UNIT 2: COST CONTROL, COST REDUCTION AND COST MANAGEMENT

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2.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the concept of cost control and cost reduction
- identify the need of cost control and cost reduction
- enumerate the techniques of cost control and cost reduction
- differentiate between cost control and cost reduction
- explain the concept of cost management
2.1 INTRODUCTION

Most of the enterprises want to maximize the profit, which is possible by decreasing the production cost. For this purpose, management uses two efficient tools, i.e. cost control and cost reduction. Cost Control is a technique which makes available the necessary information to the management that actual costs are aligned with the budgeted costs or not. Cost Reduction is a technique which we use to save the unit cost of the product without compromising its quality.

The main objective of the organization is to earn maximum profit and to achieve this objective, firm needs either to increase the revenue or reduce the cost of production. Different concepts are used in cost accounting which deals with minimizing the cost. Let us discuss these concepts in detail to have better understanding and how these concepts enable the management to achieve the main objective of earning maximum profit.

2.2 COST CONTROL

Cost Control is a process in which we focus on controlling the total cost through competitive analysis. It ensures that the cost incurred on production should not go beyond the pre-determined cost. Cost Control involves a chain of various activities, which starts with the preparation of the budget in relation to production. Thereafter we evaluate the actual performance. After that we compute the variances between the actual cost and the budgeted cost and further, we find out the reasons for the same. Finally, we implement the necessary actions for correcting discrepancies.

2.2.1 Concept of Cost Control

Cost control is prime function of cost accounting. Under cost control, cost accountant measures actual costs, compare it with the standards and find the deviations. Then redial actions are taken to reduce the variances. It involves various actions taken to keep the cost within budgeted standards and not rising beyond the limit. Cost Control focuses on decreasing the total cost of production.

2.2.2 Features of Cost Control

Cost control has following features:

i) It is an attempt to keep the expenses within the control.

ii) It is a continuous process which includes formulating standards and preparing budgets to set a target and then continuously comparing the actual with these standards.

iii) It requires a continuous cost control report to identify the variances to be resolved.

iv) It works as motivational and encouragement to the employees to achieve the budgetary goals and keep the cost, controlled.

v) It is not only focused on reducing the cost, it also focusses on the effective utilization of the resources to get better results with the same available resources.
For example:
If current cost of producing a unit is Rs. 100 per unit, then under cost control attempt will be made to reduce the costs in such a manner that it does not go beyond Rs. 100. Organization will attempt to achieve this target. If it is found that actual cost comes at Rs. 120, it will find the deviation which is Rs. 20. Then attempt will be made to find the method to reduce the cost to Rs. 100. This is known as cost control.

2.2.3 Advantages of Cost Control
The advantages of cost control are mainly as follows:

i) Cost control helps to achieve expected return on the capital invested in a company, by resolving deviations between actual and expected standards.

ii) Cost control leads to improved standards of production with the limited resources of the company.

iii) Cost control reduces the prices or tries to maintain it by reducing the cost.

iv) Cost control leads to economic use of resources.

v) It increases profitability and competitive position of a company.

vi) It enhances credit worthiness of the company.

vii) It prospers and increases economic stability of the industry.

viii) It increases the sales of the company and maintains the level of employment.

2.2.4 Disadvantages of Cost Control
The disadvantages of cost control are mainly as follows:

i) It reduces the flexibility and process improvement in a company.

ii) It restricts innovation by emphasizing to reaching the preset standards.

iii) It requires skilled personnel to set standards.

iv) It lacks creativity as it is concerned with following the current standards.

v) It does not lead to improvement in standards.

2.2.5 Techniques of Cost Control

1. Budgetary control: The budgetary control is process of continuous comparison. It works with creating budgets and continuous comparison of these budgets with the actual. It is finding the reasons for deviations and revising the budgets with needs. It helps in planning coordination and controlling.

2. Standard costing: Standard costing is setting a standard cost and using this standard cost with actual and analyze the variances. It helps in identifying the causes of variances and cost estimation.

3. Inventory control: Inventory control is regulating purchase, and usage of material to maintain the production without blocking the extra funds into it. It tries to reduce the wastage of the material and leads to effective utilization of it.
4. **Ratio analysis**: Ratio analysis identifies the relationship among different variables. It helps to identify the trends in an organization. Ratio analysis is also used for comparison of different organizations on different aspects. It is mainly used for comparing the performance with other organizations and external standards.

