

# COST ACCOUNTING - COST REDUCTION

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*Cost reduction is to be understood as the achievement of real and permanent reduction in the unit cost of goods manufactured or services rendered without impairing their suitability for the use intended or diminution in the quality of product.*

*... The institute of Management Accountants, London*

There are only two ways to maximize profit of any organization: either to increase sale price of unit, or to reduce cost of that unit. Both above cases may result into gaining good profit. As we are seeing today, most of the businesses are facing tough competitive market situation where increase in sale price may result in to loss of sale. Increasing sale price is possible only in case of those products where the company is dealing in monopoly items and we all are aware that this situation cannot prolong for any company and its products. Therefore, cost reduction is only one scientific way to deal with this situation; provided it is real and permanent. Cost reduction should not be the result of any temporary decrement in cost of raw material, change in government polices etc. and most importantly, reduction of cost should not be on price of quality of that product.

Reduction of cost should be in the following manner:

- Volume of production should be same but cost of expenditure should be reduced.
- Without changing level of production there should be increase in production.

## Cost Reduction Program

Followings are the essentials of a cost reduction program:

- Cost reduction program should be according to requirement of the company.
- Cost reduction program is a continuous activity that cannot be treated as one time or short term activity. Success of any cost reduction program may lie in only continuous improvement of efforts.
- Cost reduction program should be real and permanent.
- Example setter of cost reduction program should be top management employee. Success of this program depends on co-operation of all employees and department of an organization.
- Employees should be rewarded for their participation in cost reduction program and for giving innovative ideas related to this program.

## Fields Covered under the Cost Reduction Program

A number of fields come under the scope of cost reduction. They are discussed below.

### Design

Manufacturing of any product starts with the design of product. At the time of improvement in design of old product as well as at the time of designing new product, some investment is recommended to find a useful design that may reduce the cost of the product in following terms:

#### Material Cost

Design of product should encourage to find out possibility of cheaper raw material as a substitute, maximum production, less quantity etc.

#### Labor Cost

Design of product may reduce time of operation, cost of after-sale service, minimum tolerance,

etc.

## Organization

Employees should be encouraged for cost reduction scheme. There should be no scope for doubts and frictions; there should be no communication gap between any department or any level of management; and there must be proper delegation of responsibilities with defined area of functions of an organization.

## Factory Layout and Equipment

There should be a proper study about unused utilization of material, manpower and machines, maximum utilization of all above may reduce cost of any product effectively.

## Administration

An organization should make efforts to reduce the cost of administrative expenses, as there is ample scope to do so. A company may evaluate and reduce the cost of following expenses, but not the cost of efficiency:

- Telephone expenses
- Travelling expenses
- Salary by reducing staff
- Reduction in cost of stationery
- Postage and Telegrams

## Marketing

Following areas can be covered under the cost reduction program:

- Advertisement
- Warehouse
- Sales Promotion
- Distribution Expenses
- Research & Development Program

Any cost accountant should keep the following points in mind while focusing on cost reduction for the Marketing segment:

- Check the distribution system of an organization about the overall efficiency of the system and how economically that system is working.
- Find out the efficiency of the sales promotion system
- Find out if the costs can be reduced from the sales and distribution system of an organization and whether the research and development system of market is sufficient.
- A cost accountant should also do an ABC analysis of customers in which customers may be divided into three categories. For example:

### ABC ANALYSIS OF CUSTOMERS

Category	Number of Dispatches	Volume of Sale Covered
Customer...A	About 10%	60% to 80%
Customer...B	About 20%	20% to 30%
Customer...C	About 70%	5% to 10%

After performing this analysis, the organization can focus on the customers who are covering most of the sales volume. According to it, the cost reduction program may be run successfully in the area of category B and C.

## **Financial Management**

Attention should be given to the following areas:

- If there is any over-investment.
- How much economical is the cost of capital received?
- If the organization is getting maximum returns for the capital employed.
- If there is any over-investment, that should be sold and similarly, unutilized fixed assets should be eliminated. Slow-moving or non-moving inventories should be removed and should transfer this surplus to the working capital to re-invest it in a cycle of more profitable area of business.

## **Personal Management**

Cost reduction programs can be run using staff welfare measures and improving labor relation. Introduction of incentive schemes for labor and giving them better working conditions is very important to run an efficient cost reduction program.

## **Material Control**

Cost reduction program should be run by purchasing economical and more useful material. Economic Order Quantity *EOQ* technique should be used. Inventory should be kept low. Proper check on inward material, control over warehouse and proper issuance of material, and effective material yield should be done.

## **Production**

Using effective control over material, labor, and machine a better cost reduction program may be run.

## **Tools and Techniques of Cost Reduction**

The following tools and techniques are used to reduce costs:

- Budgetary Control
- Standard Costing
- Simplification and Variety Reduction
- Planning and Control of Finance
- Cost Benefit Analysis
- Value Analysis
- Contribution Analysis
- Job Evaluation and Merit Rating
- Improvement in Design
- Material Control
- Labor Control
- Overhead Control
- Market Research