CHAPTER 1:

INTRODUCTORY

1.1 Introduction: Cost is a measurement in monetary terms of the resources used for the purpose of production of goods or rendering services. In an organization, costs are the elements which must be occurred for running the business and day to day activities. Some cost is fixed in nature, similarly, some cost is variable. We know that one firm tries to increase their capacity utilization level as much as possible, without changing fixed cost. However, they try to achieve optimum capacity utilization on that level of fixed cost. But, when the demand is increasing continuously, the firms try to increase their capacity utilization level, as per the demand of the markets. In this situation, fixed cost will increase by a certain percentage and this will be a cost burden for them if they aren't in the optimum capacity utilization level to recover the fixed cost. Similarly, it may reverse on recession periods. In this study we try to highlight how the organizations are managing these situations by altering cost components of cost structure and analyze the strategies they have adopted at the time of pre and post recession period.

The Cost structure is the relative proportion of each type of cost of an organization (Garrison R.H, 2012). To understand the cost structure associated with the production of any type of goods or services, the first it need to understand each individual type of cost that take place during the periods. This begins with the development of the idea for the product, the acquisition of raw materials, and the creation of production facilities that are used to create the end product up to after sales services. Cost structure depends on the nature of the industries and companie's long-term strategy, i.e. some are labour intensive and others are material or capital intensive. The cost structure analysis brings numerous benefits to the firm and the industry as a whole mainly to craft their competitive advantages and to achieve the cost leadership within its peer group. Having a low-cost structure is a strong competitive advantage in the globalized market. Cost base evaluations establish fundamental competitiveness. Also, knowledge of competitors' key cost elements provides a useful indication of the strengths and weaknesses of companies. Cost competitiveness has been at the heart of the Japanese success in the 1980s. To be cost competitive in the market company should provide the better quality of products at a relatively lower cost as compared to other competitors. This will help to enhance the competitive strength of individual firms by utilizing the available resources efficiently and effectively. Competitive strategy defined by Michael Porter in 1980 as the "...broad formula for how a business is going to compete, what its goals should be, and what policies will be needed to carry out those goals" and the "...combination of the ends (goals) for which the firm is striving and the means (policies) by which it is seeking to get there." Bruce Henderson wrote in 1981 that "Strategy depends upon the ability to foresee future consequences of present initiatives." Indeed, competitiveness is the fundamental determinant of the level of prosperity a country can sustain (Porter.M, 2005). In reality, there are some companies those failing to manage their cost structure properly and some of them can achieve higher performance by managing its cost structure appropriately. The worst case that a company can face without a proper cost structure is out of business or bankrupt. It happened in the case of Solyndra**,** is a solar panel manufacturer. While Solyndra defended themselves that their bankruptcy was caused by competitiveness in the international solar panel industry, actually Solyndra went bankrupt because it had poor cost structure and not because of the solar panel industry (EconMatters, 2011). The big oil and gas company in the world 'Shell'**,** in 2010 achieve better performance by improving its cost structure. They evaluated all cost structure by using zero-based cost management and it gives them better performance in the long term.

To achieve basis goal of a firm, i.e. to improve efficiency by improving the quality along with identifying and cutting unnecessary costs; one firm needs to implement cost structure strategies (CSS). Cost structure strategies include cost reforms, which focus on a radical restructuring of business flows, maximization of returns on investment, review of workforce structure and to improve cost efficiency. CSS helps to make major cost reductions and improvements in operational efficiency. OMC Card, Inc had followed this strategy for their medium-term management plan in 2007. The Cost Structure strategy is dependent on the business model, adopting by the companies; some companies make a business out of branding themselves as having a low-Cost Structure such as discount airlines. So some business models can be Cost – driven, whereas others are more value – driven, where the focus is more on what can be created than on the cost level (Jensen, 2013). Cost structure strategy is the direction and planning of an organization over the long term with the help of cost control mechanism and tools in the way of restructuring the cost structure to achieve a competitive position in the industry with high-quality products.

Finally, Cost structure strategy helps to the company in entering the new emerging market to create a new sky for their products, in the long run, to compete in the globalized turf.

