Paper 15 - Business Strategy & Strategic Cost Management

Section A – Business Strategy

SN 1: Business Strategy

1. **Read the following case let and answer the following:**

Dr. Sukumar inherited his father's Dey's Lab in Delhi in 1995. Till 2002, he owned 4 labs in the National Capital Region (NCR). His ambition was to turn it into a National chain. The number increased to 7 in 2003 across the country, including the acquisition of Platinum lab in Mumbai. The number is likely to go to 50 within 2-3 years from 21 at present. Infusion of ₹ 28 crores for a 26% stake by Pharma Capital have its growth strategy.

The lab with a revenue of ₹ 75 crores is among top three Pathological labs in India with Atlantic (₹77 crores) and Pacific (₹ 55 crores). Yet its market share is only 2% of ₹3,500 crores market. The top 3 firms command only 6% as against 40-45% by their counterparts in the USA.

There are about 20,000 to 1,00,000 stand alone labs engaged in routine pathological business in India, with no system of mandatory licensing and registration. That is why Dr. Sukumar has not gone for acquisition or joint ventures. He does not find many existing laboratories meeting quality standards. His six labs have been accredited nationally whereon many large hospitals have not thought of accreditation; The College of American pathologists accreditation of Dey's lab would help it to reach clients outside India.

In Dey's Lab, the bio-chemistry and blood testing equipments are sanitized every day. The bar coding and automated registration of patients do not allow any identity mix-ups. Even routine tests are conducted with highly sophisticated systems. Technical expertise enables them to carry out 1650 variety of tests. Same day reports are available for samples reaching by 3 p.m. and by 7 a.m. next day for samples from 500 collection centres located across the country. Their technicians work round the clock, unlike competitors. Home services for collection and reporting is also available.

There is a huge unutilised capacity. Now it is trying to top other segments. 20% of its total business comes through its main laboratory which acts as a reference lab for many leading hospitals. New mega labs are being built to Encash preclinical and multi-centre clinical trials within India and provide postgraduate training to the pathologists.

Required:

(a) What do you understand by the term Vision? What is the difference between 'Vision' and 'Mission'? What vision Dr. Sukumar had at the time of inheritance of Dey's Lab? Has it been achieved?

(b) For growth what business strategy has been adopted by Dr. Sukumar?

(c) What is the marketing strategy of Dr. Sukumar to overtake its competitors?

(d) In your opinion what could be the biggest weakness in Dr. Sukumar's business strategy?

Answer

(a) A Strategic vision is a road map of a company's future – providing specifics about technology and customer focus, the geographic and product markets to be pursued, the capabilities it plans to develop, and the kind of company that management is trying to create. A strategic vision thus points an organisation in a particular direction, charts a strategic path for it to follow in preparing for the future, and moulds organizational identity.

A company's Mission statement is typically focused on its present business scope – "who we are and what we do". Mission statements broadly describe an organisation's present capabilities, customer focus, activities, and business makeup. Mission is also an expression of the vision of the corporation. To make the vision come alive and become relevant, it needs to be spelt out. It is through the mission that the firm spells out its vision.

Dr. Sukumar's vision at the initial stage was to turn his one pathological laboratory firm into a national chain of pathological laboratories. He is in the process of achieving the vision as a number of Labs have been opened and others are in pipeline. However, at the same time the market share is low when compared with the external benchmark from US market.

(b) To a large extent Dr. Dey's Lab has opted the business strategy of internal growth rather than going in for acquisitions or joint ventures. The reason for such a strategy is that Dr. Sukumar does not find many existing laboratories meeting the quality standards. To fund its growth and raise funds it has also given a 26% stake to Pharma Capital.

(c) Dr. Sukumar's marketing strategy is superior to its competitors. Over a period of time it is able to evolve itself as reference lab for many leading hospitals. This is a testimony of the level of confidence it enjoys among the medical professionals. It provides a high level of customer services because of the following:

- **Product mix:** It possesses technical expertise to conduct 1650 variety of tests.
- **Quality:** The laboratories use modern methods to conduct tests. Even routine tests are conducted with highly sophisticated procedures. Technology such as bar coding and automated registration of patients is also used. Thus there are no mistakes in the identity of samples. There is also daily sanitization and validation of lab equipments.
- **Speed:** Laboratories are working round-the-clock. Further, using modern systems the company is able to deliver test results faster.
- **Convenience:** There are 500 collection centres for the laboratory, thereby the reach is more. Additionally, system of collection of samples from home also provide convenience to the patients and others.

(d) A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it. In the case it is given that Dr Sukumar has not gone for mergers and acquisition as he does not find many prospective laboratories meeting the quality standards.

Thus its biggest weakness is its inability to capitalize the opportunities through mergers and acquisitions. Acquisitions and partnerships can help in leveraging the existing goodwill.

Many of these labs must be enjoying a lot of goodwill in their region. In fact, a business in the medical field such as a pathological laboratory, trust and faith are important. On account of its size and available resources Dey's Lab could have easily acquired some of these labs and built upon their names. With resources it should be feasible to modernize them to make them compatible with the business ideology and quality systems of the Dey's Lab. However, it appears that the company lacked capability to modernize an existing laboratory.

2. (a) An important part of strategic management process is implementation of strategy. Discuss the relationship of soundness of strategy with the quality of implementation.

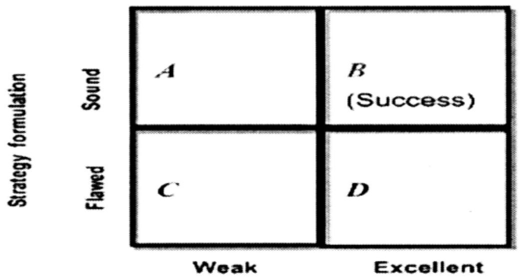
(b) Under what conditions would you recommend the use of Turnaround strategy in an organization.

(c) Explain the term "Strategy". Describe the four generic strategies as discussed by Glueck and Jauch.

Answer:

(a) Strategy implementation concerns the managerial exercise of putting a freshly chosen strategy into place. Strategy execution deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results. Strategic implementation is concerned with translating a decision into action, with presupposes that the decision itself was made with some thought being given to feasibility and acceptability.

It is crucial to realize the difference between strategy formulation and strategy implementation because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent. There is no such thing as successful strategic design. This sounds obvious, but in practice the distinction is not always made. The matrix in the figure below represents various combinations of strategy formulation and implementation:



(b) Rising competition, business cycles and economic volatility have created a climate where no business can take viability for granted. Turnaround strategy is a highly targeted effort to return an Organization to profitability and increase positive cash flows to a sufficient level. Organizations those have faced a significant crisis that has negatively affected operations requires turnaround strategy. Turnaround strategy is used when both threats and weaknesses adversely affect the health of an organization so much that its basic survival is a question. When organization is facing both internal and external pressures making things difficult then it has to find something which is entirely new, innovative and different. Being organization‟s first objective is to survive and then grow in the market; turnaround strategy is used when organization's survival is under threat. Once turnaround is successful the organization may turn to focus on growth. Conditions for turnaround strategies When firms are losing their grips over market, profits due to several internal and external factors, and if they have to survive under the competitive environment they have to identify danger signals as early as possible and undertake rectification steps immediately. These conditions may be, inter alia cash flow problems, lower profit margins, high employee turnover and decline in market share, capacity underutilization, low morale of employees, recessionary conditions, mismanagement, raw material supply problems and so on.

(c) Businesses have to respond to a dynamic and often hostile environment for pursuit of their mission. Strategies provide an integral framework for management and negotiate their way through a complex and turbulent external environment. Strategy seeks to relate the goals of the organization to the means of achieving them. A company's strategy is the game plan management is using to stake out market position and conduct its operations. A company's strategy consists of the combination of competitive moves and business approaches that managers employ to please customers compete successfully and achieve organizational objectives. Strategy may be defined as a long range blueprint of an organisation's desired image, direction and destination what it wants to be, what it wants to do and where it wants to go. Strategy is meant to fill in the need of organizations for a sense of dynamic direction, focus and cohesiveness.

The Generic Strategies: According to Glueck and Jauch there are four generic ways in which strategic alternatives can be considered. These are stability, expansion, retrenchment and combinations.

(i) Stability strategies: One of the important goals of a business enterprise is stability to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimize returns on the resources committed in the business.

(ii) Expansion Strategy: Expansion strategy is implemented by redefining the business by adding the scope of business substantially increasing the efforts of the current business. Expansion is a promising and popular strategy that tends to be equated with dynamism, vigor, promise and success. It is often characterized by significant reformulation of goals and directions, major initiatives and moves involving investments, exploration and onslaught into new products, new technology and new markets, innovative decisions and action programmes and so on. Expansion includes diversifying, acquiring and merging businesses.

(iii) Retrenchment Strategy: A business organization can redefine its business by divesting a major product line or market. Retrenchment or retreat becomes necessary or expedient for coping with particularly hostile and adverse situations in the environment and when any other strategy is likely to be suicidal. In business parlance also, retreat is not always a bad proposition to save the enterprise's vital interests, to minimize the adverse environmental effects, or even to regroup and recoup the resources before a fresh assault and ascent on the growth ladder is launched.

(iv) Combination Strategies: Stability, expansion or retrenchment strategies are not mutually exclusive. It is possible to adopt a mix to suit particular situations. An enterprise may seek stability in some areas of activity, expansion in some and retrenchment in the others. Retrenchment of ailing products followed by stability and capped by expansion in some situations may be thought of. For some organizations, a strategy by diversification and/or acquisition may call for a retrenchment in some obsolete product lines, production facilities and plant locations.

3.(a) Strategic control, financial control, and strategic planning are three ways of dividing responsibilities between corporate centre and its business units. Discuss these three ways and contrast them.

(b) The competitive (positioning) and competence (resource-based) views are two dominant theoretical perspectives in strategic management. Compare and contrast these two perspectives. Give examples to support your arguments.

Answer:

(a) The responsibilities for strategic decision making between business units and corporate centre are divided in the following three ways:

Strategic planning: It refers to the particular style of relationship between the centre and business units. This is the most centralized form in among all the three styles. The centre is the master planner recommending detailed roles for departments and business units, whose roe is basically limited to the operational delivery of the plan. The centre orchestrates, coordinates and controls all of business unit activities through the extensive use of the formal planning and control system. The centre also directly manages the infrastructure and provides many corporate services.

Financial Control: It is the most extreme form of decentralization, dissolving the organization into highly independent business units. In this style, the role of the centre is limited to setting financial targets, allocating resources, appraising performance and dominant to avoid or correct poor performance. These involvements would usually be replacing business unit managers rather than dictating changes in strategies. Therefore, the dominant processes are performance targets and business unit managers and held strictly responsible for meeting these targets.

Strategic control: This style is mostly operates in the organizations. It lies between the two extremes of the strategic planning and financial control styles. The relationship between the centre and the business units is one of a parent who behaves as a strategic shaper. Influencing the behavior in business units and forming the context within which manages are operating.

Contrast:

- Strategic planning is more appropriate where corporate managers have a detailed working knowledge of each business units whereas financial control is more appropriate to organizations operating in suitable where the centre has little knowledge about business unit strategies and operations.
- Strategic planning is more suitable where business unit strategies are of a size of sensitivity that can have major implication for the whole corporate whereas financial control is only a short time lag between management decisions and the financial consequences. Similarly strategic control is built through the processes of supportive strategic with business units but within central boundaries and guidelines.
- In strategic planning, there are bureaucratic costs of centralization and de-motivating effects on business unit manager who may feel little commitment to strategies handed down from the centres but in financial control, the business units are focused on meeting tough short term target set by a centre that does not have the resources or the competences to manage the knowledge creations and integration process. In strategic control the biggest risk would be the centre which tries to shape strategies without being clear about the corporate logic or having the competencies essentially to add value in these ways.

(b) When a firm sustains profits that exceed the average for its industry, the firm is said to process competitive advantage over its rivals. The goal of business strategy is to achieve sustainable competitive advantage.

There are two basic types of competitive advantage:

(i) Cost advantage
(ii) Differentiation advantage

A resource based view emphasizes that a firm utilizes it resources and capabilities to create a competitive advantage that ultimately results in superior value creation.

In order to develop distinctive capabilities a firm should have both resources and capabilities. In absence of any one of them the competitors can replicate and any prevailing advantage would disappear.

Resources can be described as the firm's specific assets which are useful for creating a cost or differentiation advantage which only few competitors can acquire, whereas capabilities are the firms ability to utilize the available resources in an effective manner. Capabilities are not documented; indeed they are embedded in the routine process of the organization which makes it difficult for the competitors to replicate. E.g. the ability of the organization is to bring a product to the market faster than the competitors. The competitive advantage usually is a fall out of the resource based competencies held by the organization.

A firm is said to be in a competitive position when it implements a value creating strategy which is simultaneously not being implemented by its competitors and also is Valuable, Rare, Hard to Imitate and Non-Substitutable.

Further, an organization can position itself in the market on the basis of cost or differentiation strategy. A cost advantage can be created by the effective use of available resources in order to reduce the cost of the product so as to compete in the market with the products of the competitors on the basis of low cost. Whereas, the competitive edge can be also be achieved by differentiation strategy, where the product is differentiate by a competitor's product on certain features which are not easily replicable.

A competitive edge or a competence cannot add value to an organization alone. This is due to the fact that a competitive positioning of an organization is completely dependent on the resource based competence possessed by the firm.

SN 2: Strategy Development

4.(a) Logical incrementalism is widely used by organizations to develop its strategy. Explain the term "logical incrementalism" and describe the major steps (or characteristics) involved when it is used it for strategy development. Give an example to illustrate your understanding.

(b) Describe strategic leadership. Discuss about the two approaches to leadership style.

Answer:

(a) Logical Incrementalism is a philosophy of achieving broad organizational goals by making strategic decisions in small steps. The small steps to resolve conflicting views of participants and reduce risk by capitalizing on knowledge that is gained during the process. Logical Incrementalism benefits from flexibility, but is likely to be time-consuming and inefficient.

Characteristics of Logical Incrementalism

- **Environmental uncertainty**: The Managers realize that they cannot do away with the uncertainty of their by relying on analysis of historical data or predicting how it will change. Rather, they try to be sensitive to environmental signals by encouraging constant environmental scanning through the organization. It can be also said that it is a situation where the management of a firm has little information about its external environment that is in a state of flux and, hence, largely unpredictably.
- **Generalized views of strategy:** Managers have a generalized rather than specific view of where they want the organization to be in the future and try to move towards this position incrementally. There is also a reluctance to specify precise objectives too early as this might stifle ideas and prevent innovation and experimentation. Objectives may therefore be general in nature.
- **Experimentation:** Managers may seek to develop strong secure, but flexible core business. They will then build on the experience gained in that business to inform decisions both about its development and experimentation with 'side-bet' bet ventures. Commitment to strategic options may therefore be tentative to the early stages of strategy development. Such experiments are not be sole responsibility of top management.
- **Coordinating emergent strategies:** Top managers may then utilize a mix of formal and informal social and political process to draw together an emerging pattern of strategies from these subsystems. These may then be formed into coherent statements of strategy for stakeholders that need to understand the organization's strategy.

Pros and Cons of Logical Incrementalism

The advantages of incrementalism over other formal systems is that no time is wasted planning for outcomes which may not occur. Disadvantages are that time may be wasted dealing with the immediate problem and no overall strategy is developed.

HP using Logical Incrementalism
Hewlett Packard is another company which follows Logical Incrementalism. A core technology in test and measurement lead them to improve things for the customer that led them to begin to develop computer capabilities, information processing capabilities, because that was part of building better test and measurement organizations. And then they began to apply those same ideas in other ways into the computer business, the server business and the printing business, which was an offshoot of that whole approach.

(b) Strategic leadership is the ability of influencing others to voluntarily make decisions that enhance prospects for the organization's long-term success while maintaining short-term financial stability. It includes determining the firm's strategic direction, aligning the firm's strategy with its culture, modeling and communicating high ethical standards, and initiating changes in the firm's strategy, when necessary. Strategic leadership sets the firm's direction by developing and communicating a vision of future and inspire organization members to move in that direction. Unlike strategic leadership, managerial leadership is generally concerned with the short-term, day-to-day activities.
Two basic approaches to leadership can be transformational leadership style and transactional leadership style.
Transformational leadership style use charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leadership style may be appropriate in turbulent environments, in industries at the very start or end of their life-cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a „dream‟ or „vision‟ of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.
Whereas, **Transactional Leadership** style focus more on designing systems and controlling the organizations activities and are more likely to be associated with improving the current situation. Transactional leaders try to build on the existing culture and enhance current practices. Transactional leadership style uses the authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leadership style may be appropriate in settled environment, in growing or mature industries, and in organizations that are performing well. The style is better suited in persuading people to work efficiently and run operations smoothly.

5. (a) Define Strategic drift. Discuss what can an organization do no prevent Strategic Drift.
(b) Define Learning Organization. Explain its benefits.
(c) Distinguish between Strategic Management and Strategic Planning.

Answer:
(a) The greatest challenge for ensuring a successful business strategy has traditionally been within its "execution" rather than "planning." The reason is simple: unexpected challenges always and constantly arise. As an outcome of these uncertainties leaders field countless requests and participate in many debates over whether or not to change the direction of their strategy to mitigate the newly arisen risks. This often leaves everyone questioning.... "Should **we stay the course or abandon and redirect our focus elsewhere?"** Learning to navigate these issues will support you in an ever-changing environment.
What Can an Organization do to Prevent Strategic Drift?

(i) First, start with creating a culture that is not only openly tolerant of feedback (both positive and negative) but welcomes it.

(ii) Make sure the organization can both
   a. Embrace change when necessary, and
   b. NOT hesitate to question it when is seems unnecessary.

(iii) Clarify C-suite leadership responsibilities and execute within a formal senior decision-making model. Many unwanted surprises are nothing more than tactical or operational challenges that should be handled within individual business functions and cross-functional leadership team.

(iv) Senior executives who align their individual ROI with the long-term success of the organization will be able to quickly identify the nature of the incoming challenge as well as create contingencies to combat it when and if it occurs. This way, the organization continues along its intended direction without unnecessarily deviating.

(v) Finally, the best way to combat strategic drift is to have a Grand Strategy. A comprehensive set of corporate strategies that are designed to be durable and flexible, tailored to the strengths of the senior decision-makers and organization.

(b) A **learning organization** is the term given to a company that facilitates the learning of its members and continuously transforms itself. Learning organizations develop as a result of the pressures facing modern organizations and enables them to remain competitive in the business environment.

Three definitions of a learning organization

Learning organizations [are] organizations where people continually expand their capacity to create the results they truly desire, where new and expansive patterns of thinking are nurtured, where collective aspiration is set free, and where people are continually learning to see the whole together.

The Learning Company is a vision of what might be possible. It is not brought about simply by training individuals; it can only happen as a result of learning at the whole organization level. Learning Company is an organization that facilitates the learning of all its members and continuously transforms itself.

Learning organizations are characterized by total employee involvement in a process of collaboratively conducted, collectively accountable change directed towards shared values or principles.

Benefits

The main benefits are;

- Maintaining levels of innovation and remaining competitive.
- Being better placed to respond to external pressures.
- Having the knowledge to better link resources to customer needs.
- Improving quality of outputs at all levels.
- Improving corporate image by becoming more people oriented.
- Increasing the pace of change within the organization.

(c) The basic difference between Strategic management and Strategic planning are as follows

Strategic Management	Strategic Planning
1. It is focused on producing strategic result; new market; new products; new technologies etc.	1. It is focused on making optimal strategic decisions.
2. It is management by results.	2. It is management by plans.
3. It is an organization action process.	3. It is an analytical process.
4. It broadens focus to include psychological, sociological and political variables.	4. It is focused on business, economic and technologic variables.
5. It is about choosing things to do and also about the people who will do them.	5. It is about choosing things to do.

6. (a) Discuss Contingency Planning and its seven steps process

(b) Mention qualities of Strategic Leaders.

