems are inadequate to address their business requirements”. According to Eiler et al. (1982:133ff.), “traditional cost management systems are slow to present information, and they are very expensive to operate”. “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) emphasized that “traditional cost management systems can weaken your competitive position by
encouraging an organization to set the wrong priorities and focus on the wrong problems; they can lead an organization to: focus on the wrong markets, serve the wrong customers, increase the cost of production, incorrectly change the structure of an organization, institute cost cutting programs that fail, and obtain the wrong parts from outside suppliers (incorrect sourcing decisions)”.

Shank and Govindarajan (1989:5) asserted that “the ideal goal in designing an accounting system (determination of exactly where customer value can be enhanced or cost lowered) is a function radically different from traditional record keeping. 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”.

According to Johnson and Kaplan (1991:234) “the traditional cost management systems mainly focus on short-term costs. Due to decrease share of this costs, cost management systems should more and more focus on long-term product costs; long-term product costs comprise costs of design, development, and engineering as well as costs which originate from areas out of the company (marketing, distribution, service costs) plus fixed costs, which can be linked with production output. Yet knowing these costs is critical for companies engaging in such tasks as continuous improvement, total quality management, environmental management, productivity enhancement, and strategic management. In recent years, the significance of overhead has increased extremely. Knowledge workers, particularly engineers and software specialists, have displaced much of the direct labor force in many plants. In some cases, overhead costs outside the plant - engineering, marketing and distribution - has increased to where it exceeds direct labor costs”.

As per Kammlade et al. (1989:6) “the relative importance of direct labor and overhead has changed over 150 years”. Kammlade et al. (1989:6) suggested that the growth of overhead portion of the total cost is growing along with the manufacturing Oversead. 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) suggests that, "Not only will labor costs be mostly fixed; many of them will become sunk costs”. Thus, the focus has shifted from direct cost towards overheads (Turney 1996:34).

“Changes in the manufacturing technologies such as robotics, internet of things, flexible manufacturing system, just in time philosophy have decreased the direct labor component and increased the overhead component of total cost. This has resulted in product cost distortion due to allocating overhead costs on products based on the direct labor hours used by each products” According to Boer. (Boer 1994:22). “This means that some products have costs that are too low and others have costs that are too high, and almost all products have costs that are WRONG”. Cost distortion has many
adverse side-effects. Wrong product cost data leads managers take wrong decision about marketing, product design, capital equipment make or buy decisions. The cost is very important component for any decision and decisions based on the wrong cost could lead to disastrously bad decisions.

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. In order to make these hidden cost visible, “we need to start understanding the primary cost drivers, a goal that all virtually traditional systems fail miserably to achieve” (Johnson and Kaplan 1991:237).

According to Cooper and Slagmulder, “Increased in automation resulted in shifting of direct labor costs to overhead costs. There are many examples: like procurement costs, for example, rise and in some cases fifty percent or more of the product costs are part of these two types of costs. For steel companies, that number goes up to seventy five percent and its ninety percent in the petrochemical industry. Even at service companies, the figure is typically a hefty thirty five percent. Bringing down procurement costs can have a dramatic effect on the bottom line - a five percent cut can translate into a thirty percent jump in profits. Traditional cost management systems are unable to illustrate the costs of obtaining raw materials and individual parts detailed enough, in order to realize the necessity of optimizing the procurement processes. Also, in traditional cost management systems, procurement costs are allocated to products arbitrarily” (Cooper and Slagmulder 1998b:16).

Traditional cost management systems with such lamination can lead to wrong decisions and thus resources are not well distributed. Performance of the company may get affected with these input cost data. This lead to new thinking of modern cost management approach called “Strategic Cost Management”

1.2 Strategic Cost Management (SCM):

Prof. BalaBalachandran of Kellogg’s School of Management argues that the business equation changed from “Sales = Cost + Profit to Profit = Sales – Cost”. It is the cost that drives the profit and not the sales price.

