

COST COMPETITIVENESS THROUGH COST AUDIT MECHANISM

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***Abstract:** All new mechanism for cost audit is about to take birth in our country. It's very unique in all respects and demand efforts towards the acceptance. The main aim of such mechanism is achieve competitiveness. This developmental paper tries to understand the mechanism and prepares for September 2012 submissions to government. We have identified 9 areas in cost audit mechanism which will lead to cost competitiveness. Work in those areas will lead to improvements in collecting and maintaining cost data for firms. Competitiveness is possible only when data is collected and analyzed in a scientific manner. We are not claiming that methods suggested in mechanism are most scientific but this will lead to development of profession and researchers will enrich the knowledge in the field.*

Key Words: Cost Accounting, Cost Competitiveness, Cost Audit Mechanism, Compliance Report, Cost Accounting Standards, Generally Accepted Cost Accounting Practices, MCA, ICWAI

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1. Introduction

In an era of inflationary trends, it is important for all firms to keep check on their costs. Increase of sales by one rupee does not mean increase of corresponding rupee in profit. On the other hand savings in one rupee of cost is reflected by same worth in profits. Cost Competitiveness plays vital role in every firm's survival and growth. Cost Competitiveness cannot be achieved overnight but it needs continuous efforts. One of the strategies suggested by Porter's Competitive advantage is Cost Focus leading to Cost Leadership. An even firm following differentiation does not mean they ignore costs. World Economic Forum in their global Competitiveness Report 2008-09, has defined competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by the economy. To have sustainable growth in economy, it should be competitive. World Economic Forum's Global Competitiveness Report ranked India on 56th position as compared with 51st in earlier report. There were 3 criteria for the rank namely Basic Requirements, Efficiency enhances and innovation and sophistication techniques. India scores highest in efficiency enhancements and mainly due to having 3rd rank in market size.

Interestingly our neighbor Sri Lanka has risen from 62nd position to 52nd position this year. Needless to say that, the efforts by their government on cost management techniques has bare the fruits. We are not here to compare any 2 countries or competitiveness ranking due to sophisticated cost and management techniques but it is obvious to compare and draw inferences.

To increase competitiveness among business and industry, governments across the globe need to create awareness about it. In our country all such awareness cannot be created unless it is made compulsory. Reaching to a level of self driven world class cost management techniques is still far away. Since we are building products and services competitiveness in the world, they should not just come with minor changes in accounting policies or standards but they should come with long term benefits of cost and management techniques. Once these techniques are in place, it will be easier for companies to reach to a good performance management practices as well. Also it will help in making decisions for performance and conformance at operational and strategic levels.

Coming back to competitiveness report, Indian GDP per capita with developing Asia can be compared as follows;

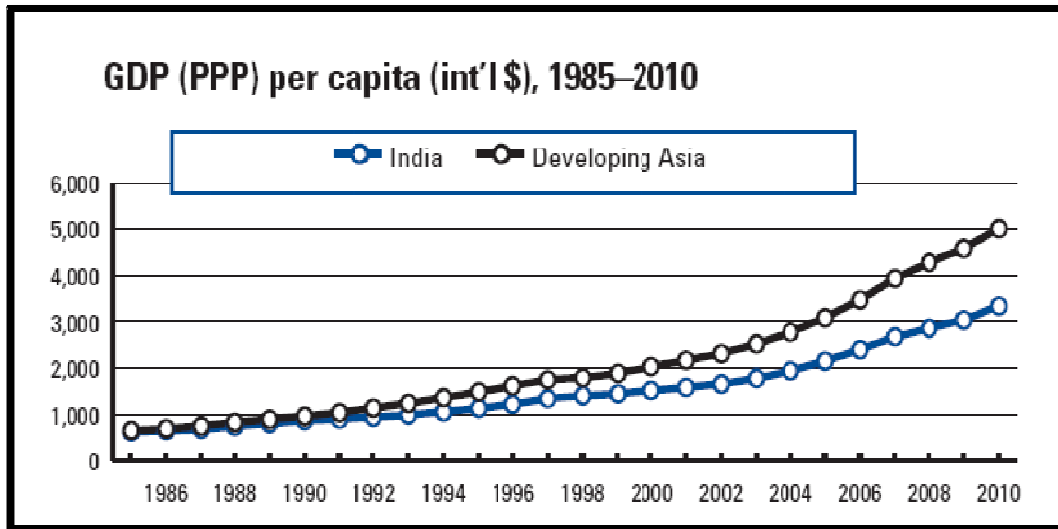


Fig1: Comparison of Indian GDP per capita with developing Asia

Source: Global Competitiveness Report 2011-2012.

