

Strategic Cost Management

Subject Code – MBAFM313

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Module – 1

Introduction to Cost Management

COST ACCOUNTING

Meaning of Cost

- The term “Cost” refers to the total expenditure including money, labour, and time that is incurred to produce goods or provide services. It represents the value of resources consumed to achieve a specific objective or produce something. Once the cost is incurred, that money or resource is no longer available for other uses.
- In business, cost includes expenses for acquisition, production, and repair of goods and services.

Definitions of Cost

- According to ICMA, London, "Cost is the amount of expenditure incurred on, or attributable to, a specified thing or activity or cost unit".
- According to Anthony and Welsh, "Cost is a measurement in monetary terms, of the amount of resources used for some purposes".

MEANING AND DEFINATION OF COST ACCOUNTING

Meaning of cost accounting

Cost Accounting is the process of recording, classifying, analyzing, and controlling all costs related to producing goods or providing services. It helps a business to know how much it costs to make a product, perform a job, or offer a service.

Definitions of cost accounting

According to the ICMA, London, cost accounting is "the process of accounting for cost which begins with the recording of income and expenditure and ends with the preparation of periodical statements and reports for ascertaining and controlling costs".

OBJECTIVES OF COST ACCOUNTING

Cost Accounting serves several important objectives that help management in planning, control, and decision-making. The main objectives are as follows:

- 1. Determining Selling Price:** Cost Accounting helps in finding out the total cost of a product or service. On the basis of total cost, a suitable profit margin is added to fix the selling price. This ensures the product is sold at a fair and profitable rate.
 - 2. Controlling Cost:** Cost Accounting helps in monitoring and controlling expenses. By comparing actual cost with standard or budgeted cost, management can identify areas of waste, inefficiency, or overspending. This assists in reducing unnecessary costs and improving overall efficiency.
 - 3. Providing Information for Decision-Making:** Cost Accounting supplies accurate and detailed cost data that helps managers make informed decisions such as:
 - Whether to make or buy a product,
 - Whether to expand or discontinue a product line, and
 - How to allocate limited resources effectively.
- It supports managerial planning, control, and decision-making.

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4. Ascertaining Costing Profit: Cost Accounting helps in determining the profit or loss of each product, job, or department separately. By comparing cost of production with sales revenue, management can identify which products are profitable and which are not.

5. Facilitating Preparation of Financial and Other Statements: Cost Accounting assists in preparing various cost sheets, reports, and statements that show the total cost, profit, and performance of different departments or products. These reports also help in preparing financial accounts and provide useful information for internal control.

FUNCTIONS OF COST ACCOUNTING

1. Ascertainment of Cost: This means finding out the actual cost of producing goods or providing services. All expenses related to materials, labour, and overheads are collected and analyzed to know how much each product or service costs.

It helps management to:

- Know the total and per-unit cost, and
- Control or reduce unnecessary expenses.

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2. Estimation of Cost: Estimation means predicting the cost before production starts.

It is based on past data and expected future conditions.

Estimated cost helps management to:

- Fix the selling price of products,
- Prepare budgets, and
- Plan production activities in advance.

Since costs like materials and labour may change, some allowance is made for fluctuations.

3) Control of Cost: Cost control means keeping costs within planned limits and ensuring efficient use of resources. By comparing actual cost with standard or budgeted cost, management can find where expenses are higher and take corrective action.

Two main techniques used are:

- Budgetary Control-Comparing actual performance with budgets.
- Standard Costing-Comparing actual cost with pre-set standards.

This helps reduce waste and improve overall efficiency.

4. Reduction of Cost: Cost reduction means bringing down the total cost permanently, without reducing product quality or performance. It focuses on eliminating wasteful activities, improving methods, and using better technology.

