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COST MANAGEMENT IN SERVICE INDUSTRY

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ABSTRACT
Cost management information is crucial for decision making in any organizational planning, operations and control activities. However, the type of cost information and the format in which it requires varies as per the prevailing situation. Different situations call for use of different types of costs. Cost can vary in different circumstances. Proportion of different cost components, even in similar circumstances, also varies with the scale of operation. This article introduces basic concepts and issues in cost management in managing organizations at different levels. The cost management information, in addition to costing products and services, is useful in planning and controlling the operations and behavior of people. The advanced level involves employing cost information for better operational choices, performance measurement and making long-term strategic decisions in increasing order of sophistication. The article also highlights the issues in costing of services arising out of intangible, inseparable, heterogeneous, and perishable aspects of services.

KEYWORDS
cost management in service industry, costing issues in service industry, cost management concepts.

1. INTRODUCTION TO COST MANAGEMENT
Cost management to most people is about budgets and financial profits, some may extend cost management to include operations and performance management, while for few cost management encompass wider business ecosystem including strategy and decision making on the premise that nonfinancial activities generate financial results. Traditional cost control systems focuses on cost containment by comparing actual results with that of budgeted targets and then taking remedial actions for the identified variances. Cost management, on the other hand, involves tools and techniques to reduce costs either using cost accounting information or with the help of process improvements that ultimately results in cost reduction. Cost management represents internal environment and cost structure. It involves managing two separate but interrelated issues – cost control and profitability. While profitability is determined by costs and revenues, the control is not only limited to cost but also spread over other nonfinancial areas such as performance management and strategy execution. The numerous costing approaches such as activity based management, bench marking, budgeting, business process reengineering, just in time, target costing, value chain, etc. may be used (Catherine Stenzel, Joe Stenzel, 2003; Colin Drury, 2001).

A strategic approach to cost management requires a broad view to ensure long-term success by way of an assessment of the company's cost position with an investigation of the underlying cost drivers and comparison of company's cost structures with that of competitors. The analysis of cost driver determine cost behaviour of firm's value adding activities that provides basis for working out firm's cost position and how it might be improved. A detailed analysis of the cost position helps not only to identify needs for cost reduction but also to provide ideas on how to realise cost savings. Cost management practices can be applied in delivering strategy. Strategic cost management focuses on using cost data for effective strategy development. Strategic cost management is more about decision making processes and cost structure that facilitate strategy execution with the help of concepts and tools from marketing, finance and economics, etc. All organizational activities involve cost of employing resources, and therefore, cost management – with the strategic emphasis – is the about using of costing information for optimum utilization of firm's valuable resources. It involves decisions about investments, expenditure, and pricing of products or services. Costing information plays a vital role at each stage of business process from formulating and communicating to implementing and controlling the strategies for efficient resource utilization. Cost management practices incorporate systematic approach for calculation, allocation and containment of costs, as well as revenue forecasts (Edward J. Blocher, et. al., 2010; John K. Shank and Vijay Govindrajan, 1993; Peter Kajüter, 2003; Shannon W. Anderson, 2007).

In short, cost management is all about management of cost in the process of achieving desired outcomes for effective strategy execution by leveraging available resources with the help of financial as well as nonfinancial approaches such as activity based management, bench marking, budgeting, business process reengineering, just in time, target costing, value chain, etc.

2. CONCEPTS AND ISSUES IN COST MANAGEMENT
Cost management practices put together valuable information to improve organizational efficiency and decision making. The decisions in organizations can broadly be classified as operational decisions and strategic decisions. Strategic decisions are major decision and have long term impact on organization while operational decisions are part of day-to-day functioning of the organization. The business decisions include decisions about investment of resources, about operations employing these resources and about financing these resources. These decisions – collective or individual, strategic or operational – are essentially about making economic trade off in deploying available resources in a ways that create value, in monetary terms. Cost reflects this monetary measure of the deployed resources. The cost management information is useful in planning and controlling the operations and behavior of people. The advanced level involves employing cost information for better operational choices and performance measurement. At the more advanced level, cost management information is used for making long-term strategic decisions. However, cost analysis for costing products and services plays a vital role at the most basic level. Different situations call for use of different types of costs. Cost can vary in different circumstances. Proportion of different cost components, even in similar circumstances, also varies with the scale of operation. (Erich A. Helfert, 1997; Hugh Coombs, et. al., 2005).