Literature review provides more insights on the Strategic Cost Management. Cooper and Slagmulder (1998a:14) argued that “strategic cost management is the application of cost management techniques so that they simultaneously improve the strategic position of a firm and reduce costs”. Three types of cost management initiatives are suggested based its impact on the organization's competitive position is positive, negative or neutral. An example of a cost management initiative that strengthens an organization's position is illustrated as follows. “A hospital redesigns its patient admission procedure so it becomes more efficient and easier for patients. The hospital will become known for its easy admission procedure so more...
people will come to that hospital if the patient has a choice. The strategic position of the hospital has just been increased over its competitors”. The second example of a cost management initiative that has no impact on the organization's competitive position is explained as follows. “An insurance company decides to reevaluate its accounts payable system to make it more efficient. The evaluation has no positive benefits to the insurance company in the external market. The objective of the change is to make the organization more profitable”. The third example of a cost management initiative that will weaken the organization's competitive position is illustrated as follows. “A large airline company only has two desks for administering and selling tickets. This set-up induces long lines for the airline customer which can ultimately result in high dissatisfaction and a bad reputation for the airline. This may reduce the amount of ticket sales when compared with the airline's competitors. Even though having only two desks available for customers may initially be cost effective, in the long run, it harms the company”. As a general rule, “an organization should never undertake any practices that are predicted to weaken the position of the organization”.

Furthermore, Cooper (1995a:89) argued that “strategic cost management needs to include all aspects of production and delivering the product; the supply of purchased parts, the design of products and the manufacturing of these products. So, 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”. According to Welfie and Keltyka (2000:33) “strategic cost management is an area that holds exciting possibilities for accountants”. They also emphasized that “strategic cost management attempts to improve the strategic position of an organization and reduces costs at the same time and it is important because global competition means that firms must be constantly aware of their strategic position”. According to Seal: (1989:117) “An organization must compete in the areas of cost, quality, customer service, and flexibility with any cost reduction efforts contributing to an improved strategic position” “A sophisticated understanding of an organization's cost structure can go a long way in the search for sustainable competitive advantage”, this point is emphasized by Shank and Govindarajan (1993:6ff.) who define strategic cost management as "the managerial use of cost information explicitly directed at one or more of the four stages of strategic management: (1) formulating strategies, (2) communicating those strategies throughout the organization, (3) developing and carrying out tactics to implement the strategies, and (4) developing and implementing controls to monitor the success of objectives".

Michael E Porter has also provided contribution to the development of strategic cost management. Accordingly to Porter (1998a) “a firm has a choice of three generic strategies in order to achieve sustainable competitive advantage. They are cost leadership, differentiation, and focus”. Porter advocates “the use of strategic cost analysis where cost leadership is selected as
a strategy. The first step in undertaking strategic cost analysis is to identify the firm's value chain. The company's value chain can be defined as the linked set of activities starting from basic raw material sources to the ultimate end-use products delivered into the final consumer's hands. The value chain comprises of five primary activities and a number of support activities. The primary activities are defined sequentially as inbound logistics, operations, outbound logistics, marketing and sales and services. They are supported by activities such as the firm's infrastructure, human resource management, technology and procurement”. In the value chain, costs and assets are assigned to each activity.