Answer:

(a) Contingency Planning

Planning is made on the basis of certain assumptions and conditions. If the conditions change drastically, the selected plans may have to be discarded altogether. The business firms are exposed to continuous changing economic environmental conditions. Therefore, a business organization should be well prepared to deal with contingencies i.e. unforeseen and other critical developments. A contingency plan is a plan to cope with such unforeseen consequences which mark major deviations from the strategic planning process. Such contingency plans are formulated in advance to take care of unknown events and unexpected challenges. They make the future through their proactive planning and advanced preparation. The advantage of contingency planning is that when external opportunities occur contingency plans could allow an organization to capitalize on them quickly.

Steps in Contingency Planning

Robert Lineman and Rajan Chandran have suggested that a seven step process as follows:

Steps 1 - Identify the beneficial and unfavourable events that could possibly derail the strategy or strategies.

Steps 2 - Specify trigger points. Calculate about when contingent events are likely to occur.

Steps 3 - Assess the impact of each contingent event. Estimate the potential benefit or harm of each contingent event.

Steps 4 - Develop contingency plans. Be sure that contingency plans are compatible with current strategy and are economically feasible.

Steps 5 - Assess the counter impact of each contingency plan. That is, estimate how much each contingency plan will capitalize on or cancel out its associated contingent event. Doing this will quantify the potential value of each contingency plan.

Steps 6 - Determine early warning signals for key contingency event. Monitor the early warning signals.

Steps 7 - For contingent event with reliable early warning signals, develop advance action plans to take advantage of the available lead time.

(b) Strategic leadership refers to a manager's potential to express a strategic vision for the organization, or a part of the organization, and to motivate and persuade others to acquire that vision. Strategic leadership can also be defined as utilizing strategy in the management of employees.

A few characteristics of effective strategic leaders that do lead to superior performance are as follows:

- **Loyalty-** Powerful and effective leaders demonstrate their loyalty to their vision by their words and actions.
- **Keeping them updated-** Efficient and effective leaders keep themselves updated about what is happening within their organization. They have various formal and informal sources of information in the organization.
- **Judicious use of Power-** Strategic leaders makes a very wise use of their power. They must play the power game skillfully and try to develop consent for their ideas rather than forcing their ideas upon others. They must push their ideas gradually.
- **Have wider perspective/outlook-** Strategic leaders just don't have skills in their narrow specialty but they have a little knowledge about a lot of things.
- **Motivation-** Strategic leaders must have a zeal for work that goes beyond money and power and also they should have an inclination to achieve goals with energy and determination.

- **Compassion-** Strategic leaders must understand the views and feelings of their subordinates, and make decisions after considering them.
- **Self-control-** Strategic leaders must have the potential to control distracting/disturbing moods and desires, i.e., they must think before acting.
- **Social skills-** Strategic leaders must be friendly and social.
- **Self-Awareness-** Strategic leaders must have the potential to understand their own moods and emotions, as well as their impact on others.
- **Readiness to delegate and authorize-** Effective leaders are proficient at delegation. They are well aware of the fact that delegation will avoid overloading of responsibilities on the leaders. They also recognize the fact that authorizing the subordinates to make decisions will motivate them a lot.
- **Articulacy-** Strong leaders are articulate enough to communicate the vision (vision of where the organization should head) to the organizational members in terms that boost those members.
- **Constancy/ Reliability-** Strategic leaders constantly convey their vision until it becomes a component of organizational culture.

To conclude, Strategic leaders can create vision, express vision, passionately possess vision and persistently drive it to accomplishment.

SN3: Strategic Position

7. (a) Consider Porter's three generic strategies. In your opinion, how cost – based advantages can be sustained. Give example to support your answer.

(b) Benchmarking exercise is based on "best exercise" and not on "best performances". Explain. Also state briefly the important benchmarking processes used in strategy implementation.

Answer:

(a) Porters Generic Strategies – These three generic strategies are defined along two dimensions; strategic scope and strategic strength, strategic scope is a demand-side dimension and looks at the size and composition of the market you intend to target. Strategic strength is a supply-side dimension and looks at the strength or core competency of the firm. In particular he identified two competencies that he felt were most important: product differentiation and product cost (efficiency).

(i) **Cost Leadership Strategy (Air Deccan, Tata Nano)**

This strategy involves the firm wining market share by appealing to cost-conscious or price-sensitive customers. This is achieved by having the lowest prices in the largest market segment, or at least the lowest price to value ratio. To succeed at offering the lowest price while still achieving profitability and a high return on investment, the firm must be able to operate at a lower cost than its rivals. There are three main ways to achieve this.

The first approach is achieving a high asset turnover:

In service Industries, this may mean for example a restaurant that turns tables around very quickly, or an airline that turns around flights very fast. In manufacturing, it will involve production of high volumes of output. These approaches mean fixed costs are spread over a large number of units of the product or service, resulting in a lower unit cost, i.e., the firm hopes to take advantage of economies of scale and experience curve effects. For industrial firms, mass production becomes both a strategy and an end in itself. Higher levels of output both required and result in high market share, and create an entry barrier to potential competitors, who may be unable to achieve the scale necessary to match the firms' low costs and price.

The second dimension is achieving low direct and indirect operating costs:

This is achieved by offering high volumes of standardized products, offering basic no-frills products and limiting customization and personalization of service. Production costs are kept low by using fewer components, suing standard components, and limiting the number of models produced to ensure larger production runs. Overheads are kept low by paying low wages, locating premises in low rent areas, establishing a cost-conscious culture, etc. Maintaining this strategy requires a continuous search for cost reductions in all aspects of the business. This will include outsourcing, controlling production costs, increasing asset capacity utilization, and minimizing other costs including distribution, R & D and advertising. The associated distribution strategy is to obtain the most extensive distribution possible. Promotional strategy often involves trying to make a virtue out of low cost product features.

The third dimension is control over the supply/procurement chain to ensure low costs:
This could be achieved by bulk buying to enjoy quantity discounts, squeezing suppliers on price, instituting competitive bidding for contracts, working with vendors to keep inventories low using methods such as Just-in-Time purchasing. Wal-Mart is famous for squeezing its suppliers to ensure low prices for its goods. Dell Computer initially achieved market share by keeping inventories low and only making computers to order. Other procurement advantages could come from preferential access to raw materials or backward integration.

(ii) **Differentiation Strategy**

Can be in Production Differentiation

Differentiation is aimed at the broad market that involves the creation of a product or services that is perceived throughout its industry as unique. The company or business unit may then charge a premium for its product. This specialty can be associated with design, Brand image, technology, features, dealers, network, or customers' service. Differentiation is a viable strategy for earning above average returns in a specific business because the resulting brand loyalty lowers customers' sensitivity to price. Increased costs can usually be passed on to the buyers. Buyers' loyalty can also serve as an entry barrier-new firm must develop their own distinctive competence to differentiate their products in some way in order to compete successfully. Examples of the successful use of a differentiation strategy are Hero Honda, Asian Paints, HLL, and Nike athletic shoes, Perstorp Byproducts, Apple Computer and Mercedes Benz automobiles.

A differentiation strategy is appropriate where the target customer segment is not price-sensitive, the market is competitive or saturated, customers have very specific needs which are possibly underserved, and the firm has unique resources and capabilities which enable it to specify these needs in ways that are difficult to copy. These could include patents or other Intellectual Property (IP), unique technical expertise (e.g. Apple's design skills or Pixar's animation prowess), talented personnel (e.g. a sports team's star players or a brokerage firm's star traders), or innovative processes. Successful brand management also results in perceived uniqueness even when the physical product is the same as competitors. This way, Chiquita was able to brand bananas. Starbucks could brand coffee, and Nike could brand sneakers. Fashion brands rely heavily on this form of image differentiation.

Variants on the Differentiation Strategy

The shareholder value model holds that the timing of the use of specialized knowledge can create a differentiation advantage as long as the knowledge remains unique. This model suggests that customers buy products or services from an organization to have access to its unique knowledge. The advantage is static, rather than dynamic, because the purchase is a one-time event.

The unlimited resources model untilizes a large base of resources that allows an organization to outlast competitors by practicing a differentiation strategy. An organization with greater resources can manage risk and sustain losses more easily than one with fewer resources. This deep-pocket strategy provides a short-term advantage only. If a firm lacks the capacity for continual innovation, it will not sustain its competitive position over time.

(iii) **Focus or Strategic Scope**

Can target niche-narrow-BMW

This dimension is not a separate strategy per se, but describes the scope over which the company should compete based on cost leadership or differentiation. The firm can choose to compete in the mass market (like Wal-Mart) with a broad scope, or in a defined, focused market segment with a narrow scope. In either case, the basis of competition will still be either cost leadership or differentiation.

In adopting a narrow focus, the company ideally focuses on a few target markets (niche strategy). There should be distinct groups with specialized needs. The choice of offering low prices or differentiated products services should depend on the needs of the selected segment and the resources and capabilities of the firm. It is hoped that by focusing your marketing efforts on one or two narrow market segments and tailoring your marketing mix to these specialized markets, you can better meet the needs of that target market. The firm typically looks to gain a competitive advantage through product innovation or brand marketing rather than efficiency. It is most suitable for relatively small firms but can be used by any company. A focused strategy should target market segments that are less vulnerable to substitutes or where a competition is weakest to earn above-average return on investment.

Examples of firm using a focus strategy include Southwest Airlines, which provides short-haul point-to-point flights in contract to the hub-and spoke model of mainstream carriers, and Family Dollar, which targets poor urban American families who cannot drive to Wall-Marts in the suburbs because they do not own a car.

How cost-based advantages can be sustained?

Cost leadership strategies are only viable for large firms with the opportunity to enjoy economies of scale and large production volumes. However, this takes a limited industrial view of strategy. Small businesses can also be cost leaders if they enjoy any advantages conducive to low costs. For example, a local restaurant in a low rent location can attract price-sensitive customers if it offers a limited menu, rapid table turnover and employees staff on minimum wage. Innovation of products or processes may also enable a startup or small company to offer a cheaper product or service where incumbents' costs and prices have become too high. An example is the success of low-cost budget airlines who despite having fewer planes than the major airlines, were able to achieve market share growth by offering cheap, no-frills services at prices much cheaper than those of the larger incumbents.

(b) The term "Benchmarking" is defined as the continuous process of measuring the products, services and business practices of a company against the toughest competitors or those companies search for industry's best practices that lead to superior performance.

In other words, it is a tool for improving performance by continuously identifying, understanding, adopting and adapting best practices and processes followed by an entity- both internally as well as externally.

From this definition, it is evident that a benchmarking exercise has to be based on "best practices" and not on "best performances". Practices signify continuity in use while performances may be flash in the pan and not continuous.

Best practice is a continuous process of learning, feedback, reflection and analysis of what works or does not work and the reasons therefore.

Important benchmarking processes used in strategy implementation

The following are some of the important benchmarking processes used in strategy implementation:

Strategic Benchmarking: This aims at enhancing company's holistic performance by analyzing the long-term approaches and strategies adopted by the 'best practice companies' for their success in any sector across the globe.

Functional Benchmarking: Optimization of functional processes or activities through Benchmarking can be done by comparing with different business sectors but engaged in similar functions or processes.

Process Benchmarking: The initiating firm focuses its observation and investigation of business processes with a goal of identifying and observing the best practices from one or more benchmark firms. Activity analysis will be required where the objective is to benchmark cost and efficiency. This type of benchmarking processes is applied to back-office processes, where outsourcing may be a consideration.

Product Benchmarking (or Competitive Benchmarking): This is confined to the area relating to the performance characteristics of the company's key products and services of the companies in the same sector.

Internal Benchmarking: This involves Benchmarking against the companies own divisions or branches or strategic business units situated at different locations. The purpose is to develop a database which gives access to information and a cross fertilization of the managerial acumen within the company.

Financial Benchmarking: This involves performing a financial analysis and comparing the results in an effort to assess the company's overall competitiveness.

8. (a) Explain the purpose of SWOT analysis. Discuss its necessity to do a SWOT analysis before selecting a particular strategy for a business organization.

(b) Discuss how you would analyze Competitive Environment.

Answer:

(a) An important component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as SWOT analysis.

- **Strength:** Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitors.
- **Weakness:** A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it.
- **Opportunity:** An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position.
- **Threat:** A threat is an unfavourable condition in the organization's environment which causes a risk for, or damage to, the organization's position.

The purpose of SWOT analysis is to gather, analyze, and evaluate information and identify strategic options facing a community, organization, or individual at a given time.

SWOT Analysis is a very effective way of identifying strengths and weaknesses, and of examining the opportunities and threats one tends to face. Carrying out an analysis using the SWOT framework helps to focus activities into areas where one is strong and where the greatest opportunities lie. This knowledge is then used to develop a plan of action.

The analysis can be performed on a product, on a service, a company or even on an individual. Done properly, SWOT will give the big picture of the most important factors that influence survival and prosperity as well as a plan to act on. Strengths and weaknesses are internal while opportunities and threats are external. Strengths and weaknesses have to be matched with the opportunities in the external environment and also to counter any threats that might pose a danger to plans. SWOT Analysis is generally considered a Marketing tool but although it has its origins in Marketing field and is predominantly used by Marketing people, and it can also be done for self. SWOT Analysis is a tool which guides one to see where one stand in terms of job prospects and career growth.

A good SWOT analysis gives you a top-view of the entire business plan, even before the actual business plan is made. Done with sincerity and honesty, this analysis can help you with:

Product Definition: Once you have clearly identified the target segments and understood their attributes, you will probably take a harder look at your product. A good understanding of whom you are trying to sell your product to would help to define the product better and position it appropriately.

Identifying Inherent Deficiencies: We all think our product is good and that it can definitely deliver benefits to the customer. But the longevity of a product is not in what it can deliver now but how it delivers it, will what it delivers continue to be a need and what more can it deliver over time. This analysis is critical to have a predictable and scalable business plan.

Defining Target Markets: Identify your opportunities and the impediments to maximize those opportunities would help in a more comprehensive Go-to-Market plan. You may just end-up realizing that there are more avenues for generating revenues than the ones you had thought of or may end up taking a re-look at your target market itself.

Understanding Key Market Attributes: Demographic, geographic, social and cultural attributes of your prime markets could seriously affect your overall business plan. Getting to identify these important factors could help to develop a more complete product offering and a marketing plan, to target specific needs that may have otherwise missed your attention.

Competitive Analysis: In trying to define your threats you would be forced to do some more work towards understanding your competition and where your product stands in comparison. Getting to know the reasons for your competition's success or failure would only help you in making your offering more robust.

Identifying Threats Other Than Competition: Direct competition may not be the only threat. For example, the watch industry's biggest threat is the mobile phone, with more and more people using this ubiquitous device to also check time. So, such an analysis would help you to do more homework to address such competitive variants and build your competitive barriers.

Any start-up should first do a SWOT of what he intends to create before even attempting anything. This will help him/her to validate most of the assumptions that had been made while planning the enterprise and enable focused efforts leading to meeting objectives.

(b) With growing industrialization, expanding size of business operation and rapid advancement of technology, degree of competition within the industry and across the industry has increased tremendously. There is neck-to-neck competition among the business organizations who are investing massive funds on research and development to innovate new methods of production or new uses of existing products or adopting new marketing devices in their market share. Under these circumstances managers must be fully aware of the competitive environment and formulate strategy to cope with the competition. The competitive environment should be analyzed from the viewpoint of all such factors which affect the ferocity of competitive behaviour. These factors are market share of the participants in the industry, growth, rate of the industry, general level of profits, cost of entry into and exit from an industry, degree of differentiation, and economies of scale and nature of product.

Analysis of market share of different firms at a point of time and over a period of time provides an insight into the competitive strength of the organization. Such analysis should be undertaken to discern the factors responsible for differential market share of firms. These factors could be product differentiation, pricing, high corporate competence, wide distribution network, customer service, dispensation of discount facilities, etc. The management must keep these factors in view while formulating strategy. Furthermore, analysis of the competitive environment presents a picture of dominance of the industry by a few firms. An industry dominated by one firm having a significant market share tends to be less fiercely competitive than the one having no firm with dominant market share.

In studying the competitive environment it should also be the prime concern of the management to find out if there is a minimum critical mass for the product. Critical mass is the market share which a firm must obtain so as to become fully competitive on price and cost.

Growth rate of the industry decisively affects the competitive behaviour. Where growth rate of the industry is relatively high and demand of industrial products tends to expand, competitive behaviour will be less aggressive because each firm can increase its sales without necessarily increasing its market share. But in an industry with falling growth rate, competition will tend to be intense. In such a situation the management should diversify the product line. High level of profits in one industry is likely to provide a measure of tolerance for competitors. A change to lower profits may trigger off more aggressive behaviour.

Cost of entry and exit is another vital factor which needs comprehensive appraisal. If market shares in the industry are widely diffused and small investment is needed to enter the business and if the government does not foreclose entry to the industry, there will be great mobility of firms in and out. In such a case, a firm in the industry lacks security of its position because any entrepreneur with a small capital and small operation can enter the market. Such a tendency poses a serious threat of entry particularly to large established organisations which lack the flexibility and quick response possessed by small firms. Small organisations will, however, consider such an environment as an opportunity to them. Where investment is large, highly specialized and fixed costs are a relatively high proportion of total costs; competition will not be aggressive because the scope of new entrants will be very limited.

High degree of product differentiation creates a barrier to entry of new firms since they might have to spend a great deal on advertising and sales promotion in order to overcome the loyalty of consumers to the existing brand. But the competition is likely to be fiercest when all firms are offering products of commodity status.

Competitive behaviour is likely to be more aggressive when there exist marked economies of scale in the industry. This may happen when cost levels depend on large volumes. The competitive behaviour will tend to be more fierce in a growth market with elastic demand and product subject to mass production. However, new firms will have to be very large so as to avoid cost disadvantages. Nature of the product is another factor to be considered while studying the competitive environment-A durable product is likely to be less vulnerable to random price cutting than one which cannot be preserved easily and cheaply.

The management must also try to study the possibility of availability of substitutes of the product in the market because the industry's prospects depend on it. With the emergence of a new substitute, a number of new firms with different cost structures may come into existence in the competitive arena. A substitute will often increase the buying power of the buyer and decrease the power of the seller.

9. Case study of PESTEL

PepsiCo is the largest selling beverage the world over, of course after its arch rival Coca Cola. It accounts for a 37% share of the global beverage market, and therefore they need to understand each and every country's market in order to stay in line with their PESTLE situations.

Pepsi is a big brand, currently holds the 23rd place in the Inter brands report of the World's Leading Brands. Their advertisements feature major celebrities and athletes like David Beckham, Robbie Williams, Britney Spears, and Michael Jackson etc.

Their market reach is also very diverse, as they're present in almost every country from the US to New Zealand. Now they are trying to diverse to Gulf Countries.

Required:

(a) Discuss the PESTEL Analysis of PEPSI Co.

(b) Do you think the PEPSI was right in his approach regarding environmental scanning?

Answer:

(a) The six environmental factors of the PESTEL analysis are the following:

Political factors
- Taxation policy;
- Trade regulations;
- Governmental stability;
- Unemployment policy.

Economical factors
- Inflation rate;
- Growth in spending power;
- Rate of people in a pensionable age;
- Recession or boom;
- Customer liquidations.

Socio-cultural
- Age distribution;
- Education levels;
- Income level;
- Consumerism.
- Diet and nutrition;
- Population growth;
- Life expectancies;
- Religion;
- Social class;
- Expectations of society about the business.

Technological factors
- Internet;
- E-commerce;
- Social media.
- Level of Automation

Environmental factors
- Competitive advantage;
- Waste disposal;
- Energy consumption;
- Pollution monitoring.

Legal factors
- Unemployment law;
- Health and safety;
- Product safety;
- Advertising regulations;
- Product labeling labor laws.

(b) Environmental scanning is one function of strategic management of analyzing external factors that can affect an organization. Environmental scanning is to scan the environment to monitor and identify the changes such as new trends that may cause an effect on the organization. In addition, environmental scanning with an internal analysis of the organization strengths, weakness, mission, and vision can assist management to formulate a strategic plan to gain control that may have potentially significant affect.