5. **Variance analysis**: Variance analysis is a method of cost control. It involves the identification of the amount of variance and to analyze the reasons of these variances. A variance is which varies from the standards set. It can be favourable or unfavourable.

### 2.2.6 Characteristics of a Good Cost Control System

According to Backer and Jacobson, effective cost control should have the following characteristics:

(a) Delineation of center’s responsibility, i.e., deciding responsibility centers;

(b) The delegation of prescribed authority;

(c) Various cost standards;

(d) The relevance of controllable cost;

(e) Cost reporting; and

(f) Cost reduction

### Check Your Progress - A

1. What do you mean by cost control?

2. What are the steps involved in cost control?

3. Name any two techniques of cost control.
   i) ....................
   ii) ....................

4. What is meant by budgetary control?

   ........................................................................
   ........................................................................
   ........................................................................

### 2.3 COST REDUCTION

Cost reduction ensures savings in cost per unit and maximization of profits of the enterprise. Cost reduction aims at cutting off the unnecessary expenses which occur during the production process like storage, selling and distribution of the product. In order to identify cost reduction, we should mainly focus on the following major elements: savings in per unit production cost, the quality of the product should not be affected and savings should be non-volatile in nature.
2.3.1 Concept of Cost Reduction

Cost reduction is real and permanent reduction in unit cost of goods and services provided by the organization with effecting their quality and efficiency. There are different techniques used for cost reduction which can be budgetary control, standard costing, material control, labour control and overhead control. Cost reduction focuses on decreasing per unit cost of a product. Cost reduction is a continuous process. It has no visible end.

2.3.2 Features of Cost Reduction

Cost control has following features:

i) Cost reduction is genuine cost reduction which can be implemented by lowering the cost of production.

ii) Cost reduction includes permanent reduction in cost. It is more due to internal factors. For example, Reduction in government taxes is not considered as cost reduction as it is not permanent nature.

iii) Cost reduction doesn’t decline the quality of production. It remains the same.

iv) Unit cost is reduced either by decreasing the expenditure at a given level of output.

v) Cost reduction can also be done by increasing the quantity produced. It means reducing the expenditure will remain the same but the output will increase.

2.3.3 Advantages of Cost Reduction

i) Cost reduction increases the profitability of an organization.

ii) Cost reduction enhances the cash flow of the company.

iii) Cost reduction program helps in achieving the goals of the company.

iv) It is permanent in nature which affects the organizational performance in the long run.

v) Cost reduction does not impair the quality of the production while reducing the cost.

2.3.4 Disadvantages of Cost Reduction

There are problems with cost reduction which are generally do faced. These are as follows:

1. Workers and employees of an organization generally do not like to implement cost reduction program and they try to resist it. These are considered as difficult to be implemented.

2. Cost reduction programs are continuous in nature. It is a continuous attempt to lower the cost. But in most of the organizations, they are implemented on adhoc basis.

3. The cost reduction technique cannot be applied in all the cases.

4. Cost reduction technique requires a lot of research which adds on to the cost of the company.

5. Cost reduction technique needs to be implemented in a planned manner.
There can be two ways to achieve the goal of the cost reduction
● By reducing the cost of that particular product and
● By increasing the efficiency so that we can increase the productivity of the production unit which lowers per unit cost.

2.3.5 Techniques of Cost Reduction
Cost reduction results from reduction of wastage, improvement in efficiency, identifying alternatives, and continuous reduction of the cost. There can be different methods for cost reduction which can be as follows:
1) Value analysis and value engineering.
2) Job evaluation and merit rating
3) Quality control
4) Economic order quantity
5) Standardization and simplification
6) Inventory management
7) Benchmarking
8) Business process reengineering
9) Job Study, Works Study and Motion Study;
10) Job Evaluation and Merit Rating;
11) Value Analysis.

2.3.6 Essentials for success of cost reduction programme
Cost reduction programme aims at improvements of human efforts at all levels of the organization, which help in reducing costs. It may be a short-term or long-term program. A short-term programmer is undertaken for sorting out immediate problems, e.g. a problem involving controlling wastages and inefficiencies in certain departments, which are likely to push up the cost and may also require capital expenditure. It involves setting up the target return on capital employed and developing a scheme for its achievement through various cost reduction measures.