1.2 Statement of the Problem: The company across the industries attempted to formulate appropriate strategies in the context of reducing the overall cost. The need to manage costs is an imperative for sustained high performance as today's business environment leaves no room for error. Since July 2008, despite several attempts to weed out the crisis of the century, the silver lining is still awaited. As corporations and households get overextended and face difficulties in meeting their debt obligations, they reduce investment and consumption, which in turn leads to a decrease in economic activity. India Inc raced to globalize and global companies sought to exploit the country's low-cost talent pool and industrialized-economy concepts. Most of the industries include IT-Software, Banking, Refineries, Pharmaceutical, Steel and even spare part producers are trying to enter the global market. The cascading effect of demand slowdown, particularly in the USA and Euro Zone has impacted external demands from all export- oriented economy across the globe (Kose et al.2009). Company like-Air India wants to cut its operating expenses by some 40% based on strict cost-control measures and revenue enhancement efforts. No doubt merger and acquisition, if planned and executed properly can provide a great opportunity for growth and cost optimization by technological up gradation, developing business process re-engineering and capturing market beyond the national boundaries.

Presently, under the global village concept, the market has been extended globally. The firms are competing at the global level at the same market with a similar basket of product. Competition is fierce in respect of capturing market share. Thus understanding the cost structure and becoming a cost leader is a necessity. However, organizations try to achieve cost leadership position in an economic downturn on panic (cost reduction); hasty and unilateral decisions do not fully consider long-term impact. So identifying all cost components of each major process and sub-processes of the business then evaluate value adding and non-value adding components of each major process and justify how the non-value adding components can be eliminated or combined, outsourced or automated. This has warranted formulation of appropriate strategies to attain a competitive edge over the peers as well as competitors in the hypercompetitive environment arose in the recent past. Thus, a holistic and intelligent approach to total cost reduction and cost optimization either for operating advantage to produce rapid economic value or for structural advantage with a focus on sustained efficiency and long-term growth is the need of the hour. Under this backdrop, an attempt has been made to assess how the firms in the selected industries are pursuing the cost structure strategies to remain competitive in the financial crisis regime.

1.3 Objectives of the Study: In the context of the above problems following objectives are considered for the study:

a. To investigate the major cost components of the firms and its behavior over the years.

b. To study the impact of cost components on firm performance.

c. To examine the cost efficiency of the selected companies during pre and post recession periods.

d. To analyze the cost strategies adopted by the firms during the study periods.

1.4 Hypotheses of the Study: For the purpose of the study following hypothesis are framed and have been tested in the respective chapters.

- $H_{01:}$ The cost components of the companies across the selected industries have no impact on firm performance.
- $H_{02:}$ There are no changes in the cost efficiency of the companies during pre and post recession periods.

1.5 Conceptual Framework: This study has covered different dimensions of the cost structure of the firm. To analyze the cost components of the firm under the study and we have considered some relevant variables are as follows-

Raw Materials Cost (RM): According to I.C.M.A. “Materials cost which can be identified with and allocated to cost centers or cost units”. Direct materials are also known as ‘process materials’, ‘prime cost materials’ or ‘productive materials’. Raw Materials consist of; Opening Stock of Raw Materials, Purchases of Raw Material, Purchase of Trading Goods, and Direct Expense on Purchase / Adjustment, Closing Stock of Raw Materials Adjustment on amalgamation/trial runs.

Power & Fuel Cost (P&F): Power & Fuel Cost consist of Power, Oil & Fuel Electricity Expenses Water Charges.

Employee cost (EC): In the words of C.I.MA., London, “direct wages is that wages which can be allocated to cost centers or cost units.” In the words of C.I.M.A., London, “Wages which cannot be allocated but which can be apportioned or absorbed by cost centers or cost units is indirect wages.’’ Reducing Employee cost increases both available cash and the productivity of existing investment. On recession time it needs to closely examine the productivity of each employee. Employee Cost consists of Salaries, Wages & Bonus, and Contribution to funds, Staff Welfare Expenses, VRS compensation, Gratuity Paid, and other Employee Cost.

Administration Expenses (Adm.Exp): CIMA defines overhead cost as “The total cost of indirect material, indirect labour, and indirect expenses. Administration costs will include salaries, rent, Council Tax, electricity, water, telephone, depreciation, a potentially infinitely long list. Reducing administration expenses increase both available cash and the productivity of existing investment. Individually, these are disparate activities and thus very different expenditure items and are thus reported separately. However, some relatively smaller companies do club all these or some.

Selling Expenses (SE): CIMA London defines selling overheads as “This item includes all the expenditure incurred or cost of seeking to create and stimulate demand and securing orders. Sometimes it is also termed as a marketing cost." Reducing Selling expenses increase both available cash and the productivity of existing investment. It includes expenditure on marketing, and distribution by the company.