The cost behavior pattern of each activity depends on a number of causal factors which Porter calls “cost drivers”. These cost drivers operate in an interactive way and it is management's success in coping with them that determines the cost structure. The strategic cost analysis also involves identifying the value chain and the operation of cost drivers of competitors in order to understand relative competitiveness. Porter advocates that “organizations should use this information to identify opportunities for cost reduction, either by improving control of the cost drivers or by reconfiguring the value chain. The latter involves deciding on those areas of the value chain where the firm has a comparative advantage. It is essential that the cost reduction performance of both the organization and its principal competitors is continually monitored if competitive advantage is to be sustained. Strategic cost management needs the support of top management, employees as well as information technology because effective and timely communication is a prerequisite for implementing it. Finally, strategic cost management has to consider the value systems, beliefs, and projections of employees; changes in business processes and in the ways activities are carried out have to be supported by incentive and other non-monetary systems - strategic cost management has to create win/win situations and to communicate effectively the benefits for all involved”. According to McIlhatten (1992: M1-1), “strategic cost management is the skillful handling or directing of costs”. Horngren et al. (2000:3) pointed out that “cost management is not practiced in isolation. It is often carried out as a key part of general management strategies and their implementation. Cost management has a broad focus. It includes the continuous reduction of costs. They define strategic cost management as the set of actions that managers take to satisfy customers while continuously reducing and controlling costs”. Howell and Sakurai (1992:29) speak “of a cost down mentality as a synonym for cost management”. Kato (1993:37) added that “in today's ever-changing environment, pursuing every possible cost reduction opportunity is surely a good strategy, but warns that it is essential to avoid reducing costs without regard for the 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. Strategic cost
management focusses on using cost management techniques that reduce costs and improve the strategic position of a firm at the same time. At this point the researcher advocates that strategic cost management is a philosophy, an attitude, and a set of techniques to contribute in shaping the future of the company (Hilton et al. 2001:8).

According to Hilton et all 2001:8, “First, strategic cost management is a philosophy of improving cost and revenue; strategic cost management is not only cost management but also revenue management, therefore, it is seeking to improve productivity, maximize profit, and improve customer satisfaction. This philosophy plays a vital role in determining the future of the company because it promotes the idea of continually finding ways to help organizations make the right decisions to create more customer value at lower cost. An organization's products and services are measures of customer value through quality products, superior customer service, fair pricing, etc. Customer value is measured by both the price that customers are willing to pay and their satisfaction with products and services (McNaughton et al. 2001:537). Efficient companies provide products and service that customer’s want by using the minimum of the organization's scarce resources, while continuously seeking to improve value, costs, and revenue. Second, strategic cost management represents a proactive attitude that all the costs of the products and services result from management decisions within the company and with customers and suppliers. Thus, this proactive attitude requires that strategic cost management must have the following attributes: Market orientation: strategic cost management considers customer needs and competitive behavior. Holistic overview: strategic cost management takes a broad focus including the entire value chain and product life cycle. Anticipatory approach: strategic cost management starts in the product design stage and aims to influence the future cost position. Continuous: strategic cost management is a permanent task. It ensures continuous improvements. Participation: strategic cost management requires involvement of every employee. Cross-functional: strategic cost management integrates business functions. Third, strategic cost management is a set of reliable techniques. These techniques or instruments may be used individually to support a specific goal or together to serve the overall needs of the organization. A set of strategic cost-management techniques that function together to support the organization's goals and activities is called a strategic cost-management system”

Hansen and Mowen (2000:31) noted that “When designing a cost-management system, we must consider many tradeoffs such as costs and benefits of cost management system. For example, the ideal cost-management system may provide any desired information, in any desired format, and on demand to any authorized person in the organization. However, the benefits of such an ideal system may not justify the cost of building and maintaining such a system. In general, an organization should seek to build the simplest, most economical cost-management system that serves the overall needs of management in the contemporary business environment”
To attain and sustain a strategic competitive advantage through long-term anticipation and formation of cost level, structure, and costs behavior patterns for products, processes and resources, Strategic Cost Management has emerged as a key element.

2. Indian SME Sectors:

Globally, SMEs contribute over 90% of Business Enterprises and 50-60% of Total Employment. 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. In Europe (2002-2007), number of SMEs grew by 11%, and number of employees went up by 9% vis-à-vis 4% and 3% respectively for the larger enterprises.