Areas where cost reduction is possible include:

- Product design
- Production process
- Administration and finance

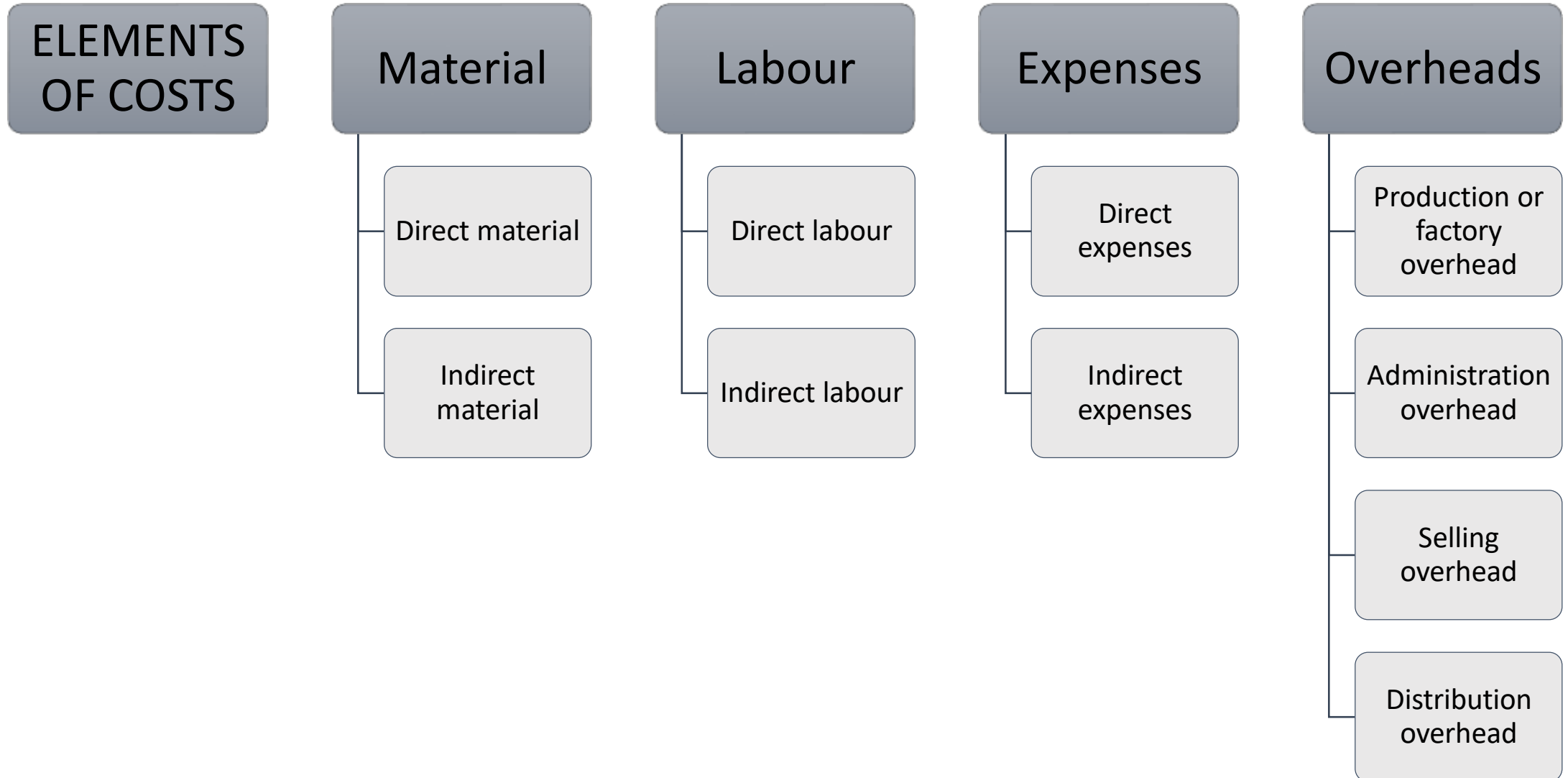
By doing this, the business can increase profits and remain competitive.

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Difference between Cost Accounting and Financial Accounting

Basis	Cost Accounting	Financial Accounting
Meaning	Records, classifies and analyses costs incurred in producing goods or services.	Records and summarizes all financial transactions of a business.
Main objective	To determine and control the cost of production/operations and support managerial decisions.	To determine profit or loss and the financial position of the business.
Users	Mainly internal management .	Mainly external users such as investors, creditors, government and shareholders.
Focus	Cost of products, services, departments and activities.	Overall financial performance and position of the business.
Nature	Can provide detailed and analytical information.	Provides summarized financial information.
Time orientation	Useful for planning, cost control and future decisions , as well as recording past costs.	Mainly concerned with historical financial transactions .
Cost classification	Classifies costs as fixed/variable, direct/indirect, product/period, etc.	Generally records transactions according to financial accounting principles.
Reports	Cost sheets, cost statements, variance reports, cost analysis, etc.	Trading Account, Profit & Loss Account and Balance Sheet/Statement of Financial Position.
Legal requirement	May be required for certain industries/businesses depending on applicable regulations.	Generally required for companies and other entities under applicable law/accounting requirements.
Example	Finding the cost of producing one unit of a product.	Finding the company's total profit for the year.

