

Aiming continuous economy in costs through the cost reduction process

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Abstract

Cost reduction is a continuous process of analysis by various methods of all the factors affecting costs, efforts and functions in an organisation. The main aim is to have continuous economy in costs. The process finds out the substitute by finding new ways or methods. Under this process necessary steps are taken for further modification in the method. It challenges the standards forthwith and attempts to reduce cost on a continuous basis. The emphasis is partly on the present costs and largely on future costs. It is a corrective action. It operates even when efficient cost control system exists. There is room for reduction in the achieved costs.

Keywords: cost-benefit analysis, cost control system, cost reduction, standard cost, the management accountant

Introduction

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. Reduction in the cost of product must be brought about by the elimination of wasteful and unnecessary resources employed in its design, manufacture, sale and distribution. Reduction in quality of a product or the range of its uses cannot be regarded as fitting cost reductions.

Cost reduction must be an attitude of mind throughout the organization. It must be organized and controlled by a senior manager, with a team of skilled people able to analyze and record business activity and find ways of improving the methods used, so that costs are reduced and output increased.

The Cost Reduction Process

Cost reduction process is shown in figure 1:

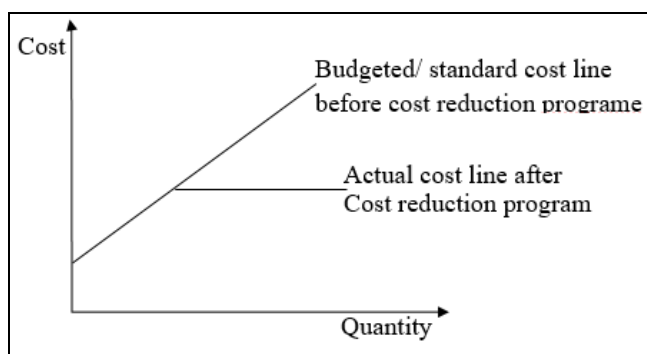


Fig 1: Cost Reduction Process

Cost reduction process contains the following sequences of steps:

1. **Analysis:** Every activity, whether in the office, factory, or warehouse, can be analyzed into a number of separate steps. This is done by asking questions and gathering and

recording answers given. From this process of data collection, it is possible to draw a picture of the activity which enables it to be examined and improvements developed.

2. **Examination:** Each activity is now examined in some detail to establish whether it is vital, secondary, or unnecessary. Vital activities are those which directly lead to achieving the objectives previously established. They become fundamental to subsequent improvements. Secondary activities do not contribute directly to achieve the objectives but are necessary to support and serve that vital activities. The remainder of the activities concerned are almost always unnecessary. As they neither contribute directly nor indirectly in achieving objectives and they cannot be considered necessary. When activities or components have been examined, it is possible to consider whether they should be eliminated, combined or simplified. Elimination of activities and components is the most ambitious and most problematic step. The greatest savings often arise from elimination of unnecessary activities and components, and this should always be the first line of attack in spite of the problems included. Combining activities is one way of making savings in areas where the activity cannot be eliminated. Considerable improvements can be achieved by combining activities.

3. **Developing Solutions:** Detailed analysis and examination should lead to the development of a number of possible solutions. No solution should be overlooked or ignored because it does not seem practical. The evaluation of a solution will depend upon the knowledge of the analyst. The evaluation process matches each solution against the following requirements:

1. Does it achieve the objectives in full?
 - Is it practical?
 - Does it fall within the constraints, if any, such as finance, time physical resources, human resources etc.?

- Is it a better way of doing the job?
 - Does it reduce cost, if so, by how much?
 - Will it be acceptable to customers, employees and management?
 - Will it stand the test of time?
2. **Selecting Solution:** The choice between several solutions will depend on numerous factors including company policies, personal preferences, aesthetic appeal, and other subjective criteria. This is the stage where the analyst has to make sure that everyone fully understands the advantages and disadvantages of various solutions so that a rational choice can be made.
3. **Obtaining Agreement:** In the evaluation stage, one of the questions asked was: 'Will it be acceptable to customers, employees and management?' The answer to this must have been yes, otherwise the solution would not have passed the evaluation test. This means that final agreement to the selected solution has to be obtained by the analyst.

Precautions in Implementation of the Program

Before implementation of the cost reduction program, the following points should be given a careful consideration:

- Cost reduction program must be appropriate to the organization.
- Its introduction and implementation must be planned soundly.
- The success of cost reduction program depends upon the cooperation of all those involved, whether directly or indirectly. Its effects and results are monitored regularly and closely.
- Resistance by employees to pressure to reduce costs, usually because the nature and purpose of the campaign has not been properly explained to them, and they feel threatened by the change.
- The mechanics and operation of such programs must be communicated clearly and concisely to organisational members preferably in writing.
- Reluctance of the managers and workers should be recognized to change their patterns of behaviour.
- Those required to operate a cost reduction program must be convinced of the personal benefits to them.
- Monitoring and assessment system must be understood by all participants in the program.
- There should not be any overlap between the cost reduction programs or double counting of reduction or saving.
- The success in one area is not severely hindering or damaging other aspects of the business or that success in one area is not being eroded by failure in another area.
- The cost reduction measures should not have any undesirable effects on external parties e.g., suppliers of raw material, buyers of finished products etc.
- The programs are within the letter and spirit of national or local legislation and regulations e.g., in the areas of health and safety standards.
- The degree of skill or efficiency of operational management has direct effect on costs.
- It must be recognized that even the most efficient