The following are the essential requisites for successful implementation of a cost reduction programme. Let us understand them in detail.

a. There should be a separate cost reduction cell responsible for proper planning and implementation of the cost reduction programme.

b. There should be an efficient system of management reporting at all levels of management.

c. The programme should have support from the top management. It is a continuous process and, therefore, should not be allowed to degenerate into a routine affair.

d. There should be an operation and research procedure.

e. There should be close co-operation amongst different executives concerned with the programme. Each departmental head should be given a list of the areas where he is expected to affect economies in cost. Moreover, he should also be encouraged to put forward his own suggestions for improvement.
f. There should be regular follow-up to the plan and continuous appraisal of the programme performed with the actual cost reduction performance.
g. The plan should not be confined only to reducing costs but should also examine whether expenditure is really required or not. In other words, there should be efforts to eliminate uneconomic and unnecessary activities.

**Check Your Progress B**

1. State whether each of the following statements is True or False:
   a. Cost reduction includes permanent reduction in cost. It is more due to internal factors.
   b. Cost reduction declines the quality of production. It should remain the same.
   c. Cost reduction increases the profitability of an organization.
   d. Inventory management is a method of cost reduction.
   e. Cost reduction is substitute of cost control.

2.4 **DIFFERENCE BETWEEN COST CONTROL AND COST REDUCTION**

Cost control and cost reduction are two different concepts under cost accounting. In cost control, we try to reduce the cost to achieve the predefined target. In cost reduction we try to reduce the cost further to lower the budgeted cost. It is an attempt to improve the standards itself. Cost control ends once the standards are reached, on the other hand, there is no limit to cost reduction as there can be improvement in the standards. It is an ongoing process. We can say that cost reduction is much broader as compared to cost control, it starts where control, ends cost. The difference between the two concepts can be explained as follows:

<table>
<thead>
<tr>
<th>BASIS</th>
<th>COST CONTROL</th>
<th>COST REDUCTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steps involved</td>
<td>Cost Control process involves defining the standards, measuring actual</td>
<td>Cost Reduction is critical analysis of existing standards to improve the</td>
</tr>
<tr>
<td></td>
<td>performance, comparing actuals with standards, estimating variances and</td>
<td>standards rather than creating the standards.</td>
</tr>
<tr>
<td></td>
<td>taking corrective actions.</td>
<td></td>
</tr>
<tr>
<td>Techniques</td>
<td>Cost Control uses techniques like budgetary control and standard costing</td>
<td>Cost Reduction uses tools like simplification, standardization, value</td>
</tr>
<tr>
<td></td>
<td></td>
<td>engineering, ABC analysis, etc.</td>
</tr>
<tr>
<td>Focus</td>
<td>Cost Control focuses on maintaining the standards and achieving the</td>
<td>Cost Reduction is challenging all the predefined standards and brings cost</td>
</tr>
<tr>
<td></td>
<td>established standards</td>
<td>down further.</td>
</tr>
</tbody>
</table>
### Time period

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control is not a dynamic function; it tries to reach to the minimum cost at a given point of time</th>
<th>Cost Reduction is a continuous process. It is not a period based concept but it analyses new ways to reduce cost.</th>
</tr>
</thead>
</table>

### Orientation

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control is focused on the past and present cost data.</th>
<th>Cost Reduction is a future oriented concept.</th>
</tr>
</thead>
</table>

### Nature

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control can be regarded as a preventive function as it attempts to maintain the cost at the required pre-set standards</th>
<th>Cost Reduction is a corrective measure. It tries to improve the efficiency of the existing control mechanism. It assumes that there is always scope of reduction.</th>
</tr>
</thead>
</table>

### Permanency

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control is temporary in nature. It is just a measure to reduce variances between actual and budgeted.</th>
<th>Cost Reduction is permanent reduction in cost of a good or a service</th>
</tr>
</thead>
</table>

### Cost concerned

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control focuses on reducing the overall cost.</th>
<th>Cost Reduction is an attempt to reduce the per unit cost</th>
</tr>
</thead>
</table>

### Quality concerns

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control does not talk of quality of the product; it focusses on reduction only.</th>
<th>Cost Reduction is reducing the cost whole maintain the quality of the product.</th>
</tr>
</thead>
</table>

### Frequency

<table>
<thead>
<tr>
<th>Management Accounting: Introduction and Basic Techniques</th>
<th>Cost Control is more of a routine activity. It requires close monitoring.</th>
<th>Cost Reduction is research oriented; it is a form of improvement so it demands creativity.</th>
</tr>
</thead>
</table>

Both the cost reduction and cost control are different concepts; they do not overlap each other and cannot be substituted with each other. They both perform different functions in an organization having their own importance.