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1. **Material:** Materials are the physical items or substances used to make a product.
 - a) **Direct Material:** These are materials that can be directly identified with a product. They form a major part of the finished product.
Examples: Wood used in making furniture, Cloth used in making garments, Flour used in baking bread
 - b) **Indirect Material:** These are materials that are used in the production process but cannot be directly identified with a particular product. Their cost is small and indirect.
Examples: Lubricants for machines, Glue, nails, and screws used in furniture.
2. **Labour:** Labour represents the human effort used in production.
 - a) **Direct Labour:** It includes wages paid to workers who are directly involved in making the product. Their work can be easily traced to the production.
Examples: Wages of machine operators, Carpenters in a furniture factory, Tailors in a garment factory.
 - b) **Indirect Labour:** This includes wages paid to workers who help in production but do not directly make the product.
Examples: Supervisors, Maintenance staff, Storekeepers, Watchmen

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3. Expenses: Expenses are the costs other than material and labour incurred in production.

a) Direct Expenses: These expenses can be directly linked to a specific product, job, or process.

Examples: Hire charges for special equipment, Cost of special designs or patterns, Royalty paid for using a patented process.

b) Indirect Expenses: These expenses are not directly connected to any particular product, but are necessary for the overall production process.

Examples: Rent of factory building, Electricity and water charges, Depreciation on machinery.

4. Overheads: Overheads include all indirect costs (indirect materials, indirect labour, and indirect expenses). They are classified into different types based on the function.

a) Production or Factory Overhead: Indirect costs incurred in the manufacturing area.

Examples: Factory rent, Power and fuel, Repairs and maintenance of machinery.

b) Administration Overhead: Costs related to the general management and administration of the business.

Examples: Office salaries, Stationery and postage, Telephone and internet bills

c) Selling Overhead: Costs incurred for promoting and selling the product.

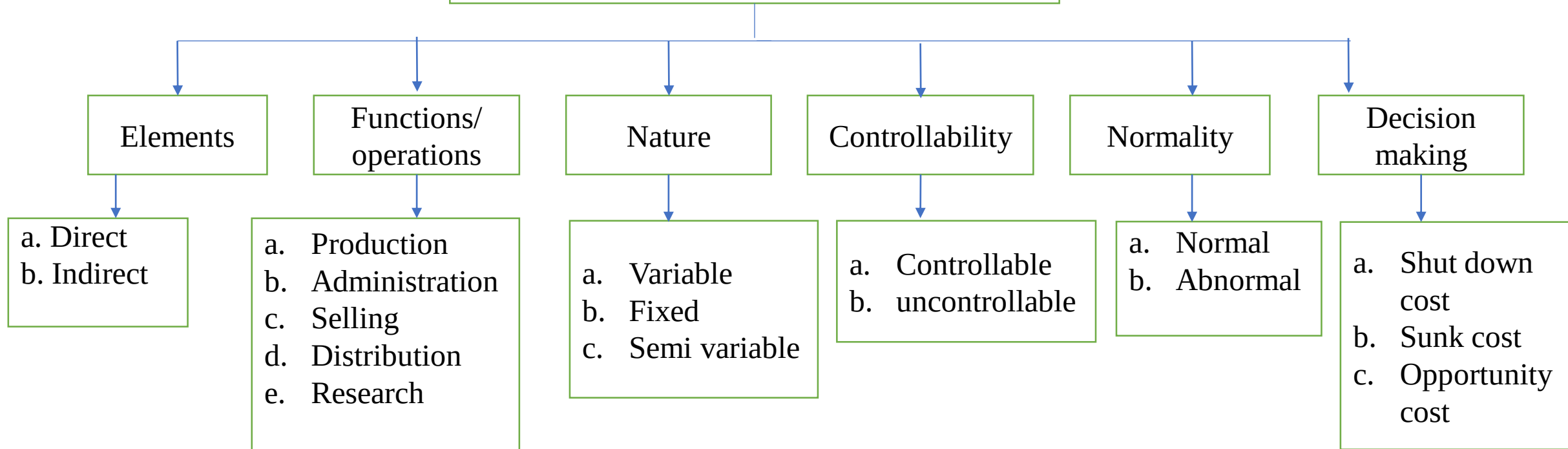
Examples: Advertising expenses, Salesmen's salaries and commission, Free samples

d) Distribution Overhead: Costs involved in delivering the product to customers.

