# Cost Management

# Key to Survival

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# Understanding Cost Management

**Overview**

A wonderful thought of Mr. Larry Carter says, "It's no longer about the big beating small; it's about fast beating the slow." A slight modification of the same in the current business environment can be: "***it's about efficient beating the inefficient***." And today the efficiency lies in managing the expectations of stakeholders through refined and redefined strategy and innovative approach in exploring the unexplored avenues.

Amidst the cost control measures being adopted by companies to manage profits, the companies in order to sustain their competitiveness have started paying heed to every minute aspect in their operations to achieve efficiency. Here lies the significance of comprehending the true role of "*Cost Management*."

**Conventional Costing v/s Cost Management**

In the era of recessionary conditions, it's imperative to understand the real substance of cost management while maintaining the desired quality in products or services offered by the concerns.

Incidentally whenever there is any financial predicament, the companies are left with no other option than to bring about a radical cost management and eliminate the root-causes. Taking a step further from the conventional costing concept of just recording the cost and focusing on the short term costing tactics viz. cost reduction or elimination of few expenditures, the present situation calls for better understanding of costing with maximum precision and analysis of the hidden costs in order to counteract the dual-impact of the strains from the market competition and the turbulent financial situation.

It's quite natural that few companies emerge from recession far before others by implementing cost effective internal regulations in the wake of crisis, while others fail to recognize the very basics of costing surveillance. An obvious reaction under such circumstances is just to cut the costs; however at the same time it is to be ensured that an arbitrary reduction can be counterproductive and denting. For a viable and sustainable future, companies must ponder over the ramifications of any action rather than merely improving the bottom line.

# What’s the relevance?

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**Let’s Do “Slashing”…!!**

The traditional costing generally follows the modus operandi of “slashing approach” implying that costs should be reduced to regain profitability in the light of economic deterioration. They ignore the basic fact that the cost cutting must be on the back of some rationale else it may lead to customer loss and inevitable loss of market share.

At the same time, the very essence of cost management is to manage the costs in relation to the economic value resulting from the same since costing in isolation has no meaning in the business environment.

**Understanding Relevance of Cost Management**

The cost management is a broad term which primarily deals with collection and analysis of the relevant costing data and supporting the management to arrive at effectual decisions. Its underlying theory states that data in itself has no significance unless analyzed effectively. For instance, every company might be very proactive in setting standards and preparing budgets but only few of them do the post-facto analysis to detect the real cause of deviations from standards, and failure to avoid the recurrence of unwanted and unfavourable factors lead to prolonged instability and business failure in the long-run. And when it’s the time of financial crunch, it is essentially required that the cost management is applied in true sense.

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# Identification of Cost Drivers

The global financial crisis has made cost management the biggest priority for all the organizations. The current financial turbulence demands every company to apply scientific cost management through cost rationalization and not just cost reduction at the expense of the company strategy. There are a number of cost management tools which are of colossal value to every business, such as identification of value-adding activities and cost drivers, proper budgeting exercise and post-mortem analysis through standard costing and variance analysis, et al. To start with, the companies need to determine the cost drivers for the various cost pools. The companies must strive to analyze the cost drivers and manage the value-adding activities to take appropriate measures to improve performance. The value drivers must be linked to the cost drivers to assess the factors which lead to the highest value-add, while eliminating the unessential activities which merely result in cost increment without any corresponding utility. For example, a hotel company targeting affluent group must ensure that it doesn't consider cost reduction in relation to its ambience as it might entail losing customers. Although it is necessary that the companies must seek to cut-down the cost but it should be made certain that the benefit accruing from any activity should be more than the related negatives. Moreover the companies must realize that they should not, in any case, deviate from their basic business model else they might be trapped in an altogether different scenario wherein there won't be an enticement for way forward. If any customer decides to move away from a company simply on account of the fact that the company adopts counterproductive savings measures without due consideration to the entire life-cycle cost model and the basic business essence, then it should better be ignored by a businessman driven by prudential norms. The fundamental concept of cost management is to properly analyze the linkages of the various cost drivers with the resulting outcomes. Cost management, in essence, is a concatenation of cost accounting and managerial economics. While the former focuses on the measurement of various aspects of costs involved and selection of cost reduction projects, the latter lays stress on visualizing the gains from the improved methodology and better quality drive on a holistic basis. The cost management involves developing a practical approach in order to enhance the competitiveness of products and services by discovering cost reduction opportunities in the production and service processes coupled with having sufficient measures to brazen out any impending problem. After becoming the victim of the global economic downfall, every company is bound to devise a proper strategy after systematic reengineering and revalidation of existing processes. The cost management here plays a vital role in eliminating the ill effects of the mar of weak market scenario.

# Budgeting is Imperative

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**Essence of Budgeting & Planning**

The cost management stands on the basic footprints of suitable appropriation of costs and preparation of budgets for various production departments and the concerned service departments. The significance of the budgeting can be boasted by the fact that it ensures direction of the resources to the most productive use thereby assuring that the wastages and losses are reduced to the minimal. Additionally the budgeting exercise facilitates automatic coordination among various departments in the organization.

