

Management Accounting
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Lecture 07

Cost Sheet- Role and Relevance in Management Decision Making-1

Welcome students, so in the previous class we started talking about the cost sheet which is a one important tool in the management accounting tool which facilitates the management decision making. As I told you that management accounting itself is not at all a disciplined, it has borrowed different techniques from the cost accounting and the financial accounting and how that information has to be converted into meaningful information.

So that management decision making of the management or the managerial decision making can be facilitated that we do in the management accounting this discipline has been developed after 1950. Only just to facilitate management decision making because cost accounting only generates some relevant information, financial accounting generates a relevant information but that information is not itself is sufficient to (say) automatically to take us to the decision.

Decision making depends upon how we make use of that information, how that information becomes useful for us, how it is relevant for us. So, in the previous class I emphasized upon that there are the different tools and techniques where we can say use them for important decision making or for the different managerial decision or say decisions to be taken by the say management of the different firms, different organizations.

And we discussed that cost sheet is one such statement which is normally prepared under the cost accounting but the information provided by the cost sheet can be used by the manager taking for the strategic decision, very useful decision. So, we discuss the structure of the cost sheet that how the cost sheet be prepared, what it include and what different type of the sub cost it works out because we have to, I mean say find out the total cost of the product and in this competitive world our cost has to be as low as possible.

I was talking to you in the previous class also the same thing that our cost to be as low as possible because we want to compete in this world. Because there is no shortage of the goods and services now, we live in a globalized world, we live in a globalized world there is no shortage. Supplies side had improved like anything. It was olden, for example, in India 1991

and before. Before globalization of Indian economy there was the shortage of the supply or the supply sites and certain sectors was weak.

Because most of the sectors was reserved for the public sector, so one or two units in the public sectors was serving the customers need of this country or the entire, customers need of this country of the entire, customers need of this country, so there might be the shortage of the goods and services and whatever those producers and those forms owned by the government. Manufacturing and selling in the market they were say successful in selling their product in the market.

But to this not scenario like that, for example, if I talk about before 1991 or even till late till mid 90s, you talk about the steel sector. In India the steel sector was dominated by one company which was having more than ninety percent of the share in the still sector and that was the public, publically held company or maybe you can call it as a government company SAIL - Steel Authority of India limited.

Steel Authority of India limited was provided the steel or was responsible for manufacturing and say providing or fulfilling the steel related requirement of the people of this country. Only one company, huge country around one million people, huge country, large country and only one company is fulfilling the needs which is very important product steel and only one company is manufacturing.

There is no competition, so when there is no competition whatever the garbage you manufacture, at whatever the price you want sell that product in the market people are bound to buy that product from that company. But after the globalization when the steel sector was opened for the private sector participation you see that SAIL has lost its significant market and I can say that half of the market of the sale is has been lost because of the poor quality of the product and very high cost of the product.

Now, when the private sector players, for example, western market, in the western part of the country we have two companies SR and the Lloyd steel. They are manufacturing the good quality steel and selling it at a very competitive price to the people, so it means by the people would depend upon SAIL or buy the product manufacture by SAIL. Similarly, in the southern region Jindal Vijay Nagar Steel plant which is now known as JSW - Jindal Steel Works.

Asia's first high-tech steel plant, when it was established after 1991, when the steel sector was opened up for the private sector participation, now SAIL also lost almost southern

market also, the SAIL is reduced now to the half of the market where they can sale their product in the central India, in the northern India or in the eastern India and these private sector players. These private sector companies are not limiting these markets only up to the western part of country or the southern part of the country.

They are coming to central India also they are selling their product in the northern markets also; they are selling their product to the eastern markets also. So SAIL finding is very difficult to compete with these very efficient players in the market and apart from many factors one important factor where the SAIL has the failed to compete is the private sector players is the cost because cost of product keeping the cost of production under control is very-very important.

If you are not able to control the cost of production in that case you are out of the market, because profit in today's economy or in today's market depends upon the cost. You cannot increase the selling price, you cannot increase the selling price, if you want maximize your profit you reduce the cost. And for reducing the cost you should know how to cost a product at the minimum possible cost how to keep the cost under control.

Similarly, we talk about the heavy industries or may be in the electrical sector, turbines sector. For example, it was reserved for the public sector BHEL which was serving the entire market of this country, Bharat Heavy Electrical Limited who are into the manufacturing of the hydro-turbines, they say for generation of the power. So power equipment's they were only manufacturing and selling in the market.