Examples: Packing and shipping charges, Transportation costs, Warehousing expenses

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CLASSIFICATION OF COST



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1. Classification According to Elements

Costs are divided based on the elements that make up total cost—Material, Labour, and Expenses. This helps in finding the exact cost of production.

(a) Material Cost

Direct Material: Materials that can be directly identified with the product.

Example: Wood in furniture, fabric in garments, metal in machinery.

Indirect Material: Materials that are necessary for production but not traceable to one product.

Example: Lubricants, glue, nails, cleaning supplies.

(b) Labour Cost

Direct Labour: Wages paid to workers who directly work on the product.

Example: Carpenters, welders, tailors.

Indirect Labour: Wages of employees who assist or supervise production.

Example: Supervisors, quality inspectors, storekeepers.

(c) Expenses

Direct Expenses: Costs directly connected to a specific job or product.

Example: Hiring special equipment, product design charges.

Indirect Expenses: General expenses not directly linked to one unit.

Example: Rent, lighting, depreciation, insurance.

2. Classification According to Functions

Costs are grouped according to the different activities or functions of a business.

- a. **Production or Manufacturing Cost:** All expenses related to the actual manufacturing of goods.
Example: Raw material, factory rent, depreciation on machinery.
- b. **Administration Cost:** Expenses related to managing and controlling business operations.
Example: Office salaries, stationery, audit fees.
- c. **Selling Cost:** Costs incurred to promote and sell products.
Example: Advertising, sales commission, samples.
- d. **Distribution Cost:** Costs of delivering finished goods to customers.
Example: Packing, shipping, delivery van fuel.
- e. **Research and Development Cost:**
Research Cost: For finding new ideas or products.
Development Cost: For converting ideas into usable products.
Example: Lab testing, prototype design.
- f. **Pre-Production Cost:** Costs incurred before starting mass production.
Example: Trial runs, pilot testing.

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3. Classification According to Behavior (Nature of Cost)

This classification shows how costs respond to changes in activity or output level.

- a. **Variable Costs:** Change in direct proportion to output.
Example: Raw materials, direct labour, power consumption.
- b. **Fixed Costs:** Remain constant regardless of production volume (within a range).
Example: Rent, salaries, insurance.
- c. **Semi-Variable Costs:** Partly fixed and partly variable.
Example: Telephone bills (fixed line rent + call charges).

4. Classification According to Controllability

This classification depends on whether a manager can control the cost.

- a. **Controllable Costs:** Can be influenced or controlled by the manager.
Example: Material wastage, overtime cost.
- b. **Uncontrollable Costs:** Cannot be changed by the manager in the short term.
Example: Factory rent, depreciation.

5. Classification According to Normality

- a. **Normal Costs:** Costs that occur regularly under normal working conditions.
Example: Regular wages, power costs.
- b. **Abnormal Costs:** Unusual costs that arise due to unexpected situations.
Example: Loss from fire, accident repairs.

6. Classification According to Decision-Making (Relevance of Cost)

Used for managerial and strategic decisions.

- a. **Shut-Down Cost:** Costs that continue even if production stops temporarily.
Example: Rent, insurance.
- b. **Sunk Cost:** Cost already incurred and cannot be recovered.
Example: Old machinery purchase cost.
- c. **Opportunity Cost:** Benefit lost when one option is chosen over another.
Example: Interest lost by using funds for machinery instead of investment.

METHODS OF COSTING

Methods of costing refer to the techniques or procedures used to determine the cost of products or services. The method used depends on the nature of production and the type of industry.

Methods of costing are divided into two categories:

- Job Costing
- Process Costing

1. Job Costing: Job Costing is a method used when products are made to meet specific customer requirements. Each job or work order is unique and treated as a separate cost unit. Costs are collected and recorded for each job separately.