A special thrust must be given to the model of '*Zero Based Budgeting*' when the business market is experiencing downturn. This concept was propounded by Peter A. Phyrr, a staff control manager at Texas Instruments Corporation, U.S.A. in the year 1969-70. This technique focuses on review of each of the activities right from the scratch and a detailed cost benefit analysis for each of them. This not only results in efficient allocation of resources, also makes sure that the consequent obsolescence and wastages are avoided. Given the contemporary scenario when the companies are struggling hard to come out from the economic slump, the zero based budgeting assumes more importance wherein this can act as an effective measure to rationalize the costs by prioritizing the business expenditure.

**Analyze Your Report Card**

If the business is driven by predefined strategies and has a well laid down plan, it can ensure that it does not meet any unparalleled situation in future. And this needs to be coupled with '*standard costing and variance analysis*' because if the actual performance is not matched with the standards to analyze the deviations, the very purpose of setting standards and having budgets gets defeated.

The basic intent under standard costing implementation is targeted to check the actual performance against company standards to support the management to understand the areas where the company is lagging behind others. The inquisition of the variations leads to better decision making as it facilitates that the concerned basic cause(s) for such divergence can be identified and corrected, or if the need be, the standards can be appropriately revised.

No company, irrespective of its size, can grow and sustain in the market unless it knows the basic integrities of its own business model and the related repercussions; and standard costing is the tool which effectively enables the same.

# Heart of Decision Making

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### Principles of Marginal Costing

When companies are finding it difficult to sustain their business owing to market disorder, every business decision must be cautiously taken to ensure that the business does not suffer as a result of poor decision making. Here comes the importance of employing the concept of '*marginal costing*' which focuses on ascertainment of cost and measuring the impact on profitability due to alterations in the volume of production or type of output. It reiterates the fact that instead of measuring the impact of total costs, the decisions must be driven by the marginal costs.

For instance, a company is operating at 60% capacity and has received a special order from a foreign client which it can fulfill by utilizing remaining 40% capacity without any corresponding increment in fixed costs. The company must only evaluate the variable costs and specific order costs to cite the minimum quotation for order rather than going without it. Marginal costing guarantees that the company does not suffer losses as it covers the incremental costs related to the assignments thereby avoiding the pricing distortions. As we know that in the current competitive business environment, one of the important challenges for the business is to retain the market share and marginal costing technique effectively supports this principle.

### Should We Shut Down Our Business?

Another point in the light of financial retardation is to take a decision as to continue a business line(s) or shut down the unprofitable business for some time. Consequently it is crucial to decide whether to close down a division for a particular period and reopening it when the business conditions improve or continuing with the same business division with some losses with hope of recovery in some time. At this point, the company must take a decision not only on the pure financial implications but also on business considerations as well. For instance, a company might evaluate that it would incur a loss of Rs.5 lakhs if it continues to operate while it would need to incur losses to the tune of just Rs.2 lakhs if it suspends its business for one year. On financial considerations, it might appear profitable for a company to go for business suspension in the light of losses comparison; while a prudent businessman should also take in to account that it might lose few of its regular customers owing to the temporary closure and would need to incur additional promotional expenditure for regaining its business and market share. In times of business uncertainty and poor economic conditions, the instinctive response of most of the companies is to cut costs by any means, whereas such decisions must be properly weighed against their long term consequences.

# Crossing Break Even Border

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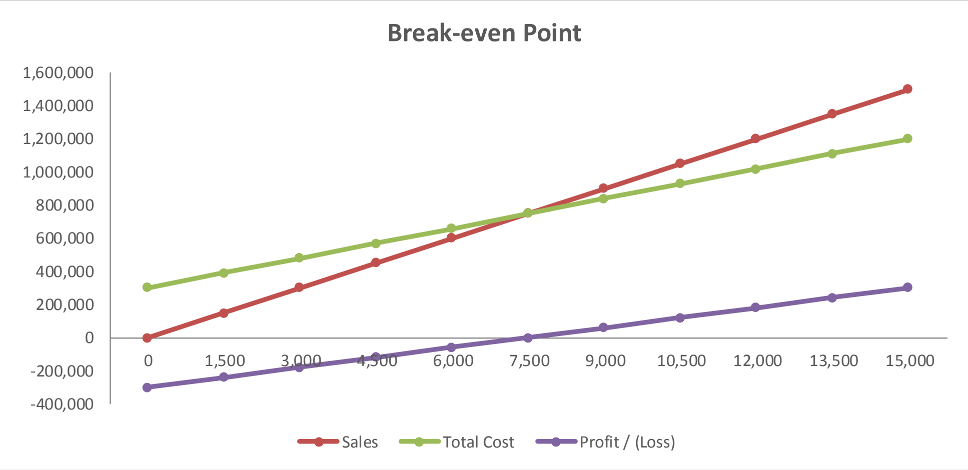
**Hey, I have crossed break even border**

At the times of recession, the businesses would obviously not be able to meet its targets but it must properly appraise whether the deviations are solely on account of the market conditions or there are some company specific factors as well which are responsible for it. Another tool that they can utilize for proper analysis is to see the *break even levels* for its various business lines and for the entire business as a whole. The proper diagnosis of break even analysis enables an organization to pay special regard to few business processes and/ or weed out the undesirable business lines. The basic idea behind such an analysis is to scrutinize the extent to which the business lines are not able to finance their fixed cost levels.