After liberalization many places are come up in the market, Kirloskar is the one, is General Electrical is the one; many private sector companies have come up in the field. So, BHEL has now started the facing with the competition and recently it has been come in loss making company from the profit making company.

So, why it has happened because BHEL also was not able to control the cost and if you are not able to control the cost and somebody else comes up and offers the customers a product which is better in the quality and say very competitive in the cost why should in the customer shift their loyalties from the existing company to the new company. So, cost is such important component especially, in the manufacturing sector even in the servicing sector also for example, we will talk about the services sector.

Now, in the mobile telephonic, when we had only companies like Airtel, Vodafone, BSNL, we have not seen the competition given in the market or coming up in the market from the very efficient player like reliance JIO. When the reliance JIO product came in the market, these companies were bound to think about that how to sustain in the market. Because whatever the service they were giving in the market and whatever the price ever charging from the customers that was no were at all means you can say competitive. Means when reliance JIO came in the market it brought a revolution in the market.

Today you find that data rates come down, your talk time very-very cheap and very-very affordable. Everybody is holding a phone and most of that people are using, using the products and services of a reliance JIO. So these companies existing companies, existing player have started feeling heat of the market because customers have started shifting their base from the existing (say) service provider to new service provider and one single company has forced the multinational company like VODAFONE.

Vodafone and Idea have entered into a joint function now that they have started feeling that is very difficult to sustain in the market on the basis of their (say) own their own single, individual (say) identity in the market or as a (say) single entity in the market and competing with each other, it will be very difficult because, we will not be able to compete with the reliance. BSNL itself started feeling the heat and most of the people are not happy with the BSNL.

So it means it depends upon who is the service provider, what the quality of the service is and what price the service provider is charging for providing the service. And ultimately pricing of the product or service to a larger extend or through a maximum possible extend depends upon the cost. How you are costing your product because, if you are increase the price into today's competitive market then people will become your former customers. They will stop buying your product.

Second important thing is means one is the competition, which has forced the companies to think about the cost and reduce it. Second important thing is people are price sensitive and this economy is highly price sensitive. People have the limited incomes, we do not have unlimited income so we always look for the quality. If some service provider or may be some manufacturer serves this market or comes out with a product in the market which is lesser in the price or very competitive in the price, but not very competitive in the quality.

Even then sometime people accepted because they know the price they are paying and quality they are getting for that product is really comparable and people are very happy because, with the limited income there are highly price sensitive people. So any reduction in the price we positively receive that react to that price reduction and we try to (say) maximize the benefits they are driving from the limited income we have in our hands.

So, for any person, any company, any organization, whether they are in the manufacturing sector or whether they are in servicing sector, if they want to sustain and adjust in the market they will have to reduce the cost. So, how to reduce the cost, in the previous class we discussed about the concept of the cost sheet, we learned about even how prepare the cost sheet right, so how to prepare the cost sheet that is important component and what purpose the cost sheet serves.

What purpose the cost sheet serves, cost sheet as I told you serves basically the purpose of dividing the total cost into the different sub cost. We have seen already that the total cost is arrived at after calculating the different sub cost and then summing of these sub cost 4 or 5 sub cost we arrive at the final total cost. So at any point of time the cost is going out of control. Right if the cost is going out of control we can easily find out that which part of the total cost is creating a problem for us and how to control it and where we should focus upon.

So, that the total cost of the product remains under control and second thing, important thing is that we will have to focus upon that which component of cost should be taken care of so that by minimizing even 5 to 10 percent cost of that particular component of the total cost. We have the total cost frequently comes down. So we have seen that for arriving at total cost by preparing its statement of the cost.

We first of all calculate the prime cost, then we calculate the factory cost, then we calculate the cost of production and then we calculate the cost of sales and finally the total cost means the cost of sale is the total cost and since we know the selling price in the market and number of units we are multiplying with the selling price which means the number of units we are going to manufacture, multiplying with the price we will gate the total sales value total sales minus total cost gives the figure of operating profit.

So, it means though we have learned about how to prepare the cost sheet, it is not the subject of the (say) management accounting, it is the part of the cost accounting, under the cost accounting we learn the how to prepare the cost sheet but how to make use of that relevant

information, how to control the cost, how to use it as a tool for the (say) planning of the cost, for the planning of the cost, execution of the cost, controlling of the cost.