2.1 BASIC CONCEPTS
Cost accounting is central to issues and concepts in designing management accounting system and cost management practices. The appropriate definition of the cost unit which can be a product, customer, function or responsibility centre – is crucial to cost management practices. Cost unit is also termed as cost object. All the expenditures that a firm incurs can be classified under different heads called cost pools such as manufacturing expenses, selling expenses, distribution expenses, service delivery expenses, etc. that can further be subdivided into direct expenses and indirect expenses. The fundamental issue is attribution of expenses to cost objectives i.e. a purpose or activity for which the cost is incurred. Direct expenses are directly traced to the cost unit. Indirect expenses are those that are difficult to trace to cost unit and hence are spread fairly over multiple relevant cost objects. Distinction between direct and indirect cost may differ when cost objectives changes, for example, salaries of salespersons and expenses on advertisements are treated as direct costs for computing cost of sales, however, the same expenses are treated as indirect costs when cost objective is product valuation (Hugh Coombs, et. al., 2005).

Another fundamental issue in the process of cost management is of classification of costs. Costs can be classified as fixed and variable costs. Fixed costs is unaffected by the volume of the activity over a considerable period of time, for example, plant and machinery, salaries of management, etc. Variable costs are directly proportional to the volume of the activity and increases with increase in volume of the activity. Examples of variable costs are piecewise labor cost, direct material costs, sales commission and fuel costs. In semi-variable cost, part of total cost is fixed and remaining is a varying variable element, for example, a telephone bill wherein monthly rental is fixed and each outgoing call is charged and hence the cost per call will depend on number of calls made during the month. Semi-fixed costs, also called stepped costs, are unaffected by the volume of activity up to a certain extend or band and then increases stepwise and remain fixed for till another band of activities, and so on. Costs can also be classified as sunk costs as costs that are already incurred and are irrelevant to future decisions; opportunity costs as a cost of opportunity foregone in pursing one course of action over the other; and marginal cost as incremental cost which is usually an increase in variable cost in altering the present course action (Hugh Coombs, et. al., 2005).

Costs are computed as unit costs for products or service provided. The three key approaches to product costing are as below.

2.1.1 Absorption Costing

The final cost of product is determined by subdividing the expenditures into direct and indirect costs. Indirect costs are spread over all the products proportionately. However, department's total cost would change if apportionment basis of any one indirect cost is changed; secondly, computed cost may be higher than actual cost for one product and less for other product.

2.1.2 Marginal Costing

Marginal costing considers total costs as consisting of variable costs and fixed costs. Marginal costing employs a concept of contribution which is equal to selling price minus variable costs. The contribution initially goes for covering fixed costs and then contributes to profit.

2.1.3 Activity Based Costing (ABC)

According to ABC, activities are involved in producing products or rendering services, and resources are consumed in performing these activities. It employs concept of cost drivers which is a factor that alters the costs for example production volume, items sold, or labor days. Indirect costs are traced and assigned to activities performed (e.g. production, administration, sales) in producing cost object such as products, works executed, services, orders (Eva Labro, 2006; Gary Cokins, Sorinel Căpuşneanu, 2010).

2.2 PLANNING AND CONTROL ISSUES

For organizations to survive and grow, it needs to put its long term strategy in place. This involves defining specific strategies for key marketing, production, financial and other functional issues. For these strategies to be operational it is essential for organization to develop specific plans and performance targets. Ideally, planning will take place at various levels within organization viz. strategic, business and operational levels. The financial plan that integrates specific tasks, performance targets, and resources is known as budgets. Budget is a financial plan expressed in monetary as well as non-monetary quantitative terms, such as labor hours, units of sales, etc. Budget highlights revenue and costs for future planned period. A budget may be short term usually 1 year or less, it can be for about 2 to 3 years or more in the longer terms.

Budget is internal to the organization. Budgets are primarily used to quantify expected incomes and allotted resources. At the next level, budgets are used to quantify payment required for procurement of these resources and collection of incomes, cash, etc. At the even higher layer, budgets may be used as means of communication to describe targets, payments and incentive schemes to employees. The detailed budgets are prepared from higher layer estimates, called master budget, thus ensuring detailed budgets relates to the overall organizational goal. Budget preparation involves forecasting of likely results and cost estimation of the future activity for the budgeted period. Budgeted figures may differ from what is actually achieved. The process of comparing actual results with that of planned is called management control. Budgets are essential tool in control. Standard costs, that represent unit costs of products and services, form the basis for budgeting. Standard costs are calculated either by analyzing past costs from production history or by the analysis of production inputs such as amount work involved, material requirement, labor hours required, etc. and cost driver consumption if activity based costing is used. Standard costs facilitate computing variances by comparing standard costs with the actual costs. The progress in firm's day to day activities is reviewed at regular interval e.g. monthly. The actual results in the year are compared with the budgeted target and the reasons for the shortfall (viz. inefficiency in operations, incorrect plans, poor communication of targets, etc.) are investigated for corrective action to be taken (Hugh Coombs, et. al., 2005).