Examples: Construction of buildings or bridges, Custom furniture or machine manufacturing.

(i) Batch Costing: Batch Costing is applied when a group of identical products is manufactured together as one batch. Each batch is treated as a single cost unit, and total cost is divided by the number of units in the batch to find cost per unit.

Examples: Medicine production, Nuts and bolts.

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(ii) Contract or Terminal Costing: Used for large-scale, long-term jobs known as contracts. Each contract is treated as a separate cost unit, and costs are recorded against it. The focus is on monitoring cost, profit, and work completion.

Examples: Construction of roads, dams, or buildings, Civil engineering projects.

(iii) Multiple or Composite Costing: Used in industries producing complex products made up of many components. Each component or part has its own cost, and then all costs are combined to find the total product cost.

Examples: Automobiles (car = engine + gearbox + tyres + interior parts), Aircraft manufacturing, Computer systems

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2. Process Costing: Process costing is applied where production is continuous and the products are homogeneous (identical). Costs are collected for each process or department, and then the average cost per unit is calculated.

Examples: Chemical manufacturing, Cement, paper, or oil industries, Food processing and textile mills

(i) Unit or Single Output Costing: Used when a company produces only one type of product on a large scale.

Cost per unit = Total cost ÷ Total number of units produced.

Examples: Brick-making units, Coal mining, Cement factories

(ii) Operating (Service) Costing: Applied by service-based organizations that provide services instead of manufacturing goods. The cost is calculated per service unit (like per passenger, per kilometre, per student, etc.).

Examples: Transport companies – cost per passenger kilometre, Educational institutions – cost per student, Hospitals – cost per bed or per patient, Power supply companies – cost per unit generated

(iii) Operation Costing: Used when the final product is made up of a series of operations or steps. Costs are determined for each operation separately rather than for the whole process.

Examples: Shoe manufacturing (cutting → stitching → polishing → packing)

COST MANAGEMENT TOOL

Cost management tools are techniques used by organizations to plan, control, and reduce costs effectively. They help management in decision-making, pricing, and improving profitability by analyzing various cost elements.

1. Target Costing: Target Costing is a strategic cost management technique used to determine the maximum allowable cost of a product so that the desired profit can be achieved at a competitive market price.

Process: Determine the market price (what customers are willing to pay). Subtract desired profit margin from that price. The remaining amount is the Target Cost, i.e., the cost at which the product must be produced.

Formula: Target Cost = Selling Price – Desired Profit

2. Inventory Systems: Inventory systems are tools used for tracking, managing, and controlling stock levels of raw materials, work-in-progress, and finished goods. They ensure that materials are available when required and help in minimizing inventory holding costs.

Perpetual Inventory System: Continuous record of stock is maintained. Updated after every purchase or issue.

Periodic Inventory System: Stock levels are checked at the end of a specific period (monthly, quarterly). Common in small organizations.

Purpose:

- To avoid overstocking or stock-outs.
- To reduce carrying and storage costs.
- To maintain optimum inventory levels.

3. Average Cost Methods: Average cost methods are used to calculate the value of materials issued or remaining in stock by averaging the costs of purchases made at different times and prices. It helps in stabilizing the impact of price fluctuations.

Simple Average Method: Average of all prices of materials purchased.

Weighted Average Method: Average cost is calculated based on quantity and price of each purchase.

$$\text{Weighted Average Price} = \frac{\text{Total Cost of Materials}}{\text{Total Quantity}}$$

4. Preparation of Cost Sheet: A Cost Sheet is a statement that shows the total cost and cost per unit of goods produced. It summarizes different elements of cost such as material, labour, and overheads and shows profit or loss.

5. Standard Costing: compares actual cost with standard cost to find variances.

6. Budgetary Control: sets cost limits and monitors performance against budgets.

7. Marginal Costing: helps in decision-making related to pricing and output level.

8. Life Cycle Costing: estimates cost from design to disposal of a product.

9. Kaizen Costing: focuses on continuous cost reduction during production.

A STRATEGIC VIEW TO COST MANAGEMENT

Strategic Cost Management (SCM) focuses on identifying and managing key cost drivers that are the main factors which cause costs to rise or fall.

Strategic cost management is not just about reducing cost; it's about aligning cost control with the company's business strategy and long-term success.