We have to look it at from the different angles from very critical angle from a very strategic angle and then try to find out the ways and means that how to keep the cost under control. Structure have discussed in the previous class, now I have wrote some very simple problems we will discuss one or two very simple problems. Then we will discuss some different complex problems also that, how to prepare the cost sheet and whatever the information is generate with the help of the cost sheet.

How to analyze it draw the meaningful inferences out of it and how to use it as a tool for the overall cost control? Because, preparation of the cost sheet is one thing, using the information given in the cost sheet is the other thing. So you can prepare it. The preparation of the cost sheet is also not a very easy process. It is a difficult process, it is difficult phenomena and I told you that number one is the most confidential document; it is not shared with anybody, any outsider that's one.

Second thing is the cost sheet is generally prepared by the people who are called as experts in that area because calculating you talk about the industrial area, we are not talking about the simple (say) industry manufacturing furniture, you are manufacturing bigger items you can easily find out how much wooden material is required, how much steel is required, how much (say) other sub materials are required, nails are required, screws are required that is not we are going to, that is a very simple job very easy job we can do it.

How much labour cost would be there for manufacturing a chair, how much time one or two laborers take, what is machine cost, what is a depreciation of the things that can easily we calculated, found out. But talk about the industries like chemical industry. For manufacturing one finished product use hundreds of the sub products and what, sometime we use the material in the milligrams, so how many milligrams in the materials has to be used for manufacturing the one unit of the finished product.

That is really very complex job, very difficult job and is you sometime materials are so expansive that if you waste even, of that material, even little part of that material that cost a very big loss to the firm so we will have to while analyzing the cost, first we have to prepare the cost sheet and preparing the cost sheet in the such industries, where you talk about the pharmaceuticals, you talk about the chemicals, you talk about the petrochemicals even, in these areas it is very difficult when you use sometime many expensive material and then you

have to prepare the dummy cost sheet knowing it about that manufacturing the one final drug, how much material different types of inputs are required.

What is their cost today and what is expected to be there in the next one year, from where to fetch that material and how to store that material, overall cost calculation is a very-very typical process and once we develop their cost sheet we keep it with us as a confidential document that is basically the you can called it is a statement which help us, guides us how to keep the cost of the product under control.

Because if we develop a cost sheet and our competitor is come to know about that, this is the way that how to calculate the cost of the product and how to add different sub components or sub materials for converting the one unit of the finished product then everybody can easily do it. And if some firm is selling one drug for 2 rupees, other is selling it for 3 rupees so the form which is selling it in 3 rupees would be able to know it how to sell it for 2 rupees.

So without spending any time any money any resource they can easily get the information strategic information from their competitors so it means everybody would start selling it for 2 rupees because they know it, how to use the material, where to save the material, how to judiciously allocate the material and keep the overall cost under control. So, that will be very easy job. So, that is not shared with the everybody, it is a very confidential document and people generally don't get it.

Sometime the competitors use the spies or sent to best firms in the market as their employees and they start working there for some period of time, take the possession of the cost sheet, leave the job, come back to their older organization and help their older form. That may be possible some time but it is otherwise very-very confidential document, so total cost if you jump at simply by adding up the cost of the material, labor and the other overheads, then you will not be able to find out how to control it.

And our purpose to this subject is to learn about the planning, execution and control of manufacturing process, distribution process, selling process and after sales service process. So, right from the idea conception till the after sales service of the product in the market we have to be very-very cost effective very-very careful and very-very particular to keep the cost under control. Many companies have failed in the market because they could not control the cost of the product.

Now, for example, I will take you back, may be in 15 – 20 years back when we were not a globalized economy or even when we announced the globalization in 1991. Even after that for the next 5, 6 years the effects of the globalization were not seeing and real effect of the globalization we started seeing after 2000 onwards, so before this globalization and some years even after globalization if you talk about the different industries. I will take the example of the electronics industry.

In the electronics Industry, for example, manufacturing of the color TVs, we have number of players manufacturing color TVs in the market serving the peoples requirement and at that time if you name the company there were the many companies like Dynora, Salora, Tesla then you call it is western, then we have other companies and the players and leaders at that time further two companies one was Videocon electronics and second was Onida, right.

These two companies were having almost 45 percent of the total market. Means the total market share, joint market share club together market share of these two companies was means near above 50 percent. 50 percent of the market was with these two companies and other companies were having the remaining 50 percent market of India. So we can understand the market of India how large and big this country is.