Competitiveness report defines 3 stages of development namely; *factor driven*, *efficiency driven* and *innovation driven*. We are still in the 1st stage of development i.e. '*factor driven*'. Country like Sri Lanka has already crossed stage 1 and is in transition period between 1st and 2nd. Switzerland is at stage 3 which is innovation driven. The change from 1st stage to 2nd will happen only after adopting techniques which are efficiency driven.

It is sometimes easy to formulate and decide strategy but implementation of the strategy is quite difficult. Especially, when there are no set parameters on judging the success of strategy. Probably success can be judged in longer run when you outplay your competitors but the path of such strategy is certainly not easy. Even after getting success sustaining the same needs more concise and pointed efforts. Government is trying to give such parameters by way of making cost and management techniques compulsory in our country. Again we are not claiming that it's the only way to achieve it but surely a step forward to achieve it.

2. Purpose of this paper

This paper aims at understanding the recent changes in Cost Audit Mechanism and its usefulness for companies striving to achieve cost competitiveness. Ministry of corporate affairs has issued notifications dated 3rd June 2011 on The Companies (Cost Audit Report) Rules, 2011 and Companies (Cost Accounting Record) Rules, 2011. Cost Audit is a mechanism which is being used in our country for more than 50 years. It is Unique in all

respects when compared with other countries and when compared with any other statutory reports in our country. The obvious focus is on drawing inferences and helping in decision making. Most of the decisions for that matter are related to cost and achieving competitiveness.

First let's try to understand what cost audit mechanism is and how it is operating in our country since 1960s. Unfortunately the scope of cost audit was kept limited till recent orders issued by government. The new mechanism started with formation of Expert Group Committee by MCA order dated 21st January 2008. One of the main purposes of constitution of such group was to increase competitiveness of the Indian Manufacturing Sector and advice the government on suitable measures for the same. This report was presented in October – November 2008. On that basis present orders are drawn with the suitable changes in recent times. For the purposes of this paper we are including following in Cost Audit mechanism;

- a. Cost Audit Orders issued by MCA dated 3rd May 2011 and further modified by another order dated 30th June 2011
- b. Cost Audit Orders issued by MCA dated 2nd May 2011
- c. Notification for Common Record Rules i.e. Companies (Cost Accounting Record) Rules, 2011 issued on 3rd June 2011.
- d. Notification for Revised Report Rules i.e. Companies (Cost Audit Report) Rules, 2011 issued on 3rd June 2011.
- e. Companies Act 1956
- f. Cost Accounting Standards issued by ICWAI (CAS 1 – CAS 13)
- g. Generally Accepted Cost Accounting Practices issued by ICWAI.

Usually companies have their own mechanism to calculate costs and compare it with others. Does this mechanism is available to all companies? Answer for this question is obviously no. Top notched companies do have such mechanism and they can find their answers in better ways than others. This privilege is not enjoyed by smaller companies and has to struggle for survival before they think of growth. This mechanism of cost audit will now be applicable to companies having turnover more than 20 Cr in bulk drugs, formulations, fertilizers etc industries. It will also be applicable to companies having turnover more than 100 Cr in Cement, Steel Paper etc industries. As a part of total mechanism, companies having turnover of more than 20 Cr in the activity of production, processing, manufacturing and mining are suppose to file Compliance Report with MCA. Obviously there are other

conditions also for companies to qualify for such reporting; readers may see those from any open source. In this paper we will try to identify how this mechanism will help in gaining cost competitiveness of a company. This mechanism demands for collecting data in such a manner that cost competitiveness can be achieved.

3. Areas in Mechanism leading to Cost Competitiveness

Many of areas in this mechanism which leads to achieving cost competitiveness. Unless they are mandatory, it will be difficult for firms to identify those parameters. Following areas/ parameters from the mechanism are chosen by us who may lead to cost competitiveness for firms.

- i. Product Grouping:** The concept of product grouping is first time introduced by any legal authorities. Product group is defined as ‘group of homogeneous and alike products, produced from same raw materials and by using similar or same production process, having similar physical or chemical characteristic and common unit of measurement and having same or similar usage or application’ We as practitioners feel that Industry chambers and confederations should take lead in defining product groups for their industries and maintain parity for collection of data. Grouping of data considers the data for products/ services covered under cost audit and not covered under cost audit as well. This is an immense help to firms on collecting data for product/ service group. Data of capacities, production, stock sales etc are to be collected and presented separately. Firms will enjoy the benefits on deciding the product groups as per their wish. Details can be seen in Para 3 of the report. We strongly recommend that ICWAI/ CMAs and Industries associations should come forward to take up the task of industry specific grouping.