Environmental scanning is the acquisition and use of information about events, trends, and relationships in an organization's external environment, the knowledge of which would assist management in planning the organization's future course of action. Organizations scan the environment in order to understand the external forces of change so that they may develop effective responses which secure or improve their position in the future. They scan in order to avoid surprises, identify threats and opportunities, gain competitive advantage, and improve long-term and short-term planning). To the extent that an organization's ability to adapt to its outside environment is dependent on knowing and interpreting the external changes that are taking place, environmental scanning constitutes a primary mode of organizational learning. Environmental scanning includes both looking at information (viewing) and looking for information (searching). It could range from a casual conversation at the lunch table or a chance observation of an angry customer, to a formal market research programme or a scenario planning exercise.

So, the PEPSI is right in his approach regarding environmental scanning. It will help them to understand the market preference.

SN 4: Strategic Choices

10. (a) Can cost leadership strategy allow a firm to earn above-average returns despite strong competitive forces- Discuss.

(b) An organization can choose from a wide variety of grand strategies such as Stability Strategies, Retrenchment Strategies and Combination Strategies". Explain these strategies and highlight the conditions under which each one is the most appropriate.

Answer:

(a) Cost leadership strategy will allow a firm to earn above average returns despite strong competitive forces. A glaring example is that of Tata's Nano Venture. The following factor facilitates a firm under 'Cost leadership strategy' to earn above average returns despite strong competitive forces:

(i) Rivalry with Existing Competitors: Having the low cost position serves as a valuable defense against rivals. Because of the cost leader's advantageous position, especially in logistics, rivals cannot reduce their costs lower than the cost leaders and so they cannot claim above average returns.

(ii) Bargaining Power of Buyers (Customers): The cost leadership strategy also protects against the power of customers. Powerful customers can drive prices lower but they are not likely to be driven below that of the next –most – efficient industry competitor. Prices below this would cause the next –most –efficient competitor to leave the market, leaving the cost leader in a stronger position relative to the buyer.

(iii) Bargaining Power of Suppliers: The cost leadership strategy also allows a firm to better absorb any cost increases forced on it by powerful suppliers because the cost leader has greater margins than its competitors. In fact, a cost leader may be able to force its suppliers to keep prices low for them.

(iv) Potential Entrants: The cost leadership strategy also discourages new entrants because the new entrant must be willing to accept no better than average returns until they gain the experience and core competencies required to approach the efficiency of the cost leader.

(v) Product Substitutes: For substitutes to be used, they must not only perform a similar function but also be cheaper than the cost leader's product. When faced with substitutes products, the cost leader can reduce its price.

(b) Four grand strategies: stability, growth, retrenchment and combination are opinions for the pace or level of efforts in the current business definition or for changing the business definition.

Stability: A stability strategy is a strategy that a firm pursues when -

- It continues to serve the public in the same product or services, market and function sector as defined in its business definition or in very similar sectors
- Its main strategic decisions focus on incremental improvement of functional performance.
- Stability strategies are implemented by 'steady as it goes' approaches to decisions. Few major functional changes are made in the product or service line, markets or functions. In an effective stability strategy, a company will concentrate

its resources where it presently has or can rapidly develop a meaningful competitive advantage in the narrowest possible product - market- function scope consistent with its resources and market requirement.

Retrenchment: A retrenchment strategy is pursued by a firm when -

- It sees the desirability of or necessity for reducing its product or service lines, markets of functions.
- It focuses its strategic decisions on functional improvement through the reduction of activities in units with negative cash flows.
- A firm can redefine its business by divesting itself of a major product line or an SBU. It could abandon some market territories. A firm could also reduce its functions. Of course, the ultimate redefinition is total liquidation.

Combination: A combination strategy is a strategy that a firm pursues when –

- Its main strategic decision focuses on the conscious use of several grand strategies at the same time (simultaneously) in several SBUs of the company.
- It plans to use several grand strategies at different future times (sequentially).

With combination strategy, the decision makers consciously apply several grand strategies to different parts of the firm or to different future periods. The logical possibilities for a simultaneous approach are stability in some areas, growth in others; stability in some areas, retrenchment in others; retrenchment in some areas, expansion in others; and all three grand strategies in different areas of the company.

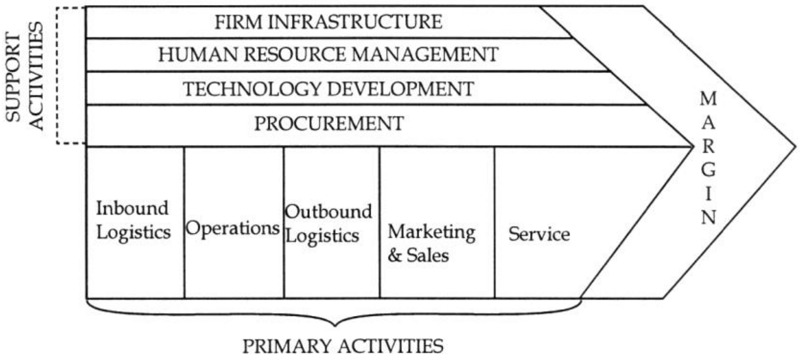
11. To get a bird's-eye view of an organization's operations is the purpose of the value chain model of corporate activities, developed by Porter of the way in which firms organize and perform activities.
Required:
(a) A brief examination of some of the elements of value chain model;
(b) A brief discussion on how value chain analysis can contribute to the strategic analysis of costs.

Answer:

(a) Activities are the means by which a firm creates value in its products. (They are sometimes referred to as value activities). Activities incur costs, and, in combination with other activities, provide a product or service which earns revenue. Firms create value for their buyers by performing these activities.
Porter (in Competitive Advantage) analyzed the various activities of an organization into a value chain. This is a mode of value activities and the relationships between them. Here is a diagram of the value chain (figure in the next page):—

Let us examine some of these elements in turn.
Primary activities are those directly related with production, sales, marketing, delivery and services. The diagram shows five primary activities.

(i) Inbound logistics are those activities involved with receiving, handling and storing inputs to the production system. It thus includes warehousing, transport, stock control and so forth.
(ii) Operations are those activities which convert inputs into final product.
(iii) Outbound logistics are those activities relating to storing the product and its distribution to customers.
(iv) Marketing and sales are those activities that relate to informing customers about the product, persuading them to buy it and enabling them to do so. This includes advertising, promotion and so forth.
(v) After sales service. For many companies there are activities such as installing products, repairing them, providing spare parts and so forth.



Support activities are those which provide purchased inputs, human resources, technology and infrastructural functions to support the primary activities. Support activities include the following.

(i) Procurement reports to those activities which acquire the resource inputs to the primary activities.

(ii) Technology development. These activities are related to both product design and to improving processes and/or resource utilization.

(iii) Human resource management is the activities of recruiting, training, developing and rewarding people.

(iv) Firm infrastructure. The system of planning, finance, quality control is activities which Porter believes are crucially important to an organisation's strategic capability in all primary activities.

Furthermore, in addition to the categories described above Porter identifies three other ways of categorizing activities.

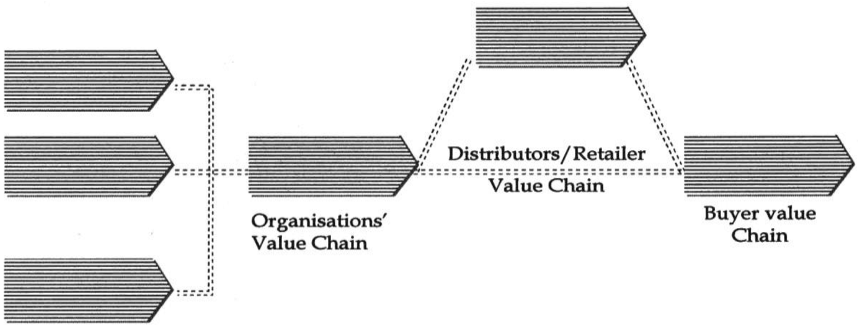
(i) Direct activities are concerned with adding value to inputs,

(ii) Indirect activities enable direct activities to be performed.

(iii) Quality Assurance. This type of activity monitors the quality of other activities and includes:

- Inspection
- Review
- Audit

Linkages connect the interdependent elements of the value chain together. They occur when the element of the value chain affects the cost or effectiveness of another. The value chain contains an element for margin. This is the excess of the amount that the customer is prepared to pay over the cost of the resource inputs and value activities. Firms can gain competitive advantage by concerning of new ways to conduct activities, employing new procedure, implementing new technologies or using different inputs and by exploiting linkage effectively.



A company's value chain is not bounded by a company's borders. It is connected to what Porter describes as a value system.

As well as managing its own value chain, a firm can secure competitive advantage by managing the linkages with its suppliers and customers. A company can create competitive advantage by making best use of these links and this means considering the value chains of these supplies and customers.

A value chain is also a model for analyzing a firm's competitors, and also further on in the planning process for designing strategies. A firm's value chain is not always easy to identify nor are the linkages between the different elements. However, it is an important analytical tool, because it helps people:

- To see the business as a whole;
- To identify potential sources of competitive advantage.

The value chain models are the process by which organization convert inputs into outputs. If the purpose of this process is the creation of value, then the accountant can contribute to the strategic analysis of costs. However, Porter has said, while systems do certain useful data for cost analysis, they often get in the way of strategic cost analysis. Although many accounting reports contain a value added statement frequently, such statements:

- Are little more that an analysis of sales revenue less purchases.
- Ignore how value is created, including :
- Linkages within the firm
- Other elements within the value system involving outsiders.

(b) A summary of the failure of traditional cost systems is outlined in the table below

	Traditional Costing System	**Value chain cost Analysis**
Focus	• Manufacturing Operations	• Customers • Value Perceptions
Cost Object	• Products • Functions • Expense heads	• Value creating activities • Product Attributes
Organizational focus	• Cost and Responsibility Centre	• Strategic Business units • Value creating Activities
Linkages	• Largely Ignores • Cost allocation and transfer prices used to reflect interdependencies	• Recognized and Maximize
Cost Drivers	• Simple volume measures	• Strategic Decisions
Accuracy	• High Apparent Precision	• Lower precisions • Indicative answers

What might influence the cost of the value chain?

(i) Structural cost drives are major strategic choices made by the firm which determine its underlying cost base.

These include the following:

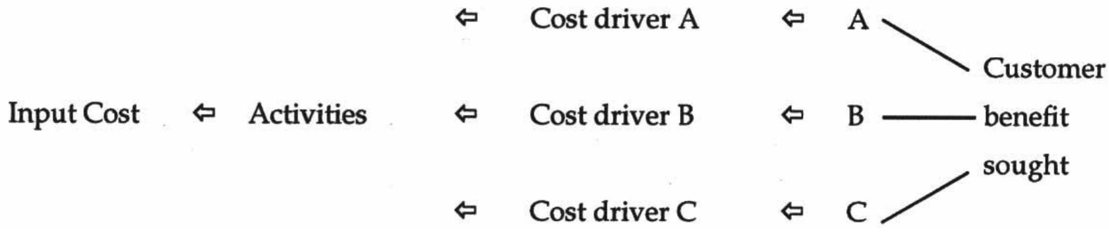
- Scale of operations, capacity etc, giving rise to economies of scale or otherwise.
- Scope: to what extent is the firm vertically integrated?
- Experience: has the firm climbed the learning curve?
- Technology used in the value chain.
- Complexity and breadth of product range.

(ii) Management issues which influence how well a firm manages the value chain in operation terms, include:

- Capacity utilization
- Product and process design.
- Continued learning opportunities offered by TQM and continuous improvement programmes.
- How well external linkages are exploited.

Firms may create a more outward-looking focus in their costing system as follows:

(i) Most products are a collection of benefits, which is why customer buys them. Ultimately, the provision of customer benefits is the real cost driver of the business, and it



Should be possible to work backwards, as it were, from the customer benefits to the underlying costs.

(ii) For different products, it should be possible to identify the:
- Customer's perception of the value of the benefit.
- The cost of providing the benefit.

This is a sort of cost/benefit analysis. Those benefits which are least costly to provide should be offered first of all.

For the accountant, a problem with this approach is:
- A lack of precision in the data;
- The inevitable subjectivity in deciding what customer's value as a benefit.

12. Discuss about competitor analysis.

Answer.

In formulating business strategy, managers must consider the strategies of the firm's competitors. While in highly fragmented commodity industries the moves of any single competitor may be less important, in concentrated industries **competitor analysis** becomes a vital part of strategic planning.

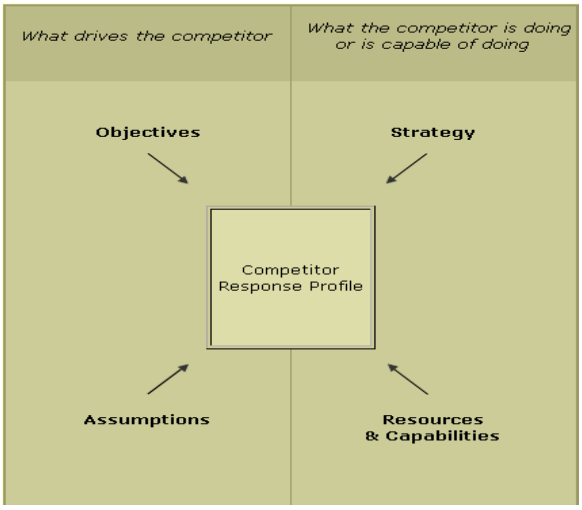
Competitor analysis has two primary activities, 1) obtaining information about important competitors, and 2) using that information to predict competitor behavior. The goal of competitor analysis is to understand:
- with which competitors to compete,
- competitors' strategies and planned actions,
- how competitors might react to a firm's actions,
- How to influence competitor behavior to the firm's own advantage.

Casual knowledge about competitors usually is insufficient in competitor analysis. Rather, competitors should be analyzed systematically; using organized competitor intelligence-gathering to compile a wide array of information so that well informed strategy decisions can be made.

Competitor Analysis Framework

Michael Porter presented a framework for analyzing competitors. This framework is based on the following four key aspects of a competitor:
- Competitor's objectives
- Competitor's assumptions
- Competitor's strategy
- Competitor's capabilities

Objectives and assumptions are what drive the competitor, and strategy and capabilities are what the competitor is doing or is capable of doing. These components can be depicted as shown in the following diagram:



A competitor analysis should include the more important existing competitors as well as potential competitors such as those firms that might enter the industry, for example, by extending their present strategy or by vertically integrating.

Competitor's Current Strategy

The two main sources of information about a competitor's strategy is what the competitor says and what it does. What a competitor is saying about its strategy is revealed in:

- annual shareholder reports
- 10K reports
- interviews with analysts
- statements by managers
- press releases

However, this stated strategy often differs from what the competitor actually is doing. What the competitor is doing is evident in where its cash flow is directed, such as in the following tangible actions:

- hiring activity
- R & D projects
- capital investments
- promotional campaigns
- strategic partnerships
- mergers and acquisitions

Competitor's Objectives

Knowledge of a competitor's objectives facilitates a better prediction of the competitor's reaction to different competitive moves. For example, a competitor that is focused on reaching short-term financial goals might not be willing to spend much money responding to a competitive attack. Rather, such a competitor might favor focusing on the products that hold positions that better can be defended. On the other hand, a company that has no short term profitability objectives might be willing to participate in destructive price competition in which neither firm earns a profit.

Competitor objectives may be financial or other types. Some examples include growth rate, market share, and technology leadership. Goals may be associated with each hierarchical level of strategy - corporate, business unit, and functional level.

The competitor's organizational structure provides clues as to which functions of the company are deemed to be the more important. For example, those functions that report directly to the chief executive officer are likely to be given priority over those that report to a senior vice president.

Other aspects of the competitor that serve as indicators of its objectives include risk tolerance, management incentives, backgrounds of the executives, composition of the

board of directors, legal or contractual restrictions, and any additional corporate-level goals that may influence the competing business unit.
Whether the competitor is meeting its objectives provides an indication of how likely it is to change its strategy.

Competitor's Assumptions
The assumptions that a competitor's managers hold about their firm and their industry help to define the moves that they will consider. For example, if in the past the industry introduced a new type of product that failed, the industry executives may assume that there is no market for the product. Such assumptions are not always accurate and if incorrect may present opportunities. For example, new entrants may have the opportunity to introduce a product similar to a previously unsuccessful one without retaliation because incumbent firms may not take their threat seriously. Honda was able to enter the U.S. motorcycle market with a small motorbike because U.S. manufacturers had assumed that there was no market for small bikes based on their past experience.
A competitor's assumptions may be based on a number of factors, including any of the following:

- beliefs about its competitive position
- past experience with a product
- regional factors
- industry trends
- rules of thumb

A thorough competitor analysis also would include assumptions that a competitor makes about its own competitors, and whether that assessment is accurate.
Competitor's Resources and Capabilities
Knowledge of the competitor's assumptions, objectives, and current strategy is useful in understanding how the competitor might want to respond to a competitive attack. However, its resources and capabilities determine its ability to respond effectively.

A competitor's capabilities can be analyzed according to its strengths and weaknesses in various functional areas, as is done in a SWOT Analysis. The competitor's strengths define its capabilities. The analysis can be taken further to evaluate the competitor's ability to increase its capabilities in certain areas. A financial analysis can be performed to reveal its sustainable growth rate.

Finally, since the competitive environment is dynamic, the competitor's ability to react swiftly to change should be evaluated. Some firms have heavy momentum and may continue for many years in the same direction before adapting. Others are able to mobilize and adapt very quickly. Factors that slow a company down include low cash reserves, large investments in fixed assets, and an organizational structure that hinders quick action.

Competitor Response Profile
Information from an analysis of the competitor's objectives, assumptions, strategy, and capabilities can be compiled into a response profile of possible moves that might be made by the competitor. This profile includes both potential offensive and defensive moves. The specific moves and their expected strength can be estimated using information gleaned from the analysis.

The result of the competitor analysis should be an improved ability to predict the competitor's behavior and even to influence that behavior to the firm's advantage.

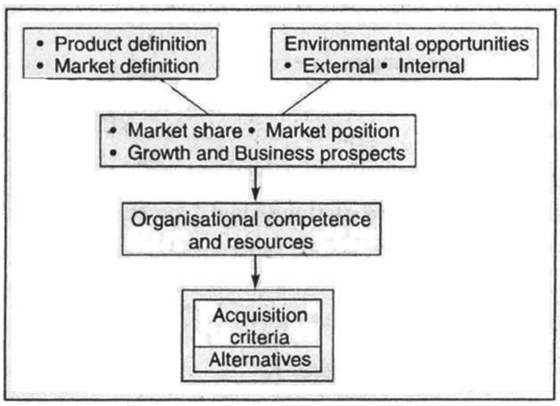
SN 5: Strategic Integration

13. (a) Explain the following terms:
(i) Joint venture, (ii) Merger, (iii) Take over, (iv) Acquisition

(b) Identify the reasons underlying them.
(c) State the advantages of 'take-overs' and 'mergers' to the national economy.

Answer
(a) Terms Explained
(i) Joint Venture:
Joint venture is 9 kind of business venture usually on the basis of an agreement, where two firms or companies pool their resources to form a business association but one firm or company does not acquire the other, and they do not form actual merger. In a joint venture, two firms together produce warehouse, transport, and market products. The profits and losses from these operations are shared in some predetermined proportion. A collaboration agreement with specific terms and conditions with respect to areas of operation and others is important in case of joint venture to avoid any future complications.
Joint venture is a management proposition and creates a synergistic condition— the addition of two parts is greater than the whole. It does not require basic structural changes in business and management but provides strategic posture to obtain synergistic effects in many areas like sales, operations, investment, and management.
(ii) Merger:
Merger is a combination of two companies wherein one company loses its corporate existence. The surviving company (which is also called the amalgamated company) acquires both the assets and liabilities of the merged company (which is also called the amalgamated company). That is why, mergers are called amalgamations in legal parlance. When two companies differ significantly in size, merger is the most appropriate term.
There may be three categories of merger:
(i) Horizontal, (ii) vertical, and (iii) conglomerate.
In fact, merger like acquisition is a part of a diversification strategy. Merger forces structural changes in business and management and creates a synergistic effect in many areas to achieve growth prospects.
A merger must be distinguished from a consolidation. Consolidation is a combination of two companies whereby an entirely new company is formed. Both the old companies cease to exist and shares of their common stock are exchanged for shares in the new company. When two companies of approximately the same size combine, the term consolidation applies. The terms merger and consolidation tend to be used interchangeably, in commercial parlance, to describe the combinations of two companies.
(iii) Take Over :
'Take over' means acquisition of a certain block of equity capital of a company which enables the acquirer to exercise control over the affairs of a company.
In theory, the acquirer must buy more than 50 per cent of the paid up equity of the acquired company to enjoy complete control. In practice, however, effective control may be exercised with a smaller shareholding, usually ranging between 10 per cent and 40 per cent because the remaining shareholders, scattered and ill organized, are not likely to challenge the control of the acquirer. Sometimes the acquirer may have tacit support of the financial institutions, banks, mutual funds or venture capital funds, having sizable holdings in the company's capital. The main objective of a takeover bid is to obtain legal control of the company.