Small and Medium Enterprises (SMEs) are important components for development of a country

- Helps reshaping the productive sectors
- Generates employment
- Creating an environment for entrepreneurship
- Promotes innovation

2.1: SMEs in India

Over last 50 years, Indian SMEs segment has become prominent, highly progressive and active part of Indian economy. These SMEs not only play a very important role in providing high employment avenues at lower investments than large industries, but also support rural areas in industrialization. As ancillary units, they support large industries and provide high contribution towards socio-economic growth of the country. SME sectors consisting of approximately 3.6 crores units currently and providing employment to over 8 Crores persons. This sector has about 8% share in the GDP and growing. Forty-five percent of the manufacturing output and forty percent of the exports comes from these SMEs in India.

Micro, small and medium enterprises as per MSMED Act, 2006 are defined based on their investment in plant and machinery (for manufacturing enterprise) and on equipment for enterprises providing or rendering services. The present ceilings on investment for enterprises to be classified as micro, small and medium enterprises are as follows:

**Definition of MSMEs in India**
(As Per Micro, Small & Medium Enterprises Development (MSMED) Act, 2006)

<table>
<thead>
<tr>
<th>Description</th>
<th>INR</th>
<th>USD($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Enterprises</td>
<td>up to Rs. 25Lakh</td>
<td>up to $ 62,500</td>
</tr>
<tr>
<td>Small Enterprises</td>
<td>above Rs. 25 Lakh &amp; up to Rs. 5 Crore</td>
<td>above $ 62,500 &amp; up to $ 1.25 million</td>
</tr>
<tr>
<td>Medium Enterprises</td>
<td>above Rs. 5 Crore &amp; up to Rs. 10 Crore</td>
<td>above $ 1.25 million &amp; up to $ 2.5 million</td>
</tr>
</tbody>
</table>
Service Enterprises – Investment in Equipment’s

<table>
<thead>
<tr>
<th>Description</th>
<th>INR</th>
<th>USD($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro Enterprises</td>
<td>up to Rs. 10 Lakh</td>
<td>up to $ 25,000</td>
</tr>
<tr>
<td>Small Enterprises</td>
<td>above Rs. 10 Lakh &amp; up to Rs. 2 Crore</td>
<td>above $ 25,000 &amp; up to $ 0.5 million</td>
</tr>
<tr>
<td>Medium Enterprises</td>
<td>above Rs. 2 Crore &amp; up to Rs. 5 Crore</td>
<td>above $ 0.5 million &amp; up to $ 1.5 million</td>
</tr>
</tbody>
</table>

By 2015, India likely to become USD 5 trillion economy expected to touch a GDP of 8.5%. Given the right set of support and enabling framework, the MSME segment has the potential to emerge as a backbone for this economy and act as an engine for growth. Accordingly MSME at a Glance 2016 Report, “The MSME opportunity is to develop entrepreneurship and support growth led by innovation over the next decade by: a) Significantly increasing the share of MSME contribution to GDP from the current 8 per cent to 15 per cent by 2020; b) Generate employment levels to the extent of 50% of the overall employment, more than doubling the current MSME workforce of 106 million across agricultural, manufacturing and services sectors; and c) Increasing the share of MSME contribution across key public and private industry sectors fulfilling increasing domestic demand, growth in exports, indigenization and import substitution”

As per the Annual Report 2015-16 published by Ministry of Micro, Small and Medium Enterprises (MSME), Government India, “MSME has shown constant growth rate around 11% every year till 2010-11. The highest growth in recent time was recorded during 2011-12 (18.45%) whereas during year 2012-13 and 2013-14 growth rate was around 14% and 12%, respectively. But it jumped to 17% in 2014-15. However, recent data for 2015 i.e., from April-September, 2015 shown impressive growth of 18.74% (year-on-year growth)”

STATE/UT WISE DISTRIBUTION OF NUMBER OF MSME DURING 2007-08 TO 2015-16 (SEPTEMBER) (based on EM-II Filings)"
SMEs report significantly poorer profitability than large corporation based on the data collated from Center for Monitoring Indian Economy (CMIE) as presented in the chart below.