And related to this concept is the *margin of safety* which implies the extent of profitability over and above the break even levels. If the management sees that a particular business line is having positive margin of safety (whether or not meeting company defined targets), it can be assured of at least a fact that it will not have to take out anything from its own pocket to finance such businesses/ divisions.

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# Appreciating Benchmarking Exercise

Any cost management technique presupposes the existence of a platform which can sustain the cost efficient measures adopted by the organization. And if such a premise is doubtful, then any effort expended by the company management is likely to be abortive in the long run. Now the question arises how an organization can assure that its internal control procedures and processes are up to the mark or not. Truly speaking there is no such measurable level for such mensuration, but it does not imply that nothing should be done in this regard. An underappreciated area of lesson from the crisis experienced by the global community is *benchmarking* the business operations against the other players in the market. Though the organizations have been effectively populating devices to evaluate their methods, processes and resulting performance with that of their peer group, the current international collapse has impelled everyone to hunt for the best practices prevalent in the industry. Benchmarking assists the management to develop plans on how to adopt the industry best practices and make improvements in existing processes, usually with the aim of increasing some aspect of performance. For many organizations, benchmarking may be an event required in problematic times, while only few appreciate the importance of treating it as a continual and pervasive process to unrelentingly seek to improve their practices. Again the catch is to appraise the utility of adopting such principles on a regular basis to strongly come out of the market related troubles and reaching further pinnacles.

The reality that needs to be inculcated is that the primary focus should be to optimize the long term value generation for the businesses. A systematic think though gives an idea as to how a company can brainstorm on the potentially effective areas for incorporation in the business operations. An article published in the BusinessWeek on 'Best Global Brands' outlines that the big shots in the market such as Kelloggs and American Express have actually increased their spending on advertisement and marketing in the recessionary period and have gained substantially from this. They have basically worked on the premise that the organizational visibility needs to be enhanced in the feeble market conditions. Thus instead of just going by the traditional viewpoint that costs must be reduced in poor financial circumstances, these companies have set a model for others in the market that it's not about being cost conscious, rather it's about costing prudence. It's all being behaving differently and researching on 'out of the box' approaches for cost effectiveness. While on an overall basis the total costs may be depicting a rising trend, however when the same is examined against the matching value adds, the expenditure is justified. Say, if the banks start closing down their ATMs to cut their costs, the customers might get baffled for the want of convenience. The eye should be on determining the cause and effect analysis to properly guide their actions in the right direction as business is intended to be run for an ongoing period.

# Putting it all together

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**Your Opinion says "It's Irrelevant" – I say "It's Relevant"**

Another steering command is to instill a learning stemming from the financial crisis that there is nothing like a consistent approach that can be applied in all circumstances. As the crisis has shattered all the myths associated with the common prototype of uniformly applying the defined strategies in every situation, there is an impelling demand for everyone to undergo a paradigm shift.

Associating it with costing principles, *a cost which is relevant in one situation might be irrelevant in another situation*.

The basic theme of relevant costing revolves around assembling the financial information to evaluate the impact of any factor on the final economic decision in hand. And this principle is equally applicable to the short term decisions as they apply to long term decisions. Further these gain special significance when the organizations are trapped in the adversities of market convulsion.

The idea of relevant costing recognizes that for managerial decision making purposes, a single cost value cannot be used ubiquitously to every berth. The costing thesis describes this as 'distinctive costs for distinctive functions.'

**Conclusion**

The observation of several methods of cost management reveals that every single penny must be on the back of clear articulation of the enterprise functions. The deliberations are required for each of the costing element to adequately tackle the business challenges. Cost management must be undertaken from a strategic perspective involving every single manager in the organization as it is very critical in current business climate. The recessionary economic scenario requires a complete re-think about the way organizations are managed from a financial perspective with special emphasis on related costs. It is not only about cost cutting, it is about effective cost management and this requires developing a practical approach among managers in enhancing global competitiveness of products and services. Nonetheless at the time of market or economic failure, the importance of cost management becomes apparent to everyone, while proactive adoption of this practice ensures that businesses do not encounter such situation. Irrespective of the tumultuous economic storm, the stakeholders expect high performance in all weather. **"When times are good, they can be very good for all companies; but when times are not so good, they can still be good for far-sighted companies."**

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T: (+91) 9811516227

E: lexaspire@lexbolster.com

W: www.lexbolster.com

India: 23-B, New Layal Pur Extn., Delhi, India

Dubai (UAE): Office 1414, Churchill Tower, Marasi Dr, Dubai, UAE

Mauritius: 105A, Moka Business Centre, Mt. Ory Road, Moka, Mauritius