2.3 OPERATIONS AND PERFORMANCE MANAGEMENT ISSUES

All accounting theories, in general, are expected to translate accounting data into management information. The ever intensifying competitive environment and growing innovations in production technologies made organizations to look for accurate information for making important decisions about pricing, product mix, and processes. The reliable and organized information enables manager exercise various strategic options, such as dropping less profitable products, product/ process redesign, price increases, outsourcing, etc. The important questions to ask in order to identify and prioritize the information requirement are: What information do we need? When? What format? And where do we get it? The answers to these questions form the foundation for the cost management practices, in the context of both organization and its environment (Peter Drucker, 1992; Robin Cooper and Robert S. Kaplan, 1988).

The context and purpose for which decision is being made determine the type and use of cost information and costing technique. For example, contribution analysis makes use of marginal cost and marginal revenue to compute contribution per unit of product or service. Another technique, similar to contribution analysis, is break-even analysis. Break-even point in terms of number of units of products is calculated by dividing fixed cost by contribution per unit. The total contribution before break-even point covers fixed cost and every extra unit sold thereafter contributes to profit. The objective for decision using these techniques may be to increase contribution. On the other hand, organizations may also be attempting to minimize costs. Crucial to use of costing information for these decisions is to consider only relevant costs and benefits. Relevant costs and benefits are those that are affected by future change in cash flows. There are numerous decision making situations that affect future cash flow, for example, decisions about pricing the product or service, decision of making product in house or buying from external supplier, decision about ceasing the production of product or service altogether, etc. In general, pricing decisions focuses on covering total cost and making profit by adding desired margin. This involves deciding upon what to include in cost when arriving the selling price of unit of products and services. In one approach, variable cost is computed and then a margin is added to cover fixed costs and expected profit. In another approach, the total cost is worked out by adding production overhead to variable costs. Yet another approach adds variable costs, production overheads and non-production costs (such as selling and distribution costs) to determine total costs. Full cost or total costs thus calculated is used as a basis for addition of markup percentage in setting selling unit price. However, whatever price is set with any of this cost based methods, firm also need to consider prevailing market prices. Target costing overcomes this limitation by setting a target price in advance using demand analysis and market intelligence (Hugh Coombs, et. al., 2005).

While profitability is determined by costs and revenues, the control is not only limited to cost but also spread over other areas of nonfinancial measures such as performance management and strategy execution. A detailed analysis of the cost position helps not only to identify needs for cost reduction but also to provide ideas on how to realise cost savings. Cost management information plays a vital role at each stage of business process from formulating and communicating to implementing and controlling of strategies (Hugh Coombs, et. al., 2005).

2.4 STRATEGIC ISSUES

Strategic decisions involve significant investment, and impact costs and benefits over the longer period. Important in this decision context is appraisal of investment decisions using discounting and non-discounting cash flow methods, sensitivity analysis, and cost-benefit analysis. The concepts such as compounding, discounting and present value are important. Compounding evaluates accumulated value of the present investment for a specified period while discounting computes present value of future cash flows, at an appropriate rate of return. Payback, a non-discounted cash flow method, represents the number of years where the initial investment equals sum of the future annual cash flows. A project with shorter payback gets precedence. Accounting Rate of Return (ARR) is another form of non-discounted investment appraisal technique where ARR is defined as percent ratio of average annual profit from the investment to average investment. The project with ARR more than company's targeted returns is accepted. The project with highest ARR is selected in case more projects are under consideration. The major disadvantage of both, payback and ARR method, is that it ignores the time value of money. Discounted cash flow methods for investment appraisal offer an improvement. Net Present Value (NPV) is a discounted cash flow method. It computes NPV as a sum of present value of future net cash flows over useful life of project less the initial investment. The project having positive NPV or the highest positive NPV (if more projects are being evaluated) is accepted. Another discounted cash flow method is Internal Rate of Return (IRR). IRR represents the discount rate at which NPV is zero. The project having IRR greater than expected return or the highest IRR (if more projects are being evaluated) is accepted. Taxation and inflation affects project appraisal. Taxes are to be paid on cash in-flows. Also value of the cash flows in the longer duration gets influenced by inflation. Hence these effects need to be included as outflows (Hugh Coombs, et. al., 2005).