(iv) Acquisition:
Acquisition may be defined as "a purchase of a company or a part of it so that the acquired company is completely absorbed by the acquiring company and thereby no longer exists as a business entity."
From theoretical as well as practical points of view, a **corporate acquisition process** is a strategic planning exercise. This process may be modeled as below:



(b) Reasons of General Nature:

The following are the reasons of general nature that can be attributed to the schemes of joint venture, merger, takeover, or acquisition:

(i) **Economies of scale:** Combination of two or more companies offers scope for larger volume of operations including R&D efforts.

(ii) **Synergistic effects:** The sales and profitability of the combined company are likely to be much higher than the sum of their individual sales and profits.

(iii) **Tax savings:** A healthy company acquiring a sick company, under certain conditions, can avail of income tax exemptions.

(iv) **Growth and diversification:** Any of the schemes, if followed or adopted, may help in achieving these corporate objectives.

(v) **Surplus funds utilization:** Companies having surplus funds, through any of the schemes cited above, can invest in another company which is starved of the same

(c) Advantages of Takeover and Merger

Advantages of the Takeover and Merger

(i) Merger or takeover route may enable companies to avoid unhealthy competition.

(ii) Patent rights, technical knowhow, established brand names, etc can be easily acquired through this process.

(iii) A merged entity enjoys higher debt capacity as its earnings are more stable than that possessed of by individual units. A higher debt capacity gives greater tax advantage and thus higher value of the firm.

(iv) Merger or takeover can affect economy in floatation cost of future equity, preference, and debenture issues.

(v) Largeness in size and earnings may reduce the cost of borrowing.

14. (a) Discuss about conglomerate diversification. Explain with suitable examples when conglomerate diversification would be a particularly good strategy to pursue.

(b) Subas Ltd. is engaged in the production of floral concentrates which have uses in a wide variety of fields from cosmetics to toiletries. At the moment the concentrates are produced and sold to perfume manufacturers, who in turn supply the producers of the ultimate products. The directors of Subas are concerned about the higher profitability at the product end of the trade compared with the production of the concentrates, and ask you to explore the possibilities of vertical Integration.

(i) Explain Vertical Integration.

(ii) In the given case what are the issues to be examined before deciding on vertical expansion.

(iii) State the drawbacks of Vertical Integration.

Answer:

(a) Unrelated diversification is known as Conglomerate diversification. Under this type of Diversification, there will be addition of dissimilar products or services to the existing line of business. It involves diversification into business fields, which are not significantly related or similar to the primary business mission. Thus it differs from concentric diversification, which also involves adding new product or service lines but in a related field. Conglomerate diversification in the case of DCM Ltd., led to the addition of a wide range of products in its business line of textiles. The products included engineering goods (castings), fertilizers, chemicals, rayon tyre cord, sugar and data product.

In Conglomerate diversification, a company moves or diversifies into product areas, which are not related to the existing product to each other by common technology or markets etc. The products manufactured by a company which has gone into unrelated diversification usually belong to different industry or market groups. This may be accomplished by setting up new projects from grass- root level, or through mergers or takeovers of running businesses. Under Conglomerate diversification, new unrelated products are added by acquiring new products. Further under Conglomerate diversification, a firm may acquire another firm, which has surplus cash even though there may be nothing in common with the existing business. The growth of ICICI, a development bank, into a financial conglomerate is a recent history.

The reasons underlying the use of Conglomerate diversification strategy may be:

(i) To achieve a growth rate higher than what can be realised through expansion,
(ii) To make better use of financial resources with retained profits exceeding immediate investment needs,
(iii) To avail of potential opportunities of profitable investments,
(iv) To achieve distinct competitive advantage and broader stability,
(v) To spread the risk or gain increased stability,
(vi) To improve the price-earnings- ratio and bring about a higher market price of shares.

Many of these objectives of conglomerate diversification can be and are actually realized by external development through acquisition and merger.

Examples of Conglomerate diversification: India has taken place in companies Like Godrej, Reliance Industries, Hindustan Machine Tools Ltd., etc.

Conglomerate diversification is a good strategy where

(i) Basic industry is experiencing declining annual sales and profits.
(ii) An organization has capital and managerial talent required to compete in a new industry.
(iii) There is some synergy between existing and proposed new areas of business (ITC in apparel/Agri-business).
(iv) Acquire an unrelated business which offers attractive investment opportunity (e.g. Kingfisher Airlines).
(v) Existing business is continuous threat of saturated demand. (Generic chemicals, Cigarette, and phone etc. business).
(vi) When an organization is subjected to environmental safety or pollution control or antitrust law.

(b)

(i) Vertical integration is the merging together of two businesses that are at different stages of production—for example, a food manufacturer and a chain of supermarkets. Merging in this way with something further on in the production process (and thus closer to the final consumer) is known as forward integration.

Vertical integration can be contrasted to horizontal integration, the merging together of businesses that are at the same stage of production, such as two supermarkets, or two food manufacturers. Merging with something further back in the process (if a food manufacturer were to merge with a farm, say) is known as backward integration. The integration of two organisations that are in completely different lines of business is sometimes referred to as conglomerate integration.

Businesses are downstream or upstream of each other depending on whether they are nearer to or further away from the final consumer (the “sea”, as it were, to which the river of production flows).

The benefits of vertical integration come from the greater capacity it gives organisations to control access to inputs (and to control the cost, quality and delivery times of those inputs). In line with the changing organisational structure of the late 20th century, however, this logic became less compelling. In the late 1990s, consultants McKinsey & Company wrote:

Whereas historically firms have vertically integrated in order to control access to scarce physical resources, modern firms are internally and externally disaggregated, participating in a variety of alliances and joint ventures and outsourcing even those activities normally regarded as core.

Some of the best known examples of vertical integration have been in the oil industry. In the 1970s and 1980s, many companies that were primarily engaged in exploration and the extraction of crude petroleum decided to acquire downstream refineries and distribution networks. Companies such as Shell and BP came to control every step involved in bringing a drop of oil from its North Sea or Alaskan origins to a vehicle's fuel tank.

The idea of vertical integration was taken a step further by Dell Computer, one of the most successful companies of the 1990s. Michael Dell, its founder, said that he combined the traditional vertical integration of the supply chain with the special characteristics of the virtual organisation to create something that he called “virtual integration”. Dell assembles computers from other firms' parts, but it has relationships with those firms that are more binding than the traditional links between buyer and supplier. It does not own them in the way of the vertically integrated firm, but through exchanges of information and a variety of loose associations it achieves much the same aim—what Michael Dell calls “a tightly co-ordinated supply chain”.

Vertical integration is a difficult strategy for companies to implement successfully. It is often expensive and hard to reverse. Upstream producers frequently integrate with downstream distributors to secure a market for their output. This is fine when times are good. But many firms have found themselves cutting prices sharply to their downstream distributors when demand has fallen just so they can maintain targeted levels of plant utilisation.

The vertically integrated giants of the computer industry, firms such as IBM, Digital and Burroughs, were felled like young saplings when at the end of the 1970s Apple formed a network of independent specialists that produced machines far more efficiently than the do-it-all giants.

(ii) Two issues that should be considered when deciding whether to vertically integrate is cost and control. The cost aspect depends on the cost of market transactions between firms versus the cost of administering the same activities internally within a single firm. The second issue is the impact of asset control, which can impact barriers to entry and which can assure cooperation of key value-adding players.

Factors Favoring Vertical Integration

The following situational factors tend to favor vertical integration:

- Taxes and regulations on market transactions
- Obstacles to the formulation and monitoring of contracts.
- Strategic similarity between the vertically-related activities.
- Sufficiently large production quantities so that the firm can benefit from economies of scale.
- Reluctance of other firms to make investments specific to the transaction.

Factors Against Vertical Integration

The following situational factors tend to make vertical integration less attractive:

- The quantity required from a supplier is much less than the minimum efficient scale for producing the product.
- The product is a widely available commodity and its production cost decreases significantly as cumulative quantity increases.
- The core competencies between the activities are very different.
- The vertically adjacent activities are in very different types of industries. For example, manufacturing is very different from retailing.
- The addition of the new activity places the firm in competition with another player with which it needs to cooperate. The firm then may be viewed as a competitor rather than a partner.

(iii) Drawbacks of Vertical Integration

While some of the benefits of vertical integration can be quite attractive to the firm, the drawbacks may negate any potential gains. Vertical integration potentially has the following disadvantages:

- Capacity balancing issues. For example, the firm may need to build excess upstream capacity to ensure that its downstream operations have sufficient supply under all demand conditions.
- Potentially higher costs due to low efficiencies resulting from lack of supplier competition.
- Decreased flexibility due to previous upstream or downstream investments. (Note however, that flexibility to coordinate vertically-related activities may increase.)
- Decreased ability to increase product variety if significant in-house development is required.
- Developing new core competencies may compromise existing competencies.
- Increased bureaucratic costs

15. (a) Distinguish between Horizontal and Vertical Integration.
(b) Discuss Strategic alliances. Explain its advantages & disadvantages.

Answer:

(a) Horizontal and a vertical integration help management to realize economies of scale, to have a strong influence on the market and to face competition with confidence. Peter Drucker lays great emphasis on the right size of business as a measure for the viability and growth of a firm and this means elimination of wrong size through by achieving horizontal and vertical integration. Without economical operation, it is difficult to achieve the long-term competitive survival goal. Hence, the role of economies of large-scale. Backward integration is concerned with economy in regard to a reliable supply of inputs at cheap prices. Forward integration, on the other hand, has to do with cutting down the marketing cost by eliminating certain channels of marketing and allocating capital resources more profitably and effectively in the face of competition.

Diversification becomes necessary when there is market saturation, when competitive pressure is high, when product lines become obsolete, or when further expansion is not permitted by the government; when higher profits and growth are expected from an alternative business. When risks have to be spread (riot to keep all the eggs in the same basket), when instantaneous profit can be made, and when executives feel bored in doing the same business again and again.

Diversification can move along with what is called the "common thread" which has been emphasized Say Prof. Ansoff and Drucker. It involves a "strategic fit" in the sense that the new business should fit the present one in terms of technology as well as products, what Prof. Thompson calls "moving into closely related products" for example, a bakery firm moving into the biscuit business; building on the company's technology, synthetic fibers firm moving into the biscuit business; building on the company's technology, synthetic fibers firm moving into carpets; utilising the company's by-products or raw materials for by-products-timber into plywood and so on. The strategic fit would also enable the company to utilise its sales force more effectively and build up its brand names and goodwill. Innumerable such examples, namely, are provided by such companies as Procter and Gamble, and Look heed. This is what may be called "concentric diversification," which has certain inherent virtues.

Thomson bases his analysis on Drucker's theme, and points out: "Extend technological diversification is becoming outmoded as a viable strategy precisely because the prolific branching out of technology eventually dilutes what once was its clear advantage". He quotes the example of Sony and Texas Instruments which branched out of their original technology into many lines. Whereas GEC and Westinghouse divested themselves of a number of consumer and industrial products in which electricity was incidental. The American Biltrite Rubber Co., Dow Chemicals, Eastman Kodak, General Motors, B. F. Goodrich, Johnson & Johnson, Minnesota Mining and Manufacturing have resumed "concentric diversification".

Conglomerate diversification, however, has not been successful in a majority of cases, because lack of "strategic fit" or "common thread technology". For a few years, a conglomerate may achieve higher profits, later, however, when it comes up against all kinds of complex problems, the management decides to divest itself of certain business by selling out. As a matter of fact, conglomerates were unable to manage unrelated business during the period of depression or recession.

Financial synergism promotes losses in the end. Therefore, what is needed is a strategic fit or distinctive competence. However, it is wrong to make blanket criticism against conglomerate. The pros and cons of what kind of and how much, diversification an organization should embark upon to get the best results for its distinctive competence are differently from case to case. A logical plan for an organization's management is to begin its evaluation with a consideration of "what is the best diversification it needs to attain its goals, accomplish its mission and still remain competitive and prosperous". At the other extreme, the management is equally obliged to examine the question: "What is the utmost in diversification that can manage, given the capacity it adds to our organization?" In all likelihood, the optimal answer lies in between. After deciding what to include and what to exclude, the next step is to make the diversification strategy specific enough to define the role of each line of business within the total organization.

It is, therefore, clear that almost all leading authorities are opposed to haphazard, loose and jungle-type of conglomerate diversification in American industry. There are several cases of companies which embarked upon such a strategy in the 1960s sold away certain unrelated business in order to achieve competitive excellence for differential advantage. Indian companies which are conglomerates should learn from the American experience, if they want to avoid sickness. Doing ventures are a method of having a holding company whereby unrelated business can be brought under economic fits.

Innovative strategy is new and different business, because the existing business product, market and technology are susceptible to sudden changes, and higher profits may be expected to accrue from innovation. It involves a huge investment, risk and entrepreneurship. If it is managed well, it can increase profits substantially (the Xerox machines). However, it has to be related to the product-line and product-mix policy and various aspects of launching a new product.

The retrenchment strategy involves cutting book on personnel, inventory, and replacement of machinery, closing uneconomic plants and pruning the product-line of unprofitable items in order to reduce cost. Retrenchment is merely a reaction to adverse environment.

Divesture strategy involves the selling out of those lines of business which cannot be managed efficiently and effectively. Generally, unsuccessful lines of business should be got rid of quickly and without hesitation. To drag on their production for years will lead to a cut in profits. But sometimes, instead of selling, the management may keep a hold on it by organizing a holding company.

Liquidation is the last alternative strategy when there is no hope of the survival of the unsuccessful unit. But it entails unemployment and loss of output. However, where there is no hope of survival of the unity it is better to liquidate it.

Strategic planning is never static. It is dynamic. Flexibility has to be built into it.

After identifying the strategic choice, the next step is to evaluate it in terms of profits, synergy effect and growth. Here, a great deal of objective analysis has to be undertaken; and profit rates, market share and growth must be based on productivity and no on physical growth.

Rothschild an executive of GEC pinpoints the relationship between functional areas and overall strategy in these words. "The best investment and management strategy in the world is of little use unless each function of the business designs and executive programme that are consistent with the strategies selected Management cannot assume that its engineering, manufacturing or marketing executives will stop what they are doing and automatically design programmes that closely fit the management's chosen strategy. This is even more vitally important if you intend to segment your business and to adopt different strategies for each segment. Functional managers and organisations will continue to repeat their past performance and will not think about changing unless they are given guidelines and direction".

Rothschild discusses functional areas like engineering and manufacturing in terms of standardisation, simplification, design, quality, facilities and equipment, technical talent, beginning with basic research and moving through application research, advanced engineering and design engineering, capacity requirement, flexibility of production system, productivity, low cost material and logistics.

Marketing strategy must fit the manufacturing strategy.

Corporate strategy aims at influencing the market size (or market share) and the growth rate of the market; and therefore attention must be focused not only on engineering and manufacturing efficiency, but on satisfying customer needs and wants. Mere economical cost by itself is of little relevance. The primary aim is customer satisfaction and the manufacturing system must be designed and revised constantly so as to meet the ultimate aim of the business. That is why Rothschild assigns a greater role to marketing and environment analysis in his design of strategic planning, while playing on the competitors' weakness. An evaluation of environmental changes, capitalising on them, the unique unchallenged strength of the company in terms of a new market and new product must be built. The very uniqueness should be the foundation of future strategy. The market position, technological position, product position, financial position and overall production must be very strong in comparison with those aspects of the competitors' "rate of return" and "corporate growth rates," for these are the best criteria of assessing strategic alternatives.

(b) Strategic alliances are distinguished from joint ventures because the companies involved do not take an equity position in one another. In many instances, strategic alliances are partnerships that exist for a defined period during which partners contribute their skills and expertise to a cooperative project. For example, one partner provides manufacturing capabilities while a second partner provides marketing expertise. Many times, such alliances are undertaken because the partners want to develop in-house capabilities to supplant the partner when the contractual arrangement between them reaches its termination date. Such relationships are tricky because, in a sense, the partners are attempting to "steal" each other's know-how.

In other instances, strategic alliances are synonymous with licensing agreements. Licensing involves the transfer of some industrial property right from the U.S. licensor to a motivated licensee in a foreign country. Most tend to be patents, trademarks, or technical know-how that is granted to the licensee for a specified time in return for a royalty and for avoiding tariffs or import quotas. Bell South and U.S. West, with various marketing and service competitive advantages valuable to Europe, have extended a number of licenses to create personal computer network in the United Kingdom (U.K.).

Advantages:

(i) Leverages several firms' core competencies

This allows alliance members to be more competitive in seeking certain project work or input.

(ii) Limits capital investment

One partner firm does not have to have all the resources necessary to do the work of the alliance.

(iii) Is flexible

Alliances allow a firm to be involved yet continue to pursue its other, "regular" business opportunities.

(iv) Leads to networking and relationship building

Alliances get companies together, sometimes even competitors. They allow key players to build relationships that are valuable, even if the present alliance doesn't "plan out". Alliance partners learn more about each others' capabilities and gain advantage or benefit from referrals and other similar behaviours, creating win—win situations.

Disadvantages:

(i) **Can result in loss of control:** A firm in an alliance by definition cedes ultimate control to the broader alliance for the undertaking for which the alliance is formed. This can prove problematic if the alliance doesn't work out as planned—or is not well planned.

(ii) **Can be hard to establish good management control of the project-loss of operational control:** Where multiple firms have interrelated responsibilities for a sizable joint project, it should not be difficult to imagine problems arising as the players go about implementing a major project as in the example of EDS and its Dutch and British partners in the Atlas Consortium. It requires good up-front planning and use of intercompany project team groups early on in the bidding process.

(iii) **Can distract a participating company: S-management and key players:** One strategic alliance can consume the majority attention of key players essential to the overall success of the home company. Whether because of their technical skills, managerial skills, key roles all three, the potential for lost focus or time to devote to key responsibilities exists.

(iv) **Raises issues of control of proprietary information and intellectual property:** Where technology development is the focus of the alliance, or maybe part of it, firms partnered together may also compete in other circumstances. Or they may have the potential to do so. So partnering together gives each the opportunity to learn much more about the other, their contacts, capabilities and unique skills or trade secrets.

Strategic alliances have proven a very popular mechanism for many companies seeking to become more agile competitors in today's dynamic global economy. They have proven a major way for small companies to become involved with large players to the benefit of both-allowing the smaller player to grow in a way that builds its future survival possibilities and the larger player to tap expertise and knowledge it can no longer afford to retain or develop in-house.

Section B – Strategic Cost Management

Study Note 6: Strategic Cost Management and Control

Question.16

(a) Distinguish between Traditional Cost Management and Strategic Cost Management.