### 2.5 COST MANAGEMENT

Cost management involves different cost accounting methods that have the goal of improving business cost efficiency by reducing costs or at least having measures in place to restrict the growth of costs. Cost management system is helpful in identifying, collecting, classifying and collating information that can be used by managers in planning, controlling and taking right decisions to keep the costs in the desirable limits. Cost manangement can be defined as the process of planning and controlling the budget of the business. It helps in predicting the expenses of the business.

### 2.5.1 Concept of Cost Management

Cost management is method of collecting, analyzing and presentation of data to plan, monitor and control cost. Cost management techniques identify how an organizational resource needs to be allocated to different projects.
while comparing its worth or outcome. Under cost management, we identify, collect and do reporting of the information required by managers and other users. Its main objective is to make the information available to the internal users of an organization. Efficient cost management helps the organization to improve its potential of the business. It provides information to managers for cost optimization and improving cost effectiveness.

2.5.2 Objectives of Cost Management

The main objective of cost management is to reduce the costs expended by an organization while strengthening the strategic position of the firm. There are many ways to apply the techniques of cost management. Some of them are as follows:

a) Establish systems to streamline the transactions between corporate support departments and the operating units.

b) Devise transfer pricing systems to coordinate the buyer-supplier interactions between decentralized organizational operating units.

c) Use pseudo profit centers to create profit maximizing behavior in what were formerly cost centers.

2.5.3 Types of Cost Management

There are three types of cost management which are as follow:

1. Those that strengthen the organization’s competitive position. An example of a cost management technique that strengthens an organization’s position is illustrated as follows. A hospital redesigns its patient admission procedure so it becomes more efficient and easier for patients. The hospital will become known for its easy admission procedure so more people will come to that hospital if the patient has a choice. The strategic position of the hospital has just been increased over its competitors.

2. Those that have no impact on the organization’s position. An example of a cost management technique that has no impact on the organization’s competitive position is illustrated as follows. An insurance company decides to reevaluate its accounts payable system to make it more efficient. The evaluation has no positive benefits to the insurance company in the external market. The objective of the change is to make the organization more profitable.

3. Those that weaken the organization’s position. An example of a cost management technique that will weaken the organization’s competitive position is illustrated as follows. A large airline company only has two desks for administering and selling tickets. This set-up induces long lines for the airline customers which can ultimately result in high dissatisfaction and a bad reputation for the airline. This may reduce the amount of ticket sales when compared with the airline’s competitors. Even though having only two desks available for customers may initially be cost effective, in the long run, it harms the company.

As a general rule, an organization should never undertake any practices that are predicted to weaken the position of the organization.
2.5.4 Techniques of Cost management

Managing a business has containing cost of utmost importance. Below are mentioned some of the techniques through which the overall cost of the business can be controlled and maintained within the required limits.

Time management

The one who owns the business definitely knows the value of time for his/her business. However, it is important to pass down the relevance across the hierarchy of business to view the desired results. It is very essential to make the employees understand the value of time and how to be efficient to do more work in the same time span. This is one of the methods that will help increase the productivity without adding to the labour cost.

Inventory management

One of the major cost as well as ways of generating revenues is through inventories. First and foremost one needs to chalk out the inventory requirements, the quantity check that needs to be stored, vendor costs, etc. as all of this helps in knowing the requirements of the business and helps avoid stocking excess inventory and deploy the capital elsewhere rather than tying up in the inventory stocks.

Outsourcing

Outsourcing is one way that helps take employees on third party roles especially when it is for one time projects. This saves the employer from taking the cost onto his books. This is definitely done keeping in mind that the outsourcing partners are of the standards that do not hamper the quality of services to the customers of the business. Besides the employees, certain projects also can be outsourced, which helps in saving the additional employee costs onboard as well as get access to outside talent and technology, helping in optimizing the resources.