Data Source: Center for Monitoring Indian Economy (CMIE)

Though the MSMEs show impressive growth year on year, the survey conducted by IFC (IFC Estimates 2010) shows that “nearly 23.7% of SMEs disappear in two years and nearly 52.7% of SMEs exit the market in four years due to business failure, bankruptcy, or other reasons”. One of the recent surveys conducted to analyze the reasons for business failure indicates that “an inability to manage costs or anticipate rising costs is among the top reasons for SME’s business failures”. Of those surveyed, “61% of SME operators said small businesses failed because of an inability to manage costs, 50% said inexperienced management, 50% said poorly designed business models or no business plan, 49% said insufficient capital, 37% said poor or insufficient marketing, and 35% said insufficient time managing the books”. Inability to manage and anticipate cost will result in reduced profitability and continued reduction in profitability will finally results SMEs disappear or exit.

This survey result is also strengthened by the recent report from Centre for Monitoring Indian Economy (CMIE). According to the
report “the SME sector, which lacks entry barrier such as brand equity or technology is exposed to significant competitive pressure; and these pressures partly account for the sectors low profitability margins”.

**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 applied

- SCM can be applied to Product Costing in order 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 of 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. This process help identify activities that add cost but no value to the customer.

**3. CONCLUSION:**

To attain and sustain a strategic competitive advantage through long-term anticipation and formation of cost level, structure, and costs behavior patterns for products, processes and resources, Strategic Cost Management has emerged as a key element.

From the review of the literatures, it is observed that one of key reasons for maximum number of SMEs exit with in four years is their ability to manage their cost with strategic focus. There is almost unanimous agreement among studies that strategic cost management impacts positively on SMEs performance. Adopting Strategic Cost Management practices would be helpful for the Indian SMEs to overcome the finance related challenges and make them cost effective and more competitive in the market. The application of strategic approach in the management of SMEs thus requires further studies that will develop a consistent theory for strategic cost management for all concerned.

**REFERENCES**

Abeer Mohammed El-Hwaity:(May, 2013) “Strategic Cost Management To Maximize The Value Of The Organization And Its Competitive Advantage”


Strategic Cost Management. Management Accounting, Vol. 79 No. 8, P.16-18”


**Ibrahim Abd El Mageed Ali El Kelety:**
“Towards a conceptual framework for strategic cost management - The concept, objectives, and instruments –Research July 2006”


**David A.J. Axson and Aneel Delawalla :”**
Good intentions in cost management are not good enough”

**Accenture Cost Management Survey –**
“Achieving Sustainable Growth through Strategic Cost Management - Insights from the Accenture Cost Management Survey”

**Implementing Activity-Based Management:**
“Avoiding the Pitfalls – Published by Institute of Management Accountants www.imanet.org”

**Journals:**


**The Management Accountant**, Journal of Institute of Cost and Works Accountants of India Vol 45, No. 05 May 2010

**Chartered Institute of Management Accountants (CIMA):** Management Accounting Practices of (UK) Small-Medium-Sized Enterprises (SMEs): Improving SME performance through Management Accounting Education: Volume 9 | Issue 4: July 2013

**Reports:**

MSMEs at a glance 2016: Government of India: Ministry of Micro, Small and Medium Enterprises


World Retail Banking Report 2009-10

Estimates IFC 2010

UNIDO Report 2009-10

Centre for Monitoring Indian Economy (CMIE) Report (https://www.cmie.com/)
SMEs – the fine line between failure and success- SMEs CCH Research Report
ENTREPRENEURS MEMORANDUM (PART-II) DATA ON MSME SECTOR: 2014-15:
Development Commissioner (Micro, Small & Medium Enterprises) Ministry Of Micro, Small & Medium Enterprises, Nirman Bhawan, New Delhi – 110 108

Author’s Profile:

Chidambara Ganapaiah
FCMA, CMA (USA), PMP, EGMP (IIMB)
Research Scholar,
CMR University, Bangalore
chidambara.upadhya@gmail.com