Answer:

The main difference between Traditional Cost Management and Strategic Cost Management are as follows:

	Traditional Cost Management	Strategic Cost Management
Focus	Internal	External
Perspective	Value-added	Value chain
Cost analysis-way	In term of: product, customer, and function With a strongly internal focus Value added is a key concept	In terms of the various stages of the overall value chain of which the firm is a part With a strongly external focus Value-added is seen as a dangerously narrow concept
Cost analysis-objective	Three objectives all apply, without regard to the strategic context: Score keeping, attention directing, and problem solving.	Although the three objectives are always present, the design of cost management system changes dramatically depending on the basic strategic positioning of the firm: either under a cost leadership strategy, or under a product differentiation strategy.
Cost driver concept	A single fundamental cost driver pervades literature - cost is a function of volume. Applied too often only at the overall firm level.	Multiple cost drivers such as: Structural drivers (e.g. scale, scope, experience, technology, complexity) Executional drivers (e.g. participative management, total quality management) Each value activity has a set of unique cost drivers.
Cost containment philosophy	Cost reduction approached via responsibility centers or product cost issues	Cost containment is a function of the cost driver(s) regulating each value activity.
Primary concern	Cost impact	Cost/Value/Revenue relationship
Key disciplines	Finance/Accounting	Marketing/Economies
Primary role	Scorekeeper	Analyst and consultant
Management responsibility	Follower/reactive Risk-averse	Leader/proactive Comfortable with ambiguity

(b) List out the objective of BPR (Business Process Re-Engineering) when applying to a business organization.

Answer:

When applying the BPR management technique to a business organization the implementation team effort is focused on the following objectives:

- **Customer focus:** Customer service oriented processes aiming to eliminate customer complaints.
- **Speed:** Dramatic compression of the time it takes to complete a task for key business processes. For instance, if process before BPR had an average cycle time 5 hours, after BPR the average cycle time should be cut down to half an hour.
- **Compression:** Cutting major tasks of cost and capital, throughout the value chain. Organizing the processes a company develops transparency throughout the operational level reducing cost. For instance the decision to buy a large amount of raw material at 50% discount is connected to eleven cross checking's in the organizational structure from cash flow, inventory, to production planning and marketing. This checking's become easily implemented within the cross-functional teams, optimizing the decision making and cutting operational cost.
- **Flexibility:** Adaptive processes and structures to changing conditions and competition. Being closer to the customer the company can develop the awareness

mechanisms to rapidly spot the weak points and adapt to new requirements of the market.

- **Quality:** Obsession with the superior service and value to the customers. The level of quality is always the same controlled and monitored by the processes, and does not depend mainly on the person, who servicing the customer.
- **Innovation**: Leadership through imaginative change providing to organization competitive advantage.
- **Productivity**: Improve drastically effectiveness and efficiency.

(c) Explain the impact of Target Costing on Profitability.

Answer:

Increase in Profits: Target Costing improves profitability I two ways:-

- **Assured Profit by Constant review:** Target Costing places detailed continuing emphasis on product costs throughout the life cycle of every product. Also the management is fully aware of costing issues since it receives regular monitoring and review reports.
- **Price Determination and Consequent Cost Control:** Target Costing improves profitability through precise targeting of the prices at which the Company can market a profitable product. Thus, Target Costing results in better cost control and also in better price control, than the traditional cost plus approach.

  Target Costing have positive impact on profitability, depending on the commitment of the management to its use, the constant involvement of cost accountants in all phases of a product's life cycle, and the type of strategy a company follows. Target Costing is part of a larger concept called Concurrent Engineering, which requires participants from many departments to work together on project teams.

Question.17 Read the following case and answers the following Question:

Polaris, a company engaged in Decision Support System (DSS) is examining the profitability and pricing policies of three of its recent engineering software packages:

- **EE-46: package for electrical engineers**
- **ME-83: package for mechanical engineers**
- **IE-17: package for industrial engineers**

Summary details on each package over their two-year "infancy-to-grave" product lives are as follows:

		Number of Units Sold	
Package	**Selling Price**	**Year I**	**Year 2**
EE-46	**₹ 2,500**	**2,000**	**8,000**
ME-83	**3,000**	**2,000**	**3,000**
IE-17	**2,000**	**5,000**	**3,000**

Assume that no inventory remains on hand at the end of Year 2.

Polaris is deciding which product lines to emphasize. In the past two years, profitability has been mediocre. Polaris is particularly concerned with the increase in R&D costs. An analyst pointed out that for one of its most recent packages (IE-17), major efforts had been made to reduce R&D costs.

Praveen, the engineering software manager, decides to collect the following life-cycle revenue and cost information for the EE-46, ME-83, and IE-17 packages:

	EE-46		ME-83		IE-17	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
Revenues (₹ 000s)	₹ 5,000	₹ 20,000	₹ 6,000	₹ 9,000	₹ 10,000	₹ 6,000
Costs (₹ 000s)						
R&D	7,000	0	4,500	0	2,400	0
Design of product	1,850	150	1,100	100	800	160
Manufacturing	750	2,250	1,050	1,050	1,430	650
Marketing	1,400	3,600	1,200	1,500	2,400	2,080
Distribution	150	600	240	360	600	360
Customer service	500	3,250	450	1,050	2,200	3,880

Required:

(i) How does a product life-cycle income statement differ from a conventional income statement? What are the benefits of using a product life-cycle reporting format?

(ii) Present a product life-cycle income statement for each software package. Which package is the most profitable and which is the least profitable? Ignore the time value of money.

(iii) How do the three software packages differ in their cost structure (the percentage of total costs in each cost category)?

Answer:

(i) A life-cycle income statement traces revenue and costs of each individual software package from its initial research and development to its final customer servicing and support. The two main differences from a conventional income statement are:

a. Costs incurred in different calendar periods are included in the same statement.
b. Costs and revenue of each package are reported separately rather than aggregated into companywide categories.

The benefits of using a product life-cycle report are:

a. The full set of revenues and costs associated with each product becomes visible.
b. Differences among products in the percentage of total costs committed at early stages in the life cycle are highlighted.
c. Interrelationships among business function cost categories are highlighted.

(ii)

	EE-46		ME-83		IE-17	
Revenue (₹ 000s)		₹25,000		₹15,000		₹ 16,000
Costs (₹ 000s)						
Research & development	₹ 7,000		₹ 4,500		₹ 2,400	
Design	2,000		1,200		960	
Production	3,000		2,100		2,080	
Marketing	5,000		2,700		4,480	
Distribution	750		600		960	
Customer service	3,750	21,500	1,500	12,600	6,080	16,960
Operating income (₹ 0,000s)		₹ 3,500		₹ 2,400		₹ (960)

Rankings of the three packages on profitability (and relative profitability) are:

Operating income	$\frac{\text{Operating income}}{\text{Revenue}}$
Operating income	
1. EE-46 : ₹ 35,00,000	1. ME-83:16.0%
2. ME-83 : ₹ 24,00,000	2. EE-46 :14.0%
3. IE-17 : ₹ (9,60,000)	3. IE-17 : (6.0%)

The EE-46 and ME-83 packages should be emphasized, and the IE-17 package should be de-emphasized. It is interesting that IE-17 had the lowest R&D costs but was the least profitable. Polaris should evaluate whether reducing R&D costs contributed in any way to IE-17's poor performance.

(iii) The cost structures of the three software packages are:

	EE-46	ME-83	IE-17
Research & Development	32.5%	35.7%	14.1%
Design	9.3	9.5	5.7
Production	14.0	16.7	12.3
Marketing	23.3	21.4	26.4
Distribution	3.5	4.8	5.7

Customer service	17.4	11.9	35.8
	100.0%	100.0%	100.0%

The major differences are:

a. EE-46 and ME-83 have over 30% of their costs in the R&D/product design categories, compared to less than 15% (14.1%) for IE-17.
b. IE-17 has 35.8% of its costs in the customer-service category, compared to 17.4% for EE-46 and 11.9% for ME-83.

There are several explanations for these differences:

a. EE-46 and ME-83 differ sizably from IE-17 in their R&D/product design intensity. For example, EE-46 and ME-83 may require considerably (a) more interaction with users, and (b) more experimentation with software algorithms than does IE-17.
b. The software division should have invested more in the R&D/product design categories for IE-17.

Study Note 7: Strategic Decision Making

Question.18

(a) Read the following case and answers the following Question:

Harish Aggarwal, a management accountant with the Maruti Udyog, is evaluating whether a component MTR.2000 should continue to manufactured by Maruti or purchased from Outside Vendor Company. Outside Vendor has submitted a bid to manufacture and supply the 32,000 units of MTR.2000 that Maruti Udyog will need for 2014 at a selling price of ₹173.

Harish has gathered the following information regarding Maruti's costs to manufacture 30,000 units of MTR-2000in 2013:

Direct materials	**₹ 19,50,000**
Direct manufacturing labor	**12,00,000**
Plant space rental	**8,40,000**
Equipment leasing	**3,60,000**
Other manufacturing overhead	**22,50,000**
Total manufacturing costs	**66,00,000**

Harish has also collected the following information related to manufacturing MTR 2000:

- **Prices of direct materials used in the production of MTR.2000 are expected to increase by 8% in 2014.**
- **Maruti Udyog's direct manufacturing labor contract calls for a 5% increase in 2014.**
- **Maruti Udyog can withdraw from the plant space rental agreement without any penalty. Maruti Udyog will have no need for this space if MTR.2000 is not manufactured.**
- **The equipment lease can be terminated by paying ₹ 60,000.**
- **40% of the other manufacturing overhead is considered variable. Variable overhead changes proportionately with the number of units produced. The fixed component of other manufacturing overhead costs is expected to remain the same whether or not MTR.2000 is manufactured.**

Pradeep, plant manager at Maruti Udyog, indicates to Harish that the current performance of the plant can be significantly improved and that the cost increases he is assuming are unlikely to occur. Hence, the analysis should be done assuming costs will be considerably below current levels, Harish knows that Pradeep is concerned about outsourcing MTR.2000 because it will mean that some of his close friends will be laid off.

Harish believes that it is unlikely that the plant will achieve the lower costs as Pradeep describes. He is very confident about the accuracy of the information he has collected, but he is also unhappy about laying off employees.

Required:

(i) On the basis of the financial information Harish has obtained, should Maruti Udyog make MTR.2000 or buy it in 2014? Show your calculations.

(ii) What other factors should Maruti Udyog consider before making a decision?

(iii) What factors should be considered while taking the decision of Make or Buy?

Answer:

(i) An analysis of relevant costs that shows whether Maruti Udyog should make MTR. 2000 or purchase it from Outside Vendor Company for 2014 follows:

	Total Costs for 32,000 Units
Cost to purchase MTR.2000 from Outside Vendor	
Bid price from Outside Vendor, ₹ 173 x 32,000	₹ 55,36,000
Equipment lease penalty	60.000
Total incremental cost to purchase	55.96.000
Cost for Maruti Udyog to make MTR. 2,000 in 2014	
Direct materials (₹19,50,000x1.08)x32,000/30,000	22,46,400
Direct manufacturing labor (₹12,00,000x1.05)x32,000/30,000	13,44,000
Factory space rental	8,40,000
Equipment leasing costs	3,60,000
Variable manufacturing overhead (₹22,50,000x40%)x $\frac{32,000}{30,000}$	9,60,000
Fixed manufacturing overhead (not relevant)	-
Total incremental cost to make MTR. 2000	57,50,400
Savings if purchased from Outside Vendor	₹ 1,54,400

(ii) Based solely on the financial results, the 32,000 units of MTR.2000 for 2014 should be purchased from Outside Vendor. The total cost from Outside Vendor would be ₹ 55,96,000, or ₹ 1,54,400 less than if the units were made by Maruti.

At least three other factors that Maruti Udyog should consider before agreeing to purchase MTR.2000 from Outside Vendor Company include the following:

- The quality of the Outside Vendor component should be equal to, or better than, the quality of the internally made component. Otherwise, the quality of the final product might be compromised and Maruti Udyog's reputation affected.
- Outside Vendor's reliability as an on-time supplier is important, since late deliveries could hamper Maruti Udyog's production schedule and delivery dates for the final product.
- Layoffs may result if the component is outsourced to Outside Vendor. This could impact Maruti Udyog's other employees and cause labor problems or affectthe company's position in the community. In addition, there may be termination costs, which have not been factored into the analysis.

(iii) Make-or-Buy decision (also called the outsourcing decision) is a judgment made by management whether to make a component internally or buy it from the market. While making the decision, both qualitative and quantitative factors must be considered.

Examples of the qualitative factors in make-or-buy decision are: control over quality of the component, reliability of suppliers, and impact of the decision on suppliers and customers, etc.

The quantitative factors are actually the incremental costs resulting from making or buying the component. For example: incremental production cost per unit, purchase cost per unit, production capacity available to manufacture the component, etc.

COST COMPARISON

COST OF MAKE	**COST OF BUY**
Variable Costs	Direct Purchase Costs
+ Specific Fixed Cost (if any)	Purchase Related Costs like buying commission, transportation etc.
+ Opportunity Cost (in case of full capacity operations)	+ Opportunity Cost if any (e.g. Purchase of different quality raw material, leading to reduction in selling price of finished product).

Decisions will be as under-

• If Cost of Make < Cost of Buy, then MAKE.
• If Cost of Make = Cost of Buy, the Firm is indifferent. (Non-Cost factors to be considered)
• If Cost of Make > Cost of Buy, then BUY.

Question.19

(a) Distinguish between Monopoly Pricing and Competitive Pricing.

Answer:

Perfect competition is the market in which there is a large number of buyers and sellers. The goods sold in this market are identical. A single price prevails in the market. On the other hand monopoly is a type of imperfect market. The number of sellers is one but the number of buyers is many. A monopolist is a price-maker. In fact monopoly is the opposite of perfect competition.

There are many points of difference which are noted below:

- Under perfect competition there are a large number of buyers and sellers in the market competing with each other. The price fixed by the industry is accepted by all the firms operating in the market. As against this, under monopoly, there is only one single seller but a large number of buyers. The distinction between, firm and industry disappears under this type of market situation.
- The average revenue curves under competition and monopoly take different shapes. The average revenue (price) curve under perfect competition is a horizontal straight line parallel to OX-axis. The industry demand curve or revenue curve slopes downward from left to right. But under monopoly the firm is itself the industry.
  There is only one demand curve common both to the monopoly firm and monopoly industry. The average revenue curve under monopoly slopes downward and its corresponding marginal revenue curve lie below the average revenue curve. Under perfect competition MR Curve is the same as AR Curve.
- Under perfect competition price equals marginal cost at the equilibrium output, but under monopoly equilibrium price is greater than marginal cost. Under perfect competition marginal revenue is the same as average revenue at all levels of output. Thus at the equilibrium position under perfect competition marginal cost not only equals marginal revenue but also average revenue.
  On the other hand under monopoly both the AR and MR curve slope downward and MR curve lies below AR curve. Thus average revenue is greater than marginal revenue at all levels of output. Hence at the equilibrium output of the monopolist price stands higher than marginal cost. Under competition price MR=MC. In monopoly equilibrium, price > MC.
- A competitive firm makes only normal profit in the long run. As against this, a monopolist can make super normal profits even in the long run. In perfectly competitive market there is freedom of entry and exit. Attracted by the supernormal profit earned by the existing firms the new competitive firms enter the market to compete away the supernormal profit. Output rises and profit becomes minimum.
  Thus in the long run a competitive firm earns only normal profit. But under monopoly the firm continues earning supernormal profits even in the long run since there are strong barriers to the entry of new firms in the monopolistic industry.
- A monopolist can discriminate prices for his product, a firm working under perfect competition cannot. The monopolist will be increasing his total profit by price discrimination if he finds Elasticity's of demand are different in different markets.
  As against this a competitive firm cannot change different prices from different buyers since he faces a perfectly elastic demand at the going market price. If he increases a slights rise in price he will lose the sellers and makes loss. Thus a competitive firm cannot discriminate prices which a monopolist can do.

(b) ABC Limited uses a small casting in one of its finished products. The castings are purchased from a foundry. ABC Limited purchases 54,000 casting per year at a cost of ₹800 per casting.

The castings are used evenly throughout the year in production process on a 360 day per year basis. The company estimates that it costs ₹9,000 to place a single purchase order and about ₹300 to carry one casting in inventory for a year. The carrying costs result from the need to keep the castings in carefully controlled temperature and humidity conditions, and from the high cost of insurance.

Delivery from the foundry generally takes 6 days, but it can take as much as 10 days. The days of delivery time and percentage of their occurrence are shown in the following table-

Delivery Time (days)	**6**	**7**	**8**	**9**	**10**
Percentage of occurrence	**75**	**10**	**5**	**5**	**5**

(i) Compute the Economic Order Quantity.

(ii) Assume that the company is willing to take a 15% risk of being out of a stock. What would be the safety stock and the Re-Order point?

(iii) Assume that the company is willing to take a 5% risk of being out of stock. What would be the safety stock and Re-Order point?

(iv) Refer to the original data. Assume that using process re-engineering the company reduces its cost of placing a purchase of order to only ₹600. In addition, the company estimates that when the waste and in efficiency caused by inventories are considered, the true cost of carrying a unit in stock is ₹720 per year. (a) Compute new EOQ and (b) How frequently would the company be placing an order, as compared to the old purchasing policy?

Answer:

(i) EOQ= $\sqrt{2AB \div C}$, Where,

A=Annual Requirement of materials= 54,000 castings

B= Buying cost per order= ₹9,000 per order

C=Carrying cost p.u. p.a.= ₹300 per unit per annum.

On substitution, EOQ=1,800 castings

(ii)

Average Consumption per day	=54,000 castings÷360 days	=150 castings
Average lead time	=(10+6)÷2	=8 days
For **15% stock-out risk**, relevant delivery time (Cumulative percentage of occurrence up to 7 days is 75 +10 = 85%. Hence, risk of stock-out is 15%)		=7 days
Hence Safety stock	=7days consumption=7x150	**=1,050 Castings**

Re-order point	=safety stock+ Lead time consumption	=1,050+(150x 8)	**2,250 Castings**

(iii)

For 5% stock-out risk, relevant delivery time		= 9 days
(Cumulative % of occurrence up to 9 days is 75+10+5+5=95%. Hence, risk of stock-out is 5%)		
Hence, Safety Stock	= 9 days consumption = 9 x 150	**=1,350 castings**

Re-order point	=Safety Stock+ Lead time consumption	=1,350+(150x8)	**=2,550 castings**

(iv) EOQ= $\sqrt{2AB \div C}$, Where,

A=Annual Requirement of Raw Materials= 54,000 castings.

B=Buying Cost per order =₹600 per order.

C=Carrying Cost p.u. p.a.=₹720 per unit per annum.

On substitution, **EOQ=300 castings.**

Number of orders p.a.	,000÷1,800	**orders(old)**	And 54,000÷300	**=180 orders(new)**

The Company should be placing an order every alternative day (360÷180) i.e. once in two days under the new system, whereas it was making an order once in 12 days earlier. (360÷30)

Question.20

(a) Ashok Products Co. Ltd. manufactured and sold in a year 15,000 units of a particular product fetching a sales value of ₹15 lakhs. After charging direct material 30% on sales value, direct labour 20% on sales value, variable overheads ₹10 per unit, the company earned profit of ₹16 2/3 per unit during the year.

The existing equipment can produce a maximum of 20,000 units per annum. In case, the demand exceeds the maximum output, new equipment will be required which will cost ₹10 lakhs and it will have a life span of 10 years, with no residual value.

A prospective is willing to place an order on the company for 10,000 units per year regularly at 90% of the present selling price, which will be, if accepted, over and above the existing market for 15,000 units.

Irrespective of the fact whether or not the new order materialises, the cost increase with immediate effect are:

(i) 10% in the Direct Materials.

(ii) 25% in the Direct Labour.

(iii) ₹50,000 in Fixed Overheads per year.

If the order additional 10,000 units is accepted, the fixed overhead will increase by another ₹50,000 by way of increased administration expenses.

You are required to recommend whether the company should accept the new business at the stipulated price or decline the new offer and make a concerted sales drive to sell the present unused capacity at the present selling price? The sales drive will cost ₹60,000 per year.

Ignore the financial charges on the cost of the equipment and assume there is no opening and closing inventories. Variable costs will increase indirect proportion to the output.