Selling and Administration Expenses (Selling & Admn. Expenses): It includes expenditure on advertising, marketing, and distribution by the company. Individually, these are disparate activities and thus very different expenditure items and are thus reported separately.

Other Manufacturing Expenses (Other Mnf. Expenses): Other Manufacturing expenses includes Freight Inwards & transport charges packing materials job work / contract / processing charges drilling operation charges stores consumed repairs repairs - plant & machinery repairs - building repairs - others technical fees paid Wheeling charges payable Project / Production charges own film production expense handling, Clearing charges etc.

Miscellaneous Expenses (ME): Miscellaneous Expenses include all the expenses reported by the companies under the head ―miscellaneous expenses or ―other expenses.

Interest (INTE): Lower debt can reduce cash demands through smaller interest payments. It includes all short-term as well as all long-term borrowings of the company. It includes interest paid on borrowings, debentures and deposits and interest paid to directors. In the case of banks, it also includes interest paid on inter-bank borrowings. Often, companies report net interest payments. These are interest payments net of interest earnings.

Reported Net Profit (RNP): The net profit earned by the company after deducting all expenses, interest, depreciation, and tax. Here, RNP= OP*- Interest-Depreciation-Tax-Deferred Tax.

*Operating Profit (OP) = Sales Turnover+ Other Income+ Stock Adjustment- Total Expenditure (RM+ Power& Fuel cost +EC+ Other Mnf. Expenses + S &Adm. Expenses + Misc. Expenses- Pre-operative Expenses Capitalised).

1.6 Scope of the Study: This study is an endeavor to find out different strategies that companies have adopted in the financial turmoil period and give us an idea about its effectiveness. The study has carried for 12 years spread over pre and post recession period, i.e. from 2002-03 to 2007-08 (six years) and 2008-09 to 2013-14 (six years). It helps us to develop an overview of the competitive strategies that the companies followed during pre and post recession period.

We know that, on September 15, 2008, the Wall Street investment bank Lehman Brothers filed for bankruptcy and subsequently was allowed to go bust, creating the largest bankruptcy in US history. Credit flows suddenly dried-up, economic activity and merchandise trade took a nosedive in the last quarter of 2008 across all markets and continued to fall rapidly in early 2009.

While India remained less susceptible to the global economic crisis as compared to many export-oriented nations, the effects were quite visible and strong in India from the second half of 2008-09. Both export and import had declined drastically. While the rate of export growth fell down from 29 percent in 2007-08 to 13.6 percent in 2008-09, import declined from 35.5 percent to 20.7 percent during the same period. However, in 2009-10 both export (-20.3) and import (-23.6) registered negative growth. Hence, we have considered pre-recession periods from March 2003 to March 2008 and post-recession from March 2009 to March 2014 for the present study.

The study has conducted on the companies listed on the Stock Exchanges and are publishing Annual Reports continuously for 12 years. For the purpose of the study we have considered two sectors namely, Manufacturing Sector and Service Sector; they together contributed 86.32 % of GDP in India.

1.7 Organization of the Study: To achieve the objective of the research, the study has been organized systematically with eight chapters coupled with Bibliography and Annexure. A brief outline of the organization of the study is presented below:

C**hapter 1** being the **Introductory** one, is containing the basic tenets of entire study encompassing objectives, hypotheses, conceptual framework and scope of the study etc.

Chapter 2, titled "**Literature Review**" which have focused on the overall understanding of the conceptual structure, framework, and challenges of adopting a better cost structure of companies.

Chapter 3, "Research Methodology" highlights to the methodology adopted for the study and present the data source & collection, sampling design, variable descriptions, and data analysis techniques.

Chapter 4 is entitled **"Cost Components and its Behaviours"** focused on major cost components and its behaviours.

Chapter 5, "**Impact of Cost Structure on Firm Performance**" emphasizes to measure the impact of cost components on firm performance.

Chapter 6 is designated to "**Cost Efficiency of the Companies in Pre and Post Recession Periods"** spotlight to examine the cost efficiency of the selected companies during pre-recession and post-recession periods.

Chapter 7 is entitled **"Cost Strategies Adopted by the Firms"** where we have analyzed the strategies adopted by the firms.

Finally, **Chapter 8** is entitled **"Epilogue"** contains the summary of the findings, conclusion, practical utility of the study, and aid for future research.