And these two companies were considered as leaders so at that time the riser was the quality of their product was considered as very good, excellent. Whatever the different range of the product were there in the market, CTVs in the market the product of the CTVs in the market of the Videocon, the Onida were considered as the best because we have not seen the color TV by Samsung, LG, Sony these players had the entered the India after 1991.

But their product took some time to come to the people or reach up to the people, so our needs were being served by these companies in the electronics sector. And later on when the multinationals came up and when they, we saw their product, the quality of their product, and the price they started charging for the product. We came to know that adjusting Indian form then exploiting the customers, a customers in the electronic industry whatever the product they ever providing to us and the price to a charging they were really looting the people.

And at that time see there was no competition from outside, whatever the production and distribution and sales were that was only from the Indian players, Indian manufacturers. So somebody was good in the quality and somebody was not good in the quality but the difference was not the very significant. Second thing is the difference in price is also not very significant because nobody cared for the cost control.

Nobody thought of learning about that how to go for that cost control and if say means the situation is there never bothered about that if the situation comes that if some best player in the world market comes up to India or they are allow to come to India and they are allow to do the business in the market or serve the Indian customers with their best electronic products then how would we compete with them for face the competition put forward by them.

And that happened later on, when the globalization was accepted in Indian then you see all this big joints multinational companies two from Korea, that is Samsung and LG, one from Japan, Sony these three companies entered in India, came to India, started serving the electronics market or the electronic customers in India and today you see that none of the Indian companies are in existence now.

Videcon and Onida who were the leaders in the market at that time having almost 50 percent half of the market in their hands they are nowhere in existing. Maximum they are striving hard to sustain in the market having 1 to 2 percent market share, so their market share has following from 50 percent almost to the 1 percent or one and half percent it means why they have gone out of the market. They have lost the market and we have to think it seriously why people have rejected them.

One important reason was that the product they was serving the market with and the cost or the price they were charging about cost because finally customer pays the price nor the cost. As a student of this subject you have to be very careful with distinguish between the difference between the price and the cost. Cost is basically the one which is some total of the resources which have sacrificed to get some finished product or service and in the cost where we add of the profit part of the marginal part then finally but we get is that is the price.

So we are talking about the price here and basis of developing a competitive price is the cost. If you do not have the cost you cannot develop the price, so cost plus margin, profit margin of the service provider or the manufacture is the total price, so it means the price being charged that time by these electronics companies and the product which they were serving in the Indian market that was really a crack.

And when we saw the product from these three multinational companies, we really literally rejected the Indian companies and how they are no were in existence. They are making last means other companies are gone out of the frame but these two companies Videcon and Onida they are making their last ditch effort and I do not see that there is future for them means in the time to come they will have to go out of the market.

So, it means the success or failure depends upon that if you are careful and well within the time if you know it that today you are operating or floating in the four walls of a country but if somebody invades in your country and gives you a competition or challenges you and if they come forward with the new product, better product, better service and if they start serving the or offering customers for the better product certainly your existing customers will become the former customers because they have their reason to buy the best, they have the reason and the right also.

It is a customer's right also to buy the best product. If you cannot serve their needs with the best product you do not have the right to be in business. So, it has happened almost in every sector in India, I told the story of steel, I told the story of hydroelectric equipment's, I told the story of the electronics market and now you think about in the services sector the mobile telephony, there was the time that BSNL or the erstwhile DoT Department of Telecommunication was the one service provider in this country, only one service provider in this country but after the opening of the telecom sector for the private sector participation.

Today see where the BSNL is, it is a loss making company I would say and even if it is a profit making company even then they have no place or existence or sustenance in the mobile telephony. Mobile telephony is fully captured by the private sector players, who give the better service to the people and at very very competitive price and after the influx of Jio reliance Jio in the market we have seen the revolution in the market and the BSNL is almost out of the fray.

They only have their existence and sustenance because of the landline telephones, but if you talk about the mobile telephones look at the service quality, look at the cost they are charging from the people and after sale service this is all very poor and people do not want to continue with them. So, it happens in every market and if you are to be there in the market and want to remain competitive you have to think about the customers.

Every time you have to give the customers a very innovative product, very cost effective product and especially in the economy which are price sensitive economies like India, all developing economies, all emerging economies are the price sensitive economies. Income level of the people in this economy is very-very low. A little reduction in the price maybe along with the quality people welcomes it.