Answer:

Present Selling price = ₹ 15,00,000/15,000 = ₹ 100 per unit

Present Cost Structure:

	₹
Direct materials (30% of sales value)	4,50,000
Direct labour (20% of sales value)	3,00,000
Variable overheads (₹10 per unit)	1,50,000
	9,00,000
Contribution	6,00,000
Profit (₹16$^2/_3$ per unit)	2,50,000
Fixed Overheads	3,50,000

Comparative statement of the proposals (Revised cost basis)

capacity	Present capacity	Maximum	Present plus 10,000 units
Units	15,000	20,000	25,000
Sales value	15,00,000	20,00,000	15,00,000
			(+) 9,00,000
			24,00,000
Direct materials (33% on sales value)	4,95,000	6,60,000	4,95,000 (+) 3,30,000

(10/15 x 4,95,000)			
Direct labour (25% on sales value) (10/15 x 3,75,000)	3,75,000	5,00,000	3,75,000 (+) 2,50,000
Variable overhead (₹10 per unit)	1,50,000	2,00,000	2,50,000
Fixed overhead	3,50,000 (+)50,000	3,50,000 (+)50,000	3,50,000 (+) 50,000 (+) 50,000
Sales drive	60,000		—
Depreciation on new Equip.			1,00,000
Total costs	14,20,000	18,20,000	22,50,000
Profit	80,000	1,80,000	1,50,000

It will be advisable for the company to accept the offer instead of selling the 20,000 units @ ₹100 per unit, since the former yields a higher profit.

(b) Neha Soap Company manufactures four different brands soaps namely Komal, Lovely, Makeup, and Nice. The data on production and sales of these brands during 1984 is reproduced below:

Brand Name	**Komal**	**Lovely**	**Makeup**	**Nice**
Production & Sale/unit	**3,00,000**	**5,00,000**	**70,000**	**40,000**
Sales value (₹Lakhs)	**15**	**31**	**2.8**	**1.2**

All the above are manufactured jointly up to a particular process. At split point they are formed into cakes and packed. The annual cost data were as under:

Direct Materials cost	**₹30 lakhs**
Value added (includes profit at 25% on total cost)	**₹20 lakhs**

Komal	**₹1,20,000**
Lovely	**₹1,30,000**
Nice	**₹50,000**

You are required to:

(i) Work out the profit and cost of each brand of soap after allocating joint cost on the basis of Net Realisable value at split up point. (Per unit cost not required).

(ii) Find our revised cost and profit on each brand if the company decides to sell all soaps at split up point at following prices :
Komal ₹4.50, Lovely ₹6.00, Makeup ₹4.00 and Nice ₹1.500 per unit
Assume that for allocation of joint cost 'Net Realisable value Method' is used.

(iii) With the working result in (i) and in (ii) above advise Neha Soap Company about the processing decision as to which soap to be sold at split up point and which to processed further so as to maximise profit. Substantiate your decision with suitable costing technique.

Answer:

(i) Calculation of Joint Costs:

	₹
Materials Cost	30,00,000
Value added	20,00,000
Selling price	50,00,000
Less: Profit at 20% on sales or 25% on cost	10,00,000
Total Cost	40,00,000
Less: further processing cost	3,00,000
Joint cost	37,00,000

Total net realisable value = Sales value – further-processing cost i.e. ₹50,00,000 – ₹3,00,000
= ₹47,00,000.

Therefore, joint cost will be distribution to the product as under:
Net Realisable Value × 37,00,000/ 47,00,000

Sales after further processing:

Particular	**Komal (₹)**	**Lovely (₹)**	**Makeup (₹)**	**Nice (₹)**	**Total (₹)**
Sales value	15,00,000	31,00,000	2,80,000	1,20,000	50,00,000
Less: Further Process cost	1,20,000	1,30,000	—	50,000	3,00,000
Net realisable value	13,80,000	29,70,000	2,80,000	70,000	47,00,000
Joint cost	10,86,383	23,38,085	2,20,426	55,106	37,00,000
Profit	2,93,617	6,31,915	59,574	14,894	10,00,000

(ii) Sole at split up point:

Particular	**Komal (₹)**	**Lovely (₹)**	**Makeup (₹)**	**Nice (₹)**	**Total (₹)**
Sale value/unit	4.50	6.00	4.00	1.50	
Qty.-sold- Units	3,00,000	5,00,000	70,000	40,000	
Revised sales value	13,50,000	30,00,000	2,80,000	60,000	46,90,000
Joint cost	10,65,032	23,66,738	2,20,895	47,335	37,00,000
Profit	2,84,968	6,33,262	59,105	12,665	9,90,000

Joint cost = Net Realisable Value × 37,00,000/ 46,90,000

(iii) Decision for further processing:

Particular	**Komal (₹)**	**Lovely (₹)**	**Makeu(₹)**	**Nice (₹)**
Sales value at split up	13,50,000	30,00,000	2,80,000	60,000
Sales after split up	15,00,000	31,00,000	2,80,000	1,20,000
Increment sale	1,50,000	1,00,000	—	60,000
Further processing	1,20,000	1,30,000	—	50,000
Incremental gain	30,000	(30,000)	—	10,000

Question.21

(a) A mineral is transported from two mines-'P' and 'Q' and unload a plots in a railway station. Mine P is at a distance of 15 kms. and Q is at a distance of 20 kms. from railhead plots. A fleet of Lorries of 5 tonne carrying capacity is used for the transport of mineral from the mines. Records reveal that the Lorries average a speed of 30 kms. per hour, when running and regularly take 15 minutes to unload at the railhead. At mine 'P' loading time average 35 minutes per load while at mine 'Q' loading time average 25 minutes per load. Drivers' wages, depreciation, insurance and taxes are found to cost ₹30 per hour operated. Fuel, oil, tyres, repairs and maintenance cost ₹20 per kms.

Draw up a statement, showing the cost per tone-kilometer of carrying mineral from each mine.

Answer:

Working Note:

Calculation of operating time

(i) Calculation of operating time

Particulars	**Mine P**	**Mine Q**
Loading time	35	25
Unloading time	15	15
Running time to and fro	60	80
Total operating time (minutes)	110	120
Total operating time (hours)	1 hour 50 minutes	2 hours

(ii) Calculation of effective ton-kms

Mine P	5 tonnes×15 kms	75 tonne-kms
Mine Q	5 tonnes×20 kms	100 tonne-kms

(iii) Calculation of Fixed cost

Drivers' wages depreciation insurance and taxes cost p.h		₹30.00
Mine P	₹30×1 hours 50 minutes	₹55.00
Mine Q	₹30× 2 hours	₹60.00

(iv) Calculation of Running and maintenance cost

Fuel, oil, tyres, repairs and maintenance

Per km	₹20	
Mine P	30 km×₹20	₹600
Mine Q	40 km×₹20	₹800

Statement showing cost per ton-km. of carrying Mineral from each mine

Particulars		**Mine P**	**Mine Q**
Fixed cost per trip		55.00	60.00
Running and maintenance cost		600.00	800.00
Total cost per trip	(i)	655.00	860.00
Effective tonne-kms.	(ii)	75	100
Cost per tonne-kms.	(i)/(ii)	₹8.73	₹8.60

(b) X Ltd. is considering a project with following cash flows :

Year	**Purchase of plant (₹)**	**Running Cost (₹)**	**Savings (₹)**
0	**(7,000)**		
1		**2,000**	**6,000**
2		**2,500**	**7,000**

The cost of capital is 8% .Measure the sensitivity of the project to changes in the levels of Plant Value, Running Costs and Savings (considering each factors at a time) such that Net present value becomes zero. Which factor is most sensitive to affect the acceptability of the project? The Present value factors at 8% are as follows:

Year	**Factor**
0	**1.00**
1	**0.93**
2	**0.86**

Answer:

The present values of the cash flows are as follows:

Year Cost	**Discount Factor at 8%**	**PV of plant cost (₹)**	**PV of running (₹)**	**PV savings (₹)**	**PV of Net cash flows (₹)**
0	1.00	(7,000)			(7,000)
1	0.93		(1,860	5,580	3,720
2	0.86		(2,150)	6,020	3,870
		(7,000)	(4,010)	11,600	590=NPV

The project has a positive NPV and therefore accepted. The changes in cash flows which would need to occur the project only just breaks even (NPV= 0) are as follows:

Sensitivity Analysis:

(i) Plant costs would need to **increase** by a **PV** of ₹590
i.e. by 590 × 100 = 8.43% 7,000

(ii) Running costs would need to **increase** by a **PV** of ₹590
i.e. by 590 × 100 = 14.71% 4,010

(iii) Saving would need to **fall short** by a **PV** of ₹590
i.e. by 590 × 100 = 5.09% 1,600

(c) List out the objectives of Transfer Pricing.

Answer:

(i) Goal congruence: The prices should be set so that the divisional management desire to maximize divisional earnings is consistent with the objectives of the company as a whole. The transfer prices should not encourage sub-optimal decision-making. The system should be so designed that decisions that improve business unit profits will also improve company profits.

(ii) Performance appraisal: The prices should enable reliable assessments to be made of divisional performance. The prices form part of information, which should:
- Guide decision making.
- Appraise managerial performance.
- Evaluate the contribution made by the division to overall company profits.
- Assess the worth of the division as an economic unit.
  The transfer prices should be designed such that they help in measuring the economic performance

(iii) Divisional autonomy: The prices should seek to maintain the maximum divisional autonomy so that the benefits of decentralization (motivation, better decision-making, initiatives, etc.) are maintained. The profits of one division should not be dependent on the actions of other divisions.

(iv) Simple and easy: The system should be simple to understand and easy to administer.

(v) The transfer price should provide each segment with the relevant information required to determine the optimum trade-off between company costs and revenues.

(vi) To optimise the profit of the company over a given short period of time. Here the stress is on maximum utilisation of plant capacity.

(vii) To optimise the allocation of companies' financial resources. This is a long-term objective.

Study Note 8: Budgetary Control and Standard Costing in Profit Planning

Question.22

(a) What are the essential steps for installation of Budgetary Control System?

Answer:

Essential Steps for Installation of Budgetary Control System

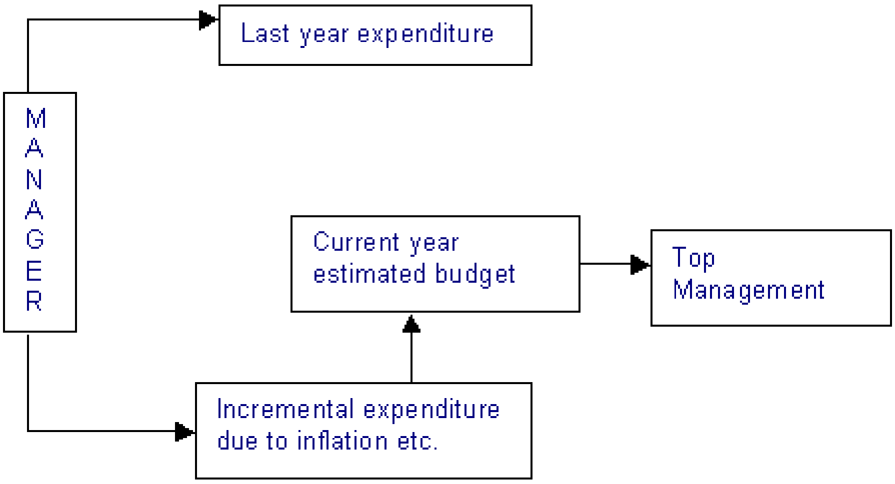
In order to have effective Budgetary Control System, it is appropriate to take the following steps:

- **Budget Manual:** This is a written document specifying the objectives and procedures of budgetary control. **It spells out the duties and responsibilities of executives.** The budget manual defines the sanctioning powers of the various authorities.
- **Budget Centres:** A budget centre is that part of organisation for which the budget is prepared. **Budget centre can be a department, section of a department or any other part of department.** Budget centres are necessary for the purpose of ascertaining cost, performance and its control.
- **Budget Committee:** In a large concern, all the functional heads are the members of the budget committee. They discuss their respective budgets and finalise the budget, after collective decisions. **The committee is responsible for its execution and achievement of the goals set.**
- **Budget Officer:** The chief executive appoints some person as the budget officer. He is conversant with the functioning of the various departments. All budgets are presented to the budget officer who places before the budget committee, after making the necessary changes, for its approval. The actual performance of each department is communicated to the budget officer. He determines the variances, analyses the reasons and reports to the top management to take the necessary steps to remove the deviations. The variances are reported to the concerned departments too for necessary action, as may be necessary. **As the convenor of the budget**

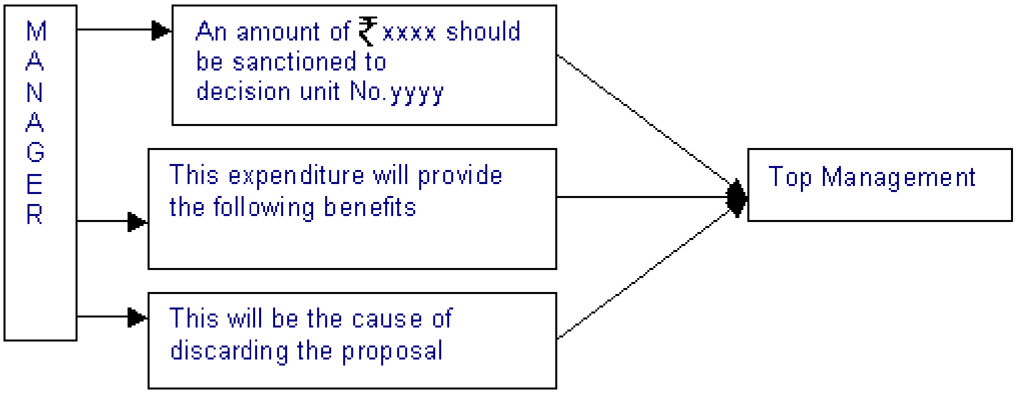
committee, the main function of Budget officer is co-ordination to ensure achievement of the budgeted targets.

- **Functional Budgets: Separate functional budgets have to be prepared.** Examples are Production Budget, Sales Budget, HR Budget, Cash Budget, Capital Expenditure Budget and R & D Budget.
- **Budget Period: A budget period is the length of the period for which budget is prepared.** Normally, budgets like purchases and sales budgets are prepared for one year. However, a capital expenditure budget is prepared for a longer period i.e. 3 to 5 years.
- **Determination of Key Factor:** Budgets are prepared for all the functional areas such as production, sales, purchases, finance, human resources and research and development. These activities are inter-connected and inter-dependent and so the budgets are. For example, raw material supply may be limited. So, production and sales budgets are prepared, based on the purchase budget. To some of the firms, finance may be a constraint. Then, all other budgets are prepared based on the availability of finance. **A factor, which influences all other budgets, is known as key factor or principal factor.**

Traditional Budget



Zero Based Budgeting



(b) Aoulakh Ltd engaged in the manufacture of four products has prepared the following budget for 2014.

	A	B	C	D
Production Units	**20,000**	**5,000**	**25,000**	**15,000**
Selling price Rs/unit	**21.75**	**36.75**	**44.25**	**64.00**

Direct Materials Rs/unit	**6.00**	**13.50**	**10.50**	**24.00**
Direct Wages Rs/Unit	**7.50**	**10.00**	**18.00**	**24.00**
Variable Overheads ₹/unit	**2.25**	**5.00**	**6.00**	**6.50**
Fixed Overheads ₹p.a.	**75,000**	**25,000**	**2,25,000**	**1,80,000**

When the budget was discussed, it was proposed that the production should be increased by 10,000 units for which capacity existed in 2014.

It was also decided that for the next year i.e.2015, the production capacity should be further increased by 25,000 units over and above the increase of 10,000 units envisaged as above for 2014. The additional production capacity of 25,000 units should be used for the manufacture of product 'B' for which new production facilities were to be created at an annual fixed overhead cost of ₹35,000. The direct material costs of all the four products were expected to increase by 10% in 2015 while the other costs and selling prices would remain the same.

Required: -

(i) Find the profit of 2014 on the assumption that the existing capacity of 10,000 units is utilised to maximize the profit.

(ii) Prepare a statement of profit for 2015.

(iii) Assuming that the increase in the output of product 'B' may not fully materialise in the year 2015, find the number of units of product B to be sold in 2013 to earn the same overall profit as in 2014.

Answer:

(i) Statement showing computation of profit for the year 2014

			A	B	C	D	Total
I.	Selling Price	₹	21.75	36.75	44.25	64.00	
II.	Variable Cost	₹	15.75	28.50	34.50	54.50	
III.	Contribution	₹	6.00	8.25	9.75	9.50	
IV.	No. of units		20,000	5,000	35,000	15,000	
V.	Total Contribution	₹	1,20,000	41,250	3,41,250	1,42,500	6,45,000
VI.	Fixed Cost	₹	75,000	25,000	2,25,000	1,80,000	5,05,000
VII.	Profit	₹					1,40,000

(ii) Profit for the year 2015

			A	B	C	D	Total
I.	No. of Units		20,000	30,000	35,000	15,000	
II.	Contribution per unit	₹	5.4	6.9	8.7	7.1	
III.	Total Contribution	₹	1,08,000	2,07,000	3,04,500	1,06,500	7,26,000
IV.	Fixed Cost	₹					5,40,000
V.	Profit	₹					1,86,000

(iii) In order to get the profit of 2014, the 'Contribution' to be recovered as follows:

	₹
Profit for the year 2014	1,40,000
Existing Fixed Cost	5,05,000
Additional Fixed Cost	35,000
	6,80,000
(-) 'Contribution' Recovered from A, C, D	5,19,000
To be recovered from 'B'	1,61,000

No. of units of B required= 1,61,000 / 6.9 = 23,333 units

Additional units minimum required = 23,333-5,000 = 18,333 units

Question.23

(a) Distinguish between ZBB and Traditional Budgeting.

Answer:

The distinctions between the traditional budgeting & zero-base budgeting are the following:

- In traditional budgeting, emphasis is given on previous level of expenditure, whereas, in ZBB, every time a budget is prepared, new economic appraisal is made.
- Traditional budgeting is a function which is accounting oriented, whereas, ZBB is a function which is project or decision oriented.
- For the preparation of a traditional project, rejustification of the existing programme is not needed, whereas, for the preparation of a zero-base budgeting, the justification of existing & new projects is needed to be done in the light of benefits & costs.
- In the case of traditional budget, the justification regarding why, for a particular decision unit, a particular amount of expenditure is decided upon, is justified by the top management, whereas, in case of ZBB, the amount of expenditure is justified by the manager of the decision unit & not the top management.
- In the case of traditional budgeting, the amount to added with or deleted from the figures of the previous budget figures is only taken into account, whereas, in case of ZBB, existing level of expenditure is appraised & the justification of future proposal for expenditure is done from different angles.
- Preparation of a traditional budget is a simple job which is done year after year monotonously, whereas, preparation of a zero-base budgeting requires logical approach & many complex steps are involved for the establishment of logic behind a proposal.

(b) A manufacturer has an order for one lakh units. With his present equipment they cost 80 paise each to make and there is a 6% fraction defective. However, he may install special controls which together with their cost of development, cost ₹18,000 . His variable cost per unit, then falls to 60 paise each; but the process may be less reliable. How much less reliable can the process be, before he should reject the special controls?

Answer:

Let the break-even fraction defective = x

Manufacturer's order = 1,00,000 units

In order to get 1,00,000 goods unit $\frac{1,00,000}{1-x}$ items should be made

Cost without special controls = $\frac{1,00,000 \times 0.08}{1-0.06}$ = 85,106

Cost with special controls = ₹18,000 + (0.60) $\frac{1,00,000}{1-x}$

By equating both proposals

₹85,106 = ₹18,000 + (0.60) $\frac{1,00,000}{1-x}$

or, 67,106 = $\frac{60,000}{1-x}$

or, 1-x = 0.894

or, x = 1- 0.894

or, x = 0.106

or, x = 10.6%

(c) Following information is given regarding standard composition and standard rates of a gang of workers:

Standard composition	Standard hourly rate
10 Men	**₹ 0.625**
5 Women	**0.400**
5 Boys	**0.350**

According to given specifications, a week consists of 40 hours and standard output for a week is 1,000 units.
In a particular week, gang consisted of 13 men, 4 women and 3 boys and actual wages were paid as follows:
Men @ ₹ 0.6 per hour Women @ ₹ 0.425 per hour Boys @ ₹ 0.325 per hour
Two hours were lost in the week due to abnormal idle time. Actual production was 960 units in the week.
Find out—
(i) Labour rate variance
(ii) Labour mix variance.
(iii) Labour idle time variance.
(iv) Labour yield variance.
(v) Labour efficiency variance.
(vi) Labour cost variance.