- business organisations incur unnecessary costs.
- The skill of the management is tested in identifying those unnecessary costs and acting to eliminate or reduce them.
- Generally, when the enterprise is facing difficulty in trading conditions, the attention of the managers will be forced to focus on costs; when conditions improve, there may be less inclination to control costs and their impacts. It must be recognized; cost reduction is a continuous process.
- It is vital that costs are examined and restrained at source.
- It must be appreciated that perfect scheme covering all eventualities will be both expensive and complicated to implement. This calls for realistic appreciation of the costs and benefits involved in any cost reduction program.
- It must result in unit costs.
- They may be limited to a small area of the business with the result that costs are reduced in one cost centre only to reappear as an extra cost in another cost centre.
- Cost reduction campaigns are often introduced as a rushed, desperate measure instead of a carefully organized, well thought-out exercise.
- Cost reduction does not happen of its own accord, and managers must make positive decisions to reduce costs.

The efforts on developing such cost reduction programs presupposes the desirability of the existence of the objective. Since in a number of circumstances the objective may not be desirable. Control and reduction of cost need to begin from areas of maximum occurrence. Reduction of cost, unless it aims at cost improvement will not be helpful. It does not serve any purpose to stop purchase of petty things to reduce overheads. Reduction in material wastage in an area linked simultaneously with total quality management and cost control. Engineering units often spend on reworking which could be avoided by thoughtful design, purchase and processing. Concepts like zero-base budget, productivity improvement and total quality management help in improvement in productivity which will automatically reduce cost of production per unit.

Approaches to Cost Reduction

There are two basic approaches to cost reduction:

Crash Programs: If an organization is having problems with its profitability or cash flow, the management might decide on an immediate program to reduce spending to a minimum. Some current projects might be abandoned, capital expenditure deferred, employees made redundant or new recruitment stopped and so on. The absence of careful planning might give such crash programs the characteristics of panic measures and authoritarian dictatorship from top management. Cost reduction measures might be too little, too late or misdirected. Poorly planned crash programs to reduce costs might result in decisions which seriously reduce operational efficiency without the effects being immediately noticeable. Decisions by a company, for example, to reduce the size of its Legal department, or its Internal audit or Organization and Methods (O & M) sections might cut staff costs in the short-term but increase costs in the longer term.

Planned Programs: Many companies tend to introduce crash programs for cost reduction in times of crisis and ignore the problem completely in times of prosperity. A far better approach is to introduce continual assessments of an organization's entire products, production methods, services, internal administration system and so on. The Management Accountant will normally become involved when compiling reports on the costs and benefits of different alternatives, and also on providing cost benefit analysis of the cost reduction schemes themselves. Cost reduction exercise are planned campaigns to cut expenditure. They should preferable be continuous, long-term campaigns, so that short-term cost reductions are not soon reversed and forgotten. A planned program of cost reduction will begin with an assumption that some costs can be reduced significantly. The benefits of cost savings must be worthwhile and should exceed the costs of achieving them. Areas for potential cost reduction should be investigated, and unnecessary costs identified. Cost reduction measures should be proposed, agreed, implemented and then monitored.

Long-range Programs: Long-range cost control and cost reduction programs mainly arise due to huge capital expenditure designed toward a continual reduction in costs, depending upon better layouts relocation of plant, modernization programs, material handling improvements etc. They often operate as perspective plan during which all the aspects of business and the whole sphere of its operations will be covered.

Short-range Programs: Short-range programs may arise from the following considerations:

- A temporary fall in profits which has to be corrected promptly.
- An impending unfavourable competitive situation.
- Identification of certain products which competitors are selling at a lower price in the market.
- Adverse cost variance which calls for immediate action.
- Some operation which appear to be inefficient and provide opportunities for quick and substantial cost savings.
- Some operations or functions which appear to be costing too much.

Conclusion

Finally, we may opine that cost reduction is the improvement of the environment. This involves the examination of the purposes for which costs are incurred and, by a variety of means, eliminates or reduces the reasons for spending. The existing standards are closely examined at the broad and detailed levels with a view to improvement. Cost reduction is the process of the seeking ways to achieve a given result through improved design, better methods, new layouts, incentive schemes, establishing of new standards etc. Cost reduction plan is a coordinated set of contingent actions to achieve the dual objective of reducing overall costs without corresponding loss of efficiency. It should be remembered that involvement of management in cost reduction programme is necessary to bring real and permanent reduction in costs. Thus, something more than loose directive to economise is necessary for cost reduction.

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