Meaning:

Strategic Cost Management means using cost information to plan and execute business strategies that help an organization gain competitive advantage. It is a process of controlling and reducing business cost in a planned, well informed manner. Managing cost is very important part of business to manage the finance.

Cost management is the process of getting all cost-related information (data about expenses), organizing it, and using it to decide prices, plan activities, control costs, and take better managerial decisions.

Advantages of Cost Management

- **Helps in Strategic Planning:** Cost management supports cost-based strategic planning. It gives important cost information that managers need to design and implement long-term strategies. It focuses on the long-term competitive success of the firm, not just short-term profit.
- **Improves Productivity and Profit Margin:** By controlling and analysing costs, it helps in better use of resources (factor productivity) and increasing profit margins. Waste is reduced, efficiency increases, and profit improves.
- **Controls Cost of Sales Promotion & Product Modification:** It ensures that costs on sales promotion, advertising, and product changes are properly planned and controlled and their impact on revenue and profit is studied. So, money is spent only when it adds value.
- **Supports Overall Business Success:** Cost management methods and techniques (like ABC, target costing, etc.) are used to help the firm achieve its goals, remain competitive, and grow in the market.
- **Improves Understanding of Processes and Activities:** The same cost can be analysed in different ways (by product, by activity, by department, etc.), which helps managers understand how costs are linked to activities. This improves planning, control, and decision making.

TARGET COSTING

- Target costing is a cost management technique that starts from the market price, not from the cost.
- Target costing is a technique that determines the desired (allowable) cost of a product based on a given competitive selling price, such that the product will earn a desired profit.

$$\text{Target Cost} = \text{Expected Selling Price} - \text{Desired Profit}$$

- So, first we decide selling price and profit, and then design and produce the product in such a way that $\text{actual cost} \leq \text{target cost}$.

FEATURES OF TARGET COSTING

Market-Driven Approach: Target costing starts with the market price based on customer demand and competition, not from adding a markup to cost. So it is price-led.

Profit Planning Tool: Desired profit is decided in advance. Target costing ensures that the cost is controlled so that the required profit is achieved at the given selling price.

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- Used at Product Design Stage:** Target costing focuses on cost control at the design and planning stage of the product. Most costs are locked in at design; hence cost reduction is easier here than after production starts.
- Cross-functional Involvement:** It involves different departments – marketing, design, engineering, production, purchasing, costing – working together to design a product that meets cost, quality and customer requirements.
- Customer-Focused:** The product is designed to meet customer needs and expected quality at a price they are willing to pay. It avoids reducing cost by sacrificing essential quality.
- Continuous Cost Improvement:** Target costing encourages continuous efforts to reduce cost through better design, alternative materials, process improvement, supplier coordination, etc.
- Part of Strategic Cost Management:** It is a long-term, strategic technique, useful especially in competitive industries where prices are dictated by the market.

STEPS IN TARGET COSTING

- **Identify Customer Needs and Market Price:** Study customers, competitors and market conditions. Decide a competitive selling price for the product.
- **Decide Desired Profit Margin:** Management fixes the required profit (e.g., 20% of selling price or a fixed amount). This profit is based on long-term business objectives.
- **Calculate Target Cost:** $\text{Target Cost} = \text{Selling Price} - \text{Desired Profit}$. This gives the maximum allowable cost of the product.
- **Estimate Current / Expected Cost:** Prepare a cost estimate based on current design, materials, and processes. Compare this estimated cost with the target cost.
- **Identify Cost Gap:** If estimated cost > target cost, there is a cost gap. This gap shows how much cost must be reduced.
- **Cost Reduction through Value Engineering / Analysis:** Use value engineering, alternative materials, simpler design, process improvement, better supplier negotiation etc. Remove non-value-added features and costs while maintaining quality and function.
- **Finalize Design within Target Cost:** Only when the product is designed to meet the target cost, it is approved for production. Then standard cost and budgets are fixed.

ADVANTAGES OF TARGET COSTING

- Ensures Profitability at Market Price
- Strong Cost Control from the Beginning
- Customer-Oriented Products
- Encourages Cross-Functional Coordination
- Promotes Continuous Improvement and Innovation
- Reduces Unnecessary Costs
- Supports Long-Term Competitiveness