Answer:

L_1 - Actual payment to workers for actual hours worked

Actual composition of gang		**Hrs. worked**		**Rate**	**Amount**
13 Men	x	40	x	₹0.600	`₹312
4 Women	x	40	x	0.425	68
3 Boys	x	40	x	0.325	39
					419

L_2 – Payment involved, if workers had been paid at standard rate

Actual composition of gang		**Hrs. worked**		**S. Rate**	**Amount**
13 Men	x	40	x	₹ 0.625	₹325
4 Women	x	40	x	0.400	64
3 Boys	x	40	x	0.350	42
					431

L_3 – Payment involved, if workers had been used according to proportion of standard gang and payment had been made at standard rate.

Actual composition of gang		**Hrs. worked**		**S. Rate**	**Amount**
10 Men	x	40	x	₹0.625	₹250
5 Women	x	40	x	0.400	80
5 Boys	x	40	x	0.350	70
					400

L_4 – Standard labour cost of labour hours untilized.

Actual composition of gang		Hrs. worked		S. Rate	Amount
10 Men	x	38	x	₹ 0.625	₹237.50
5 Women	x	38	x	0.400	76.00
5 Boys	x	38	x	0.350	66.50
					380.00

L_5 – Standard labour cost of output achieved.

$$\frac{\text{Standard labour cost for standard output}}{\text{Standard output}} \times \text{Actual output} = \frac{₹\,400}{1{,}000 \text{ units}} \times 960 \text{ units} \quad \text{or } ₹384$$

Variances

(i) Labour Rate Variance = $L_1 - L_2$ = ₹419 – ₹431 or ₹12 (F)
(ii) Labour Mix Variance = $L_2 - L_3$ = ₹431 – ₹400 or ₹31 (A)
(iii) Labour Idle Time Variance = $L_3 - L_4$ = ₹400 – ₹380 or ₹20 (A)
(iv) Labour Yield Variance = $L_4 - L_5$ = ₹380 – ₹384 or ₹4 (F)
(v) Labour Efficiency Variance = $L_2 - L_5$ = ₹431 – ₹384 or ₹47 (A)

Alternatively, Labour Efficiency Variance = Labour Mix Variance + + Labour Idle Time Variance + Labour Yield Variance.
= 31 (A) + 20 (A) + 4 (F) or ₹47 (A)

(vi) Labour Cost Variance = $L_1 - L_5$ = ₹419 – ₹384 or ₹35 (A)

Alternatively, Labour Cost Variance = Labour Rate Variance + Labour Mix Variance + Labour Idle Time Variance + Labour Yield Variance = 12 (F) + 31 (A) + 20 (A) + 4 (F) or 35 (A)

Study Note 9: Process Control and Activity based Cost Management, JIT & ERP

Question.24
(a) List out the benefits and pitfalls of Simulation Modeling.
Answer:

Benefits of Simulation Modeling and Analysis

Simulation modeling and analysis is one of the most frequently used operations research techniques. When used judiciously, simulation modeling and analysis makes it possible to:

- Obtain a better understanding of the system by developing a mathematical model of a system of interest, and observing the system's operation in detail over long periods of time.
- Test hypotheses about the system for feasibility.
- Compress time to observe certain phenomena over long periods or expand time to observe a complex phenomenon in detail.
- Study the effects of certain informational, organizational, environmental and policy changes on the operation of a system by altering the system's model; this can be done without disrupting the real system and significantly reduces the risk of experimenting with the real system.
- Experiment with new or unknown situations about which only weak information is available.
- Identify the "driving" variables - ones that performance measures are most sensitive to - and the inter-relationships among them.
- Identify bottlenecks in the flow of entities (material, people, etc.) or information.
- Use multiple performance metrics for analyzing system configurations.
- Employ a systems approach to problem solving.
- Develop well designed and robust systems and reduce system development time.

Pitfalls of Simulation:

Simulation can be a time consuming and complex exercise, from modeling through output analysis, that necessitates the involvement of resident experts and decision makers in the entire process. Following is a checklist of pitfalls to guard against.

- Unclear objective.
- Using simulation when an analytic solution is appropriate.
- Invalid model.
- Simulation model too complex or too simple.
- Erroneous assumptions.
- Undocumented assumptions. This is extremely important and it is strongly suggested that assumptions made at each stage of the simulation modeling and analysis exercise be documented thoroughly.
- Using the wrong input probability distribution.
- Replacing a distribution (stochastic) by its mean (deterministic).
- Using the wrong performance measure.
- Bugs in the simulation program.
- Using standard statistical formulas that assume independence in simulation output analysis.
- Initial bias in output data.

- Making one simulation run for a configuration.
- Poor schedule and budget planning.
- Poor communication among the personnel involved in the simulation study.

(b) Explain the different steps or stages of Activity Based Costing.

Answer:

Stages of Activity Based Costing

The different steps or stages in ABC system can be given as follows:

(ii) Identify the chosen cost objects

The cost objects of any organization are the products or services and the goal is to first calculate the total cost of manufacturing and distributing these products and their unit cost.

(iii) Identify the different activities within the organization

After the identification of cost objects, the main activities, which are being performed in the organization, have to be identified. Usually the number of activities over cost centers in ABC will be much more as compared to traditional overhead system. The exact number will depend on how the management subdivides the organizations activities.

(iv) Identifying the direct cost of products

The direct cost of products or objects may comprise direct material cost, direct labor cost and direct expenses. Classification of as many of the total costs as direct costs as is economically feasible should be made. It reduces the amount of costs classified as indirect.

(v) Relating the overhead to the activities

After identifying the organizations activities, the various items of overhead are related to activities both support and primary, that caused them. As a result of relating the items of overhead to various activities, cost pool or cost buckets are created.

(vi) Spreading the support activities across the primary activities

The spreading of support activities (i.e., activities which support or assist manufacturing) across the primary activities (correlated to the number of units produced) is done on some suitable base which reflects the use of support activity. The base is the cost driver and is measured of how the support activities are used.

(vii)Determining the activity cost drivers

The determination of the activity cost drivers is done in order to relate the overhead collected in cost pools to the cost objects of products. It is done on the basis of the factor that drives the consumption of the activities.

(viii) Calculating the activity cost driver rates

The activity cost rates for each activity are calculated in the way in which overhead absorption rates would be calculated under the traditional system. It can be presented as follows:

Activity cost driver rate = Total cost of activity/Activity driver

These activity cost driver rates are to be used for ascertaining the amount of overhead chargeable to various cost objects or products.

(ix) Computing the total cost of products or cost objects

The total costs of the products shall be computed by adding all direct and indirect costs assigned to them. The amount of overhead chargeable to a product or cost object shall be calculated by multiplying the activity cost drivers rates by different amounts of each activity that each product or other cost object consumes.

Question.25 Read the following Case and answer the following questions.

Shaw Wallace makes two wines: a regular wine and a premium wine. Shaw Wallace distributes the regular wine and the premium wine through different distribution channels. It distributes 2,40,000 cases of regular wine through 10 general distributors and 1,60,000 cases of the premium wine through 30 specialty distributors. Shaw Wallace incurs ₹42,60,000 in distribution costs. Under its existing costing system, Shaw Wallace allocates distribution costs to products on the basis of cases shipped.

To understand better the demands on its resources in the distribution area, Shaw Wallace identifies three activities and related activity costs.

a. Promotional costs-Shaw Wallace estimates it incurs ₹ 16,000 per distributor.

b. Order handling costs-Shaw Wallace estimates costs of ₹ 600 pertaining to each order. Shaw Wallace records show that distributors of regular wine place an average of 10 orders per year, whereas distributors of premium wine place an average of 20 orders per year.

c. Delivery costs-₹ 8 per case.

(i) Using Shaw Wallace existing costing system, calculate the total distribution costs and distribution cost per case for the regular wine and the premium wine.

(ii) Using Shaw Wallace activity-based costing system, calculate the total distribution costs and distribution cost per case for the regular wine and the premium wine.

(iii) Explain the cost differences and the accuracy of the product costs calculated using the existing costing system and the ABC system. How might Shaw Wallace management use the information from the ABC system to manage its business better?

(iv) Why a Company choose ABC System.

Answer:

(i) Total distribution costs (given), ₹42,60,000
Distribution cost per case under existing system

$$= \frac{\text{Total distribution costs}}{\text{Total case of premium and regular wine shipped}}$$

= ₹42,60,000/4,00,000 = ₹10.65 per case

	Regular Per case		Premium Per case	
	Total (1)	**(2) (1) ÷ 2,40,000**	**Total (3)**	**(4)3 ÷ 1,60,000**
Distribution costs ₹10.65 × 2,40,000 and ₹ 10.65 × 1,60,000	₹25,56,000	₹10.65	₹17,04,000	₹10.65

(ii)

Particulars	**Regular Per case**		**Premium Per case**	
Delivery costs	**Total (1)**	**(2) (1) ÷ 2,40,000**	**Total (3)**	**(4) 3 ÷ 1,60,000**
₹8 × 2,40,000 cases ₹8 × 1,60,000 cases	₹19,20,000	₹8.00	₹12,80,000	₹8.00
Ordering costs ₹600 × 10 orders/year × 10 distributors ₹600 × 20 orders/year × 30 distributors	60,000	0.25	3.60,000	2.25
Promotion costs ₹16,000 × 10 distributors ₹16,000 × 30 distributors	1,60,000	0.67	4,80,000	3.00
Total costs	21,40,000	8.92	21,20,000	13.25

(iii) The existing costing system uses cases shipped as the only cost allocation base for distribution costs. As a result, the distribution cost per case is the same for premium and regular wines (₹ 10.65). In fact, premium wine uses distribution resources more intensively than regular wine: (a) Shaw Wallace spends ₹16,000 on promotional costs at each distributor independent of cases sold. Premium wine distributors sell fewer cases a year than regular wine distributors. As a result the promotional cost per case of wine sold is higher for premium wine than for regular wine, (b) Shaw Wallace's cost per order is ₹ 600 regardless of the number of cases sold in each order. Because premium wine distributors order fewer cases per order, the ordering costs per case are higher for premium wines than for regular wines.

The existing costing system under costs distribution costs per case for premium wine and overcasts distribution costs per case for regular wine.

Shaw Wallace's management can use the information from the ABC system to make better pricing and product mix decisions, to reduce costs by eliminating processes and activities that do not add value, to reduce the costs of doing various activities, and to plan and manage activities.

(iv) The reasons for choosing ABC System are as follows:

- Cost Reduction: ABC measures how much activities that are costly and then take steps to reduce their costs by changing the productions process or outsourcing those activities.
- Production pricing and decisions of weather to continue producing a product or keeping a particular customer. ABC implementers generally believe that ABC provides more accurate cost information than conventional costing does. Management can use this information to negotiate price increases with customers or to drop unprofitable product.
- Budgeting and performance measurement: Management can use more accurate cost information to improve budgets and measures of department and division performance.

Study Note 10: Cost of Quality and Total Quality Management

Question.26

(a) Write Short notes on "PRAISE Analysis" and the difficulties in the PRAISE process.

Answer:

Identification of improvement opportunities and implementation of quality improvement process, of the TQM Process is through a six-step activity sequence, identified by the acronym 'PRAISE'.

Step	Activity	Elements
1	Problem Identification	• Areas of customer dissatisfaction. • Absence of competitive advantage.
2	Ranking	• Prioritise problems and opportunities by – **(i)** Perceived importance, and **(ii)** 2. Ease of measurement and solution.
3	Analysis	• Ask "Why?" to identify possible causes. Keep asking 'Why?' beyond to the move symptoms and to avoid jumping to premature conclusion;,. • Ask 'What?' to consider potential implications. • Ask 'How much?' to quantify cause and effect.
4	Innovation	• Use creative thinking to generate potential solutions. • Operationalise these solutions by identifying – **(i)** Barriers to implementation, **(ii)** Available enablers, and **(iii)** People whose co-operation must be sought.
5	Solution	• Implement the preferred solution. • Take appropriate action to bring about the required

		changes. • Reinforce with training and documentation back-up.
6	Evaluation	• Monitor the effectiveness of actions. • Establish and interpret performance indicators to track progress towards objectives • • Identify the potential for further improvements and return to step 1.

Difficulties in PRAISE Analysis

Step	Activity	Difficulties	Remedies
1	Problem Identification	• Effects of a problem are apparent, but the problems themselves are difficult to identify. • Problem may be identifiable, but it -is difficult to identify a measurable improvement opportunity. • Some problems are too vague to define e.g. morale, communication, productivity etc.	• Participative approaches like brainstorming, multi-voting, panel discussion. • Quantification and precise definition of problems.
2	Ranking	• Difference in perception of individuals in ranking • Difference in preferences based on functions, e.g. production, finance, marketing etc. • • Lack of consensus between individuals.	• Participative Approach. • Subordination of individual to group interest.
3	Analysis	• Adoption of adhoc approaches and quick-fix solutions.	• Lateral Thinking. • Brainstorming.
4	Innovation	• Lack of creativity or expertise. • Inability to operationalise ideas, i.e. convert thoughts into action points.	• Systematic evaluation of all aspects of each strategy.
5	Solution	• Resistance from middle managers.	• Effective internal communication. • Training of personnel and managers. • Participative approach.
6	Evaluation	• Problems in implementation. • Lack of measurable data for comparison of expectations with actual.	• Effective Control System to track actual. • Feedback system.

(b) What are the components of cost to be reported in a Cost of Quality Report?
Answer:

- **Prevention costs** are all costs incurred in the process of preventing poor quality from occurring. They include quality planning costs, such as the costs of developing and implementing a quality plan. Also included are the costs of product and process design, from collecting customer information to designing processes that achieve conformance to specifications. Employee training in quality measurement is included as part of this cost, as well as the costs of maintaining records of information and data related to quality.

- **Appraisal costs** are incurred in the process of uncovering defects. They include the cost of quality inspections, product testing, and performing audits to make sure that quality standards are being met. Also included in this category are the costs of worker time spent measuring quality and the cost of equipment used for quality appraisal.
- **Internal failure costs** are associated with discovering poor product quality before the product reaches the customer site. One type of internal failure cost is *rework*, which is the cost of correcting the defective item. Sometimes the item is so defective that it cannot be corrected and must be thrown away. This is called *scrap*, and its costs include all the material, labor, and machine cost spent in producing the defective product.
- **External failure costs** are associated with quality problems that occur at the customer site. These costs can be particularly damaging because customer faith and loyalty can be difficult to regain. They include everything from customer complaints, product returns, and repairs, to warranty claims, recalls, and even litigation costs resulting from product liability issues. A final component of this cost is lost sales and lost customers. For example, manufacturers of lunch meats and hot dogs whose products have been recalled due to bacterial contamination have had to struggle to regain consumer confidence. Other examples include auto manufacturers whose products have been recalled due to major malfunctions such as problematic braking systems and airlines that have experienced a crash with many fatalities. External failure can sometimes put a company out of business almost overnight.

(c) A Company manufactures a single product, which requires two components. The Company purchases one of the components from two suppliers: X Ltd and Y Ltd. The price quoted by X Ltd is ₹180 per hundred units of the component and it is found that on an average 3% of the total receipt from this Supplier is defective. The corresponding quotation from Y Ltd is ₹174 per hundred units, but the defective would go up to 5%. If the defectives are not detected, they are utilized in production causing a damage of ₹180 per 100 units of the component.

The Company intends to introduce a system of inspection for the components on receipt. The inspection cost is estimated at ₹20 per 100 units of the component Such as inspection will be able to detect only 90% of the defective components received. No payment will be made for components found to be defective in inspection.

(i) Advise whether inspection at the point of receipt is justified?

(ii) Which of the 2 Suppliers should be asked to supply? Assume total requirement is 10,000 units of the component.

Answer:

(i) Computation of Cost per 100 units of good components without inspection

Particulars	X Ltd	Y Ltd
Purchase Price Add: Production Damage	₹180 × (10,000 ÷ 100) = 18,000 (18,000 × 3%) = 540	₹174 × (10,000 ÷ 100) = 17,400 (17,400 × 5%) = 870
Total Costs	**₹18,540**	**₹18,270**
Number of good components	(10,000 - 300) = 9,700 units	(10,000 - 500) = 9,500 units
Cost per 100 good components	18,540 ÷ 9,700 = **₹191.13**	18,200 ÷ 9,500 = **₹192.31**

(ii) Computation of Cost per 100 units of good components with inspection

Particulars	X Ltd	Y Ltd
a) Total Units Required	10,000 units	10,000 units
b) Defective Units	3% of 10,000 = 300 units	5% of 10,000 = 500 units
c) Defectives not detected	30 units	50 units

	(10%)		
d)	Defectives Detected	270 units	450 units
e)	Components paid for (a) – (d)	9,730 units	9,550 units
f)	Purchase Price	(9,730 ×180)÷ 100=17,514	(9,550 × 174)÷ 100=16,617
g)	Inspection Cost	(10,000 × 20)÷ 100 = 2,000	(10,000 × 20) ÷ 100 = 2,000
h)	Production Damage	(30 × 180) ÷ 100 = 54	(50 × 174) ÷ 100 = 87
i)	**Total Costs (f + g + h)**	**19,568**	**18,704**
j)	Cost per 100 good components	(19,568 ÷ 9,700)× 100 = **201.73**	(18,704 ÷ 9,500) × 100 = **196.88**

Conclusion:

- Inspection at the point of receipt is not advantageous as -there is an additional cost per 100 good components ₹10.6 in case of X Ltd and ₹4.57 in case of Y Ltd.
- Purchase from X Ltd is cheaper, as there is cost saving of ₹1.18 per 100 good components.

Study Note 11: Application of Operations Research and Statistical Tools in Strategic Decision Making

Question.27

(a) Four operators A, B, C and D are available to a senior manager who has to get four jobs J1, J2, J3 and J4 done assigning one job to each operator. The time needed by different operators for different jobs are given in the matrix below (in minutes):

Operator/Jobs	J1	J2	J3	J4
A	12	10	10	8
B	14	12	15	11
C	6	10	16	4
D	8	10	9	7

(i) How should the manager assign the jobs so that the total time needed for all jobs is minimum?

(ii) If Job J1 is to be assigned only to Operator A, what should be the assignment and how much additional total time will be required?

Answer:

The objective is minimization and data is balanced, (i.e number of rows = number of columns = 4).

I. Given Time Matrix

12	10	10	8
14	12	15	11
6	10	16	4
8	10	9	7

II. Row Operations

4	2	2	0
3	1	4	0
2	6	12	0
1	3	2	0

III. Column Operations

3	1	0	0
2	0	2	0
1	5	10	0
0	2	0	0

IV. Drawing Lines, we have:

3	1	0	0
2	0	2	0
1	5	10	0
0	2	0	0

Number of lines = 4 = order of Matrix.

V. Optimal Assignment

3	1	$\boxed{0}$	~~0~~
2	$\boxed{0}$	2	~~0~~
1	5	10	$\boxed{0}$
$\boxed{0}$	2	~~0~~	~~0~~

Answer:

Worker Job	Job	Time
A	J3	10
B	J2	12
C	J4	4
D	J1	8
Total Time 34 min.		

Impact of Facilitative Condition: Since Job J1 is to be assigned only to Worker A, we eliminate A Row and Jl Column for the purpose of balance assignment. The revised matrix is as under -

I. Given Time Matrix

12	15	11
10	16	4
10	9	7

II. Row Operations

1	4	0
6	12	0
3	2	0

III. Column Operations

0	0	0
5	10	0
2	0	0

IV. Drawing Lines, we have:

0	2	0
5	10	0
2	0	0

Number of lines = 3 = order of Matrix.