And they want to have a product which is very competitive in the price, lesser in the price in terms of the price and if that product available in the market, people want to go for that. I will

share another story with you, there is a product called Nirma, in the washing powder segment we have one product called as Nirma and Nirma came in the market in 1982. And today Nirma has become an international company and Nirma has its existence in many sectors that is into the cosmetics, detergents, then it is in the consumer sector and then now into big way there into education also.

A one single person means Karsanbhai who had an idea of manufacturing the washing powder in 1982. Because in 1982 HUL Hindustan Unilever limited we called, used to this company as Hindustan Unilever Limited at the time was having the largest market share in the detergents market. They had two products to serve the customers need as the detergents were concerned, for the premium segment people they had the product called a Surf which we today use, again for the lower people segment, for the people have limited income they had a product which was called as Sunlight.

But both the product at that time but beyond the reach of the masses in this country because the price ever charging for the product, though they were the good quality products where the price at that time they were charging people were not able to buy these products and make use of this product, so most of the people in the rural areas, in the villages were using the caustic soda to wash the cloths.

It is a very harsh product it reduces the life of the product, quality of the product but since there is no alternative available in the market and the product of the HUL or HLL was really not within the reach of the people as far as the price was concerned so they were bound to use of caustic soda. Then Karsanbhai thought, understood this need of people of India, he started developing of this product and he was successful developing a very cost effective and efficient product and for the first time he manufactured this product Nirma washing powder. He started distributing it to his friends and relatives nearby.

The result were very good and then he started giving to his nearby and people in his office and its nearby streets and here and there. Initially he did it as a free of cost product like Jio. The strategy of Jio was adopted by the single individual Karsanbhai and everybody said that the results are very good, product is very good. It is very, you can call it as excellent product. And he was encouraged by these results he started manufacturing it at the bigger level and started selling.

So at that time he fixed the price of the 1 kg of Nirma washing powder as 10 rupees and HULs product at that time not certainly available Sunlight I can say was not available for 10

rupees. It was more than 10 rupees at that time. So, when people saw the 1 kg of the washing powder is available for 10 rupees and he started serving the markets in a big way professionally, people welcomed the product. People came out totally and they supported the product, welcomed the product. And you see today where now the Nirma is everywhere now, they into the almost many sectors of the country and Nirma has become international company now.

Within a short span of time started in 1982 and today we are here in 2018, so how much in more than 35 years look at the size and the growth of the company. So secret of the success of the Nirma is what, that is a cost. That at what cost the product has been developed, provided to the people and how the people's needs have been taken care of, if we are taking care of the market and the people's need, certainly people respond and ultimately the success or the failure of any business to a larger extent depends upon the cost of the product you are generating the price you are charge from the people and the profit you able earn of it.

So if you are very-very competitive if the cost is low, price we will set is low and you will be accepted by the people in the market. Means there are the different segments, if the premium segments also that people some time buy the expensive product also but you have to match the product with the quality or the quality of the product with the price. That segment is also there, in India also we have the premium segments. When we buy the cars, we buy the small cars also we buy medium size cars also, we buy the bigger cars also the premium cars also.

Segment is there but large segment in this part of this entire part of this country is market of the small cars. That is why in the Maruti came with a small cars for the first time in the beginning of 80s, the success of Maruti was that first time they brought a car in the Indian market just for 40,000 rupees Maruti 800, that old car was just for 40,000 rupees in the market, so having a car enjoying the luxury of a car just for 40,000 rupees.

Means people never had thought about it, but when the Maruti Suzuki joint venture other made it possible people were very happy, people bought the cars they gave a good response and today India has become a market which is known a market of the small cars, all companies operating in India, though they were manufacturing bigger and premium segment cars in the other country economies. For example, we talk about Honda.

Honda is manufacturing different cars for American economy, American market, for the Japanese market for the European market but they are manufacturing different cars for India. Small cars become very popular one because of the space problem, where the other is

because the cost and the price of product. So means ultimately success or failure of the business to a larger exchange depends upon the cost of the product you are manufacturing and the price at which we are passing it on to the people.

Success depends upon the sale and profitability. So if the cost is within the control, price is also within the control of the buyers, our margin is also intact, so it means our growth is also intake. So this is just a foundation about the cost sheet and the importance of the controlling the cost that if you control the cost how effective and useful it is for all of us and all the businesses.

And finally, how to control the cost, I have discussed in the previous class also about the cost sheet and in the next class we will have some hypothetical problems, small and simple problems where we learn about how to prepare the cost sheet and how to use that information for the strategic decision making by the management of a company or an organization. This all I will discuss with you in the next class. Thank you very much.