Updated market sense

It is very important to be updated with the trends in the markets as it is game of survival of the fittest. One has to be constantly in touch with the vendors and see that renewal of the contracts keep happening with the trend in prices. This will help in negotiating for the best prices available rather than dragging on the set prices of long term contracts.

Control of headcount

The second most important cost to a business is the employee cost. Although we take employees as assets or the backbone of the business, one needs to keep in mind that they also have cost associated with them. Besides the regular pays and salaries, workplace, licenses, softwares are the additional costs added per employee. That is why, it is essential that the manager knows how to reduce the employee costs, either by taking less number of people onboard, or by taking more of low cost employees rather than few high costs ones.

2.5.5 Advantages of Cost Management

a. It helps in controlling the project specific cost, in turn also the overall business cost.
b. One can predict the future expenses and costs and accordingly work towards the expected revenues.

c. Predefined costs can be maintained as records for the business.

d. It helps in taking those actions that are necessary to assure that the resources and business operations aim at attaining the chalked objectives and goals.

e. It helps in analysing the long term trends of the business.

f. The actual cost incurred can be compared to the budgeted ones to see if any component of the business is spending more than expected.

g. It helps in analysing the business positioning in terms of making an acquisition factoring the cost component involved.

Check Your Progress C

a) Simplification, Standardization, Value Engineering, ABC Analysis are tools used under……………………………..

b) ……………………….. is method of collecting, analyzing and presentation of data to plan, monitor and control cost.

c) ……………………….. is research oriented so it demands creativity.

d) ……………………….. is challenging all the predefined standards and bring cost down further.

e) ……………………….. focuses on reducing the overall cost while ……………………….. focuses on reducing per unit cost.

2.6 LET US SUM UP

Cost accounting involves two important functions: one is cost control another is cost reduction.

Cost control aims at keeping the cost within the predefined limits. Cost reduction is to rediscover the standards by lowering the cost further down.

Steps under cost control are setting standards for the organization, measuring the actual performance, comparing the actual performance with the pre-defined standard, finding the deviations and taking corrective actions.

Cost control helps in achieving expected returns, reducing cost, economies of scale, increases economic stability of the company. Cost control involves different techniques like inventory control, budgetary control, standard costing, ratio analysis and variance analysis.

Cost reduction is real and permanent reduction in nature without impairing the quality. It can be either by reducing cost or by increasing output. Cost reduction improves profitability and affects the organization in long run.

Techniques of cost reduction are value engineering, job evaluation, quality control, standardization, simplification and job evaluation.

Cost control is different from cost reduction on many aspects like techniques used, its focus, frequency, orientation, permanency and nature.
Cost management is collecting, analyzing and presentation of data to plan, monitor and control cost. Its primary purpose is to make the information available to the internal users of an organization.

### 2.7 KEY WORDS

- **Cost Control**: Comparing actual and standard performance to rectify deviations.
- **Cost Reduction**: Reducing cost without affecting quality.
- **Cost Management**: Collection analysis and presentation of data to manage the cost.
- **Budgetary Control**: Controlling the cost by creating budgets.
- **Standard Costing**: Setting standards to compare with actual performance.
- **Value Engineering**: Finding and replacing less expensive methods of performing the job.
- **Quality Control**: Retaining the standards by quality check.
- **Economic Order Quantity**: Ideal size of order which should be made.
- **Inventory Management**: Managing the flow of from point of purchase to sale.

### 2.8 ANSWERS TO CHECK YOUR PROGRESS

B. a) True   b) False   c) True   d) True   e) False

### 2.9 TERMINAL QUESTIONS

1. Define concept of cost control with its features and example.
2. What are different advantages and disadvantages of cost control?
3. Differentiate between cost control and cost reduction.
4. Explain different techniques used under cost control.
5. What do you mean by cost reduction? Discuss its advantages and disadvantages.
6. What are the essential requisites for the successful implementation of cost reduction programme? Explain.
7. Discuss in detail the advantages and limitations of cost reduction.
8. Explain the concept and objectives of cost management.
9. What are the different types of cost management? Explain with example.
10. State the advantages of cost management in brief.