V. Optimal Assignment

$\boxed{0}$	2	~~0~~

5	10	$\boxed{0}$
2	$\boxed{0}$	$\cancel{0}$

Answer:

Worker Job	Job	Time
A	J1	12 (given)
B	J2	12
C	J4	4
D	J3	9
		Total Time 37 min.

Number of lines =3 = Order of matrix.

Additional time of 3 minutes is required due to the condition that J1 should be assigned to Worker A only.

(b) A paper mill produces rolls of paper used in cash registers. Each roll of paper is 100 m in length and can be used in widths of 2, 4, 6 and 10 cm. The company's production process results in rolls that are 24 cm in width. Thus the company must cut its 24 cm wide roll to the desired widths. It has six cutting alternatives as follows:

Cutting alternative	Width of rolls (cm.)				Waste (cm.)
	2	4	6	10	
1	6	3	-	-	-
2	-	3	2	-	-
3	1	1	1	1	2
4	-	-	2	1	2
5	-	4	1	-	2
6	4	2	1	-	2

The minimum demand for the four rolls is as follows:

Roll width (cm.)	demand
2	2,000
4	3,600
6	1,600
10	500

The paper mill wishes to minimize the waste resulting from trimming to size. Formulate the LP Model.

Answer:

Step 1. The key decision is to determine how the paper rolls be cut to the required width so that trim loss (wastage) is minimum.

Step 2. Let x_j (j = 1, 2….6) represent the number of times each cutting alternative is to be used. There alternatives result/do not result in certain trim loss.

Step 3. Feasible alternatives are sets of values of x_j.
where $x_j \geq 0$, j = 1, 2.....6

Step 4. The objective is to minimise the trim losses, i.e., minimize $Z= x_3 + x_4 + x_5 + x_6$

Formulation of LP Model

Objective Function: Minimise (wastage produced) $Z = 2(x_3 + x_4 + x_5 + x_6)$

Subject to the constraints

$6x_1 + x_3 + 4x_6$	$\geq 2{,}000$	...(For roll width of 2 cm)
$3x_1 + 3x_2 + x_3 + 4x_5 + 2x_6$	$\geq 3{,}600$	...(For roll width of 4 cm.)
$2x_2 + x_3 + 2x_4 + x_5 + x_6$	$\geq 1{,}600$	...(For roll width of 6 cm.)
$x_3 + x_4$	≥ 500	...(For roll width of 10 cm,

Question.28

(a) ABC Company is considering the question of marketing a new product. The fixed cost required in the project is ₹4,000. Three factors are uncertain viz., the selling price, variable cost and annual sales volume. The product has a life of only one year. The management has the data on these three factors as under:

Selling Price ₹	Probability	Variable Cost ₹	Probability	Sales Volume (Units)	Probability
3	**0.2**	**1**	**0.3**	**2,000**	**0.3**
4	**0.5**	**2**	**0.6**	**3,000**	**0.3**
5	**0.3**	**3**	**0.1**	**5,000**	**0.4**

Consider the following sequence of thirty random numbers: (81,32,60), (04,46,31), (67,25,24), (10,40,02), (39,68, 08), (59,66,90), (12,64,79), (31,86,68), (82,89,25), (11,98,16). Simulate the average profit for the above project on the basis of 10 trials.

Answer:

1. Random Numbers Allocation

Selling Price			
₹	Prob.	Cum. Prob.	R No.
3	0.2	0.2	00 – 19
4	0.5	0.7	20 – 69
5	0.3	1.0	70 – 99

Variable Cost			
₹	Prob.	Cum. Prob.	R No.
1	0.3	0.3	00 – 29
2	0.6	0.9	30 - 89
3	0.1	1.0	90 – 99

Sales Volume			
Units	Prob.	Cum. Prob.	R No.
2,000	0.3	0.3	00 – 29
3,000	0.3	0.6	30 - 59
5,000	0.4	1.0	60 – 99

2. Simulation Table

S No.	R No.	Selling Price (₹)	R No.	Variable Cost (₹)	R Ns.	Sales Qtty (units)	Profit (₹) [(c) -(e)]× (g)- ₹4,000
(a)	**(b)**	**(c)**	**(d)**	**(e)**	**(f)**	**(g)**	**(h)**
1	81	5	32	2	60	5000	11,000
2	04	3	46	2	31	3000	(1,000)
3	67	4	25	1	24	2000	2,000
4	10	3	40	2	02	2000	(2,000)
5	39	4	68	2	08	2000	NIL
6	59	4	66	2	90	5000	6,000
7	12	3	64	2	79	5000	1,000
8	31	4	86	2	68	5000	6,000
9	82	5	89	2	25	2000	2,000
10	11	3	98	3	16	2000	(4,000)
		Total					**21,000**

Average Profit = ₹21,000 ÷ 10 = ₹2,100.

(b) Discuss the factors affecting the Learning Curve.

Answer:

Factors affecting Learning Curve:

- While pricing for bids, general tendency is to set up a very high initial labour cost so as to show a high learning curve. This should the learning curve useless and sometimes misleading.
- The method of production i.e. whether it is labour oriented or machine oriented influences the slop of the learning.
- When labour turnover rate is high management has to train new workers frequently. In such situations the company may never reach its maximum efficiency potential. One of the important requisites of the learning curve concept is that there should be uninterrupted flow of work. The fewer the interruptions, the grater will be the improvement in efficiency.
- Changes in a product or in the methods of production, designs, machinery, or the tools/used affect the slope of the learning curve. All these have the effect of starting learning a fresh because of new conditions if the changes are frequent, there may be no learning at all.
- Also other factors influencing the learning curve are labour strikes, lock outs and shut downs due to other cause also/affect the learning curve. In each such case there is interruption in the progress of learning.

As far as possible the effects of above factors should be carefully separated from the data used to establish the curve. The effects of these factors must also be separated from the actual costs used to measure the performance. Unless this is done analysis of the projected cost or the actual cost will not be meaningful.

(c) Explain the procedure of drawing a network analysis.

Answer:

The procedure of drawing a network is:

- **Specify the Individual Activities:** From the work breakdown structure, a listing can be made of all the activities in the project. This listing can be used as the basis for adding sequence and duration information in later steps.
- **Determine the Sequence of the Activities:** Some activities are dependent on the completion of others. A listing of the immediate predecessors of each activity is useful for constructing the CPM network diagram.
- **Draw the Network Diagram:** Once the activities and their sequencing have been defined, the CPM diagram can be drawn. CPM originally was developed as an activity on node (AON) network, but some project planners prefer to specify the activities on the arcs.
- **Estimate Activity Completion Time:** The time required to complete each activity can be estimated using past experience or the estimates of knowledgeable persons. CPM is a deterministic model that does not take into account variation in the completion time, so only one number is used for an activity's time estimate.
- **Identify the Critical Path:** The critical path is the longest-duration path through the network. The significance of the critical path is that the activities that lie on it cannot be delayed without delaying the project. Because of its impact on the entire project, critical path analysis is an important aspect of project planning.

The critical path can be identified by determining the four parameters for each activity. The four parameters are Earliest Start, Earliest Finish, Latest Finish and Latest Start.

Study Note 12: Entrepreneurial Approach to Cost Management with Reference to Core Competencies

Question.29

(a) Explain the factors which are considered for success of Value Analysis.

Answer:

- **Gain approval of senior management** to conduct a Value Analysis exercise. Senior management support, endorsement and mandate for the VA project provide legitimacy and importance to the project within the business. This approval process also removes many of the obstacles that can prevent progress from being made by the team.
- **Enlist a senior manager as a champion** of the project to report back directly to the board of directors and also to act as the programme leader.
- Once a programme team has been developed it is important to **select an operational leader** to co-ordinate the efforts, monitor progress and to support the project champion.
  This leader will remain with the VA team throughout the life of the project and will be the central linking pin between the team and the senior management champion.
- **Establish the reporting procedure** for the team and the timing of the project. This project plan needs to be formal and displayed as a means of controlling and evaluating achievements against time.
- **Present the VA concept and objectives of the team to all the middle and senior managers** in the business. Widespread communication of the VA project is important so that other employees, particularly managers (who may not be involved directly with the process) understand the need to support the project either directly by assigning staff or indirectly through the provision of data.
- Maintain a list of those business functions that should receive a **regular communication of progress** even though they may not be directly involved with the project. This process allows other individuals in the business to be informed about the progress and findings of the group. This form of promotion is important as it maintains a momentum and communicates the findings of the team as widely as possible
- **Provide an office space and co-locate the team members** where practical and possible to do so. The ability to locate a VA improvement group in one area of the business is important and assists the communication within the group. A convenient area can also be used to dismantle the product and also the walls of the area can be used to record, on paper charts, the issues that have been discovered by the team (and the associated actions that must be undertaken).
- **Select the product** for the first study. Ideally the existing product, or family of products, will be one that is established, sells in volume and has a relatively long life expectancy.
- As such any improvement in the cost performance of the product will provide a large financial saving to the business.
- Write down the **objectives of the project** and the key project review points. Estimate the targets to be achieved by the project. These objectives provide a reference point and framework for the exercise. The objectives also focus attention on the outputs and achievements required by the company.
- **Select and inform any personnel** who will act in a part time or temporary role during the project. This process is used to schedule the availability of key specialist human resources to support the team throughout the duration of the project.
- **Train the team** in both the process of VA and also in basic team building activities. It is important that all members understand the nature of the project and its importance. The initial team building exercises are also a good way of understanding the attitude of all members to the project – especially those with reservations or a negative attitude to what can be achieved. As with most team exercises there is a requirement to allow the team to build and bond as a unit. It is often difficult for individuals, drawn from throughout the factory, to understand the language that is used throughout the business and also to understand the 'design to market' process when their own role impacts on a small section of this large and complex process.

(b) State the term Value Engineering.

Answer:

Value Engineering

Value Engineering is an organized/systematic approach directed at analyzing the function of systems, equipment, facilities, services, and supplies for the purpose of achieving their essential functions at the lowest life-cycle cost consistent with required performance, reliability, quality, and safety. Society of Japanese Value Engineering defines VE as:

"A systematic approach to analyzing functional requirements of products or services for the purposes of achieving the essential functions at the lowest total cost".

Value Engineering is an effective problem solving technique. Value engineering is essentially a process which uses function analysis, team - work and creativity to improve value. Value Engineering is not just "good engineering." It is not a suggestion program and it is not routine project or plan review. It is not typical cost reduction in that it doesn't "cheapen" the product or service, nor does it "cut corners."

Value Engineering simply answers the question "what else will accomplish the purpose of the product, service, or process we are studying?". VE technique is applicable to all type of sectors. Initially, VE technique was introduced in manufacturing industries. This technique is then expanded to all type of business or economic sector, which includes construction, service, government, agriculture, education and healthcare

(c) Explain the sequential phases of Value Engineering Job Plan.

Answer:

VE Job Plan

The Job Plan consists of the following sequential phases

- **Orientation Phase**
  In the orientation phase, the project is selected and those who are going to work the problem are familiarized with it.
- **Information Phase**
  The team is made familiar with the present state of the project. All team members participated in a functional analysis of the project as a whole, and then of its component parts, to determine the true needs of the project. Areas of high cost or low worth are identified.
- **Functional Phase**
  'Function' can be defined, as the use demanded of a part of a product and the esteem value that it provides. These functions therefore make the product work effectively or contribute to the 'salability' of the product. Functional analysis outlines the basic function of a product using a verb and a noun such as 'boil water' as in the case of our kettle.
- **Creative Phase**
  This step requires a certain amount of creative thinking by the team. A technique that is useful for this type of analysis is brainstorming. This stage is concerned with developing alternative, more cost effective ways of achieving the basic function. All rules of brainstorming are allowed, and criticism needs to be avoided as it could cease the flow of ideas. Simply list down all ideas, not regarding whether they sound apparently ridiculous
- **Evaluation Phase**
  In this phase of the workshop, the VA team judges the ideas developed during the creative phase. The VA team ranks the ideas. Ideas found to be irrelevant or not worthy of additional study are disregarded; those ideas that represent the greatest potential for cost savings and improvements are selected for development. A weighted evaluation is applied in some cases to account for project impacts other than costs (both capital and life cycle). Ideally, the VA team would like to evaluate all attractive ideas but time constraints often limit the number of ideas that can be developed during the workshop. As a result, the team focuses on the higher ranked ideas. This phase is designed so that the most significant ideas are isolated and prioritized.
- **Development Phase**

In the development phase, final recommendations are developed from the alternatives selected during the analysis phase. Detailed technical and economic testing is conducted and the probability of successful implementation is assessed.

- **Presentation Phase**
  The presentation phase is actually presenting the best alternative (or alternatives) to those who have the authority to implement the proposed solutions that are acceptable. It includes preparing a formal VECP or value engineering proposal (VEP) that contains the information needed to reach a decision and implement the proposal.
- **Implementation And Follow Up**
  During the implementation and follow-up phase, management must assure that approved recommendations are converted into actions. Until this is done, savings to offset the cost of the study will not be realized.

Question.30
(a) List out the merits and demerits of Business Process Outsourcing (BPO).
Answer:

Benefits of Business Process Outsourcing

Organizations can gain a number of benefits by outsourcing or using a business process outsourcing company.

- **Saving money:** Most companies that provide BPO services are able to carry out the work for considerably less. This is generally achieved through having lower operational costs themselves because labour is less expensive, social costs are lower and they don't have to provide benefits to their workers. Typically, BPO should save companies in the region of 40-50%.
- **Quality of service:** It is also possible in some instances to improve the quality of service through being able to have more resources and better qualified personnel.
- **Productivity improvements:** It allows executives and management to focus on critical functions of the business. For example, it will allow expensive and skilled personnel to focus on sales and marketing strategy rather than operational issues such as preparing a VAT return or payroll. You normally find that executives spend 80% of their time in management of day-to-day issues and only 20% on strategy. Outsourcing certain processes can in many instances reverse this statistic. Giving management time to carry out other functions can enable an organisation to become more profitable and find other ways of generating income.
- **Access to a wider array of skills:** BPO enables an organisation to access different skills sets and expertise that their company would not normally have access to. Many BPO companies have skills and intellectual assets that take many, many years to generate.
- **Allocation of resources:** Organisations that use BPO can effectively reallocate personnel into areas that will have a positive impact upon other projects, such as expansion or opening offices in new territories.
- **Operational expertise:** BPO companies are able to provide the relevant expertise that most companies don't have access to or would be difficult and expensive to develop in-house.
- **Flexibility:** BPO can help organisations become more flexible, for example by speeding up key business processes such as purchasing, and thereby ensuring that not too much or indeed too little stock is held at any one time.
- **By allowing organisations to retain flexibility and agility:** BPO also ensures that companies do not become too bureaucratic. This is a feature of smaller and younger companies but as they grow, more processes and procedures are put in place which while allowing for control, can stifle a company and the people working for it.

Pitfalls of Business Process Outsourcing

Although the benefits can be extensive, there are many risks associated with business process outsourcing.

- **Risk is seen as the biggest potential issue with BPO:** Risk can be reflected in security issues in relation to sensitive data and privacy, risk of losing independence and potentially losing control.
- **Loss of flexibility in reacting to changes in business conditions:** It is important that communications continue throughout the life cycle of any BPO agreement. This means informing the BPO provider of any change of strategy or conditions that might impact their ability to function properly.
- **Potential threat to security or access to confidential information:** There are many examples where confidential data has gone 'astray' or been sold. Processes and procedures must be put in place to ensure that only certain personnel can access specific information, especially with payroll systems, HR and client records.
- **Staff turnover:** It is expected that within call centres, for example there may be a fairly high turnover of staff, typically some 30%, but typically within BPO companies this can be up to 50%. This can be critical because losing key people can have a serious impact operationally, e.g. having to retrain people on a particular system or product within a call centre if people are leaving. Also, if absenteeism is high within a call centre environment, this will naturally badly impact customer service and call waiting times.
- **Cultural differences:** If a BPO company's staff is based abroad, for example in India, there can be potential problems. This can be anything from communications difficulties to not totally understanding what perhaps a British customer expects. Many BPO off-shoring companies train their staff in order to resolve this.
- **Job losses:** People often believe that BPO only leads to staff losing their jobs. This could be true to a certain extent, but while there might be a perceived threat to staff's finances, generally the roles that are outsourced are those which typically a company can have difficulty fulfilling anyhow.
- **Potential loss of managerial control:** Naturally it can be easier to manage your own personnel than relying upon a third party, but again, this can be resolved with good communication and regular update meetings.
- **BPO can badly impact customer relationships:** As it may eliminate direct communication between a company and its' customers.
- **Failure to meet service levels:** This can be caused by changing needs, unclear objectives or through incompetence.

(b) Write a note on IGPG (International Good Practices & Governance).

Answer:

Objectives

In pursuit of its goals of serving the public interest, strengthening the accountancy profession worldwide, and contributing to the development of strong international economies, the International Federation of Accountants (IFAC) develops standards, statements, information papers, guidance, and special reports. This preface sets out the scope, purpose, and due process of International Good Practice Guidance (IGPG) published by IFAC's Professional Accountants in Business (PAIB) Committee (the Committee). IGPG, which starts by clearly identifying **principles,** (a) is generally accepted internationally, and (b) applies to organizations of all sizes in commerce, industry, the public sector, education, and the not-for-profit sector.

Scope and Purpose

IGPG covers management accounting and financial management, as well as broader topics in which professional accountants in business, sometimes in conjunction with professionals from other disciplines, are likely to engage. IFAC's prime **purpose** in issuing guidance in these areas is to foster a common and consistent approach to those aspects of the work of professional accountants in business that are not already covered by international standards. A secondary purpose is to help professional accountants in business to explain their work to non-accountants. By setting out principles for each topic, the documents create a contextual background for the more detailed methods and techniques used by professional accountants in business.

The Importance of Principles

A significant feature of IGPG is its explicit grounding in principles. The Committee reviews available guidance in a topic area, applying the extensive expertise and experience of its members and IFAC member bodies to draw out a set of globally applicable statements of principles. These principles should (a) guide the thought processes of professional accountants in business when they tackle the relevant topic, and (b) underpin the exercise of the professional judgment that is important in their roles. They provide the professional accountant in business (and those served by them) with a common frame of reference when deciding how to address issues encountered within a range of individual organizational situations. General guidance supports the consistent implementation of the principles and, where appropriate, provides signposts to sources of greater detail

Due Process

Although IGPG does not impose an obligation on professional accountants in business, it does represent IFAC's recommended practice in the areas it covers. Therefore, each proposed guidance document is subject to a formal **due** process, whose key component is wide consultation including public exposure. The due process for IGPG is appended and is derived from the due process used by IFAC's public interest activity committees, but also reflects the Committee's meeting and operational procedures. Following due process is intended to ensure both the quality and global applicability of the final document, attributes that lend the document its authority.

Getting the Most Out of International Good Practice Guidance

Professional accountants in business should consider the relevance of IGPG documents to their organizational roles. The extensive and vital range of roles they perform is featured in the Committee's 2005 publication Their roles include understanding and driving the creation of value; provision of information for decision-making, accountability and control; performance measurement and communication to stakeholders; financial control; improving efficiency; and managing risk. IGPG documents help professional accountants in business to select and apply the appropriate tools for analyzing and managing organizations in performing these critical tasks. This will encourage professional accountants in business, irrespective of geographical location or size or type of employer, to adopt broadly consistent approaches to their work. Some organizations might find it useful to distribute the content to subsidiaries, or to stakeholders in their value chain.

The Committee recommends that professional accountants in business (a) use the principles in IGPG to guide their decision-making, and (b) use the application guidance and signposting to other resources to consider how to implement guidance in practice. Good practice is always evolving. Therefore, over time newer and better techniques and approaches to the work of the accountant will inevitably emerge. Although the Committee periodically reviews its IGPG, it is the personal responsibility of the professional accountant to keep abreast of developments that may affect their work. IGPG also builds on the fundamental principles of integrity; objectivity; professional competence and due care; confidentiality; and professional behavior already required of professional accountants in business by IFAC's Code of Ethics for Professional Accountants.