A common approach to cost reduction is to take an isolated initiative to reduce costs across individual function of business. The benefits arising out of such isolated initiatives are short-lived. Cost saving in one part usually pop up in other part of the organization. This makes cost management too complex issue to deal with at a level other than the strategic level. Strategic cost management is more about decision making processes and cost structure that facilitate strategy execution with the help of concepts and tools from marketing, strategy, economics, etc. Cost structure reflects business model of the company. There is a need to restructure the operations and possibly whole business model around lower cost by exploring cost saving alternatives offered by outsourcing, shared service centers, off-shoring, internet sales, etc. This requires cost improvements across whole processes on the basis of reliable cost data and realistic cost saving targets. Companies that made changes at the strategic level, reflecting on cost as a function of their business model, could achieve the cost reduction on sustainable basis (KPMG Report, 2007).

The advanced approaches to cost management encompass wider business ecosystem on the premise that nonfinancial activities generate financial results. The numerous approaches such as target costing, activity based management, business process reengineering, value chain analysis, bench marking, just in time etc. may be used.

3. COST MANAGEMENT ISSUES IN SERVICE INDUSTRY

For costing purposes services are different from products because of different product manufacturing and service provisioning processes. Manufacturing processes are classified as project, job, batch, line/mass and continuous process. Project process is suitable for producing highly customized products, at one end, while line/ mass process is used for producing high volume products, at the other end. Job and batch processes are suitable for manufacture of low volume products and products in batches respectively. Fluid products, such as pharmaceutical or food, are manufactured using continuous processes. Computing accurate products costs is one of the major requirements for pricing, planning and control in product manufacturing businesses. The processes for services, on the other hand, can be classified as professional services, service shops and mass services with the decreasing order of customization and customer contact. In service industries costs of functional activities are more appropriate than product costs for pricing, planning and control. Costs in service sector are increasing due to slower improvements in service sector productivity as compared to manufacturing productivity and hence service organizations strive for continuous improvements by cost control and process improvement initiatives. (Rogelio Oliva, 2001; Susan Miller, 2011; T. J. Brignall, et. al., 1991).

All service costs are period costs and difficult to compute. In addition, intangibility, inseparability, heterogeneity, perish-ability of services further complicates the costing of services. Intangibility as a lack of physical evidence is one of the most important characteristic of services that separate it from products. For example, when we purchase a product such as bicycle or four-wheeler we have a physical product with two wheels or four wheels to demonstrate, on the other hand, when we purchase a service such as holiday package we hardly have anything tangible to demonstrate apart for intangible experience to share. This intangibility of services makes it difficult to describe or communicate services, to measure or define quality, and to understand value added by the organization. Inseparability implies simultaneous production and consumption of services. Services are produced and consumed instantaneously as against the products which are first manufactured, then stored as inventory before being consumed, at different times. Product manufacturing companies can carry inventory of finished products which is absent in service companies because of perishability of services. Services are produced and delivered while customer is present and hence cannot be stored, returned or resold. Services are heterogeneous in a sense that different customers perceive quality of the same service offering differently. Quality of service is partly dependent on personality of service personnel and partly on customers' expectations, thus, making it difficult to guarantee standard service experience. The costing systems that are widely used for financial reporting requirement in manufacturing may not apply to service industries. In service organizations cost calculation and control is performed via cost centers. The pricing decision in service organizations is not fully based on full costs for the reasons of difficulty in tracing the costs and the strategies of competing organizations. Despite these differences there are similarities as well in manufacturing and service costing. Both product and service production drives activities that consume resources. Challenges faced by service and manufacturing companies are more or less similar. However, it is difficult to calculate exact cost for individual services using any of absorption, marginal and activity based costing approaches due to presence of numerous joint costs. The question is not about whether traditional accounting or contemporary accounting, such as ABC, but about choice of accounting practices and sophistication required for context specific joint costs assignments (Belund Terzioglu and Elsie S.K. Chan, 2013; Susan Miller, 2011; Susan Segal – Horn, 2003; T. J. Brignall, et. al., 1991).

4. CONCLUSION

Cost management is all about management of cost in the process of achieving desired outcomes for effective strategy execution by leveraging available resources. Cost management practices incorporate systematic approach for calculation, allocation and containment of costs, as well as revenue forecasts.

Cost management issues in service industry are different from manufacturing industry owing to different product manufacturing and service provisioning processes. The presence of numerous joint costs in addition to the characteristics such as intangibility, inseparability, heterogeneity and perish-ability of services complicates the costing of services.

Cost management extends from financial to non financial activities and takes account of wider areas ranging from financial planning and control, operations management, performance management, strategy and decision making using numerous approaches such as activity based management, bench marking, budgeting, business process reengineering, just in time, life cycle costing, standard costing, target costing, value chain analysis, etc.

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