Some examples can be given as; per unit cost of constructing a road at various locations in the country can help in deciding pricing for such roads across the country. In Casting and Forging industry, GDC/ PDC and tonnage specific product grouping will help for benchmarking in the Industry. In case of lower costs in any of the companies will definitely give lead to government which will decide subsidy infusions for technology. In another example we propose that airline services should be classified with A, B and C routes as per passenger load they carry. This will help government in deciding correct fares for such airlines and higher charges by any airlines can be identified.

- ii. Quantitative Information:** Once we define product and product group, quantitative information about various aspects is to be given as per details provided in Para 4 of the said report rules. This included capacities installed, additions deletions during the year. Actual production for each product group needs to be given separately. This will help companies to make separate cost sheets for various plant locations and bringing clarity on differentiations in costs between them.
- iii. Cost Statement:** An abridged cost statement with the help of various cost accounting standards will help companies to bring cost competitiveness. Usually it is found that cost allocations are made on general basis to various products and with the development of advanced tools like Activity Based Costing etc. very accurate cost allocation is possible. While preparing abridged cost statement as per Para 5 in the report rules, companies have to follow basic principles of cost accounting specially while allocation of corporate overheads etc. Cost Accounting Standard 11 issued by ICWAI clearly specifies that administrative costs are to be allocated on the basis of cause and effect and benefits received. Detailed analysis of processes and costs will help in generating exact costs of all products/ product grouping. Yet another advantage of brining this cost statement is to have estimate on research and development expenses on specific product grouping. This will again help government on understanding the needs of specific industry and some concessions can be granted on that basis.
- iv. Operating Ratios:** After working on all costs, there is a need to work on various ratios. A comparison between the ratios given in last 2 years will definitely help company management to understand increase or decrease in expenses/ ratios for each product group. In any of mechanism, enforced or otherwise, does not have such detailed analysis of costs which will lead cost competitiveness. Example which we would like to give here is of utility expenses at different location of same company. Resources are scares and public resources needs to be utilized properly. Company having such awareness, will definitely try to benchmark these resources as between the factories located at various places producing same

products / groups. If this system is voluntarily adopted for foreign factories of same company, the results would be even better.

- v. **Profit Reconciliation:** Simple profit reconciliation between cost and financial accounts is also going to help companies in understanding the impact of expenses other than cost accounts. When such report is prepared within time limit given of 180 days and also by third party independent observer, will definitely lead to cost competitiveness. Competitiveness can also be achieved by having detailed working on reconciliation of indirect taxes as per Para 11 of said report. There can be situations where cost accounting is showing profits but financial accounting is showing profits. This will help companies in deciding reduction of Non cost expenses. Even vice- versa is equally true where company is making profits on account of incomes other than its core business. In all the ways competitiveness will improve and it is compulsory to improve.

- vi. **Value Addition for Company as whole:** Companies in recent times are putting more and more emphasis on value added by them rather than profits earned. Para 8 of the report demands for calculation for value added and distribution of earnings by company. A report of this kind is also going to help government in getting a fair value for value added by specific industry. This is very helpful for utilities provider government companies for strategic decision making. Costing is an important tool for assessing organizational performance in terms of shareholder's value. Value Addition reflects the real worth created by the organization. It is a resultant of factors like Technological Superiority, Efficient Utilization of the Resources, Brand Image of the Organization and many more. This is unique and critical information helping the organization to identify the key contributors to Value Addition and formulate strategic planning accordingly.

- vii. **Financial Position:** Yet another Para in the same report talks about financial position of a company. This talk about financial performance of a company along with various ratios calculated under this. We as practitioners and researchers are very sure that cost competitiveness in smaller companies can be brought under this mechanism which will help our economy to grow. This gives a detailed analysis of the Financial Position of the company. The ratios are categorized into

three major categories – Financial Performance, Profitability Ratios and Working Capital Ratios. Working Capital ratios are critical to help organization manage the working capital requirements and with better planning the cost of Working Capital can be reduced giving a critical cost advantage to the organization. As the major shift is from corporate governance to enterprise governance, the content and relevance of purely financial data has seen a major change. This financial position Para in reporting system try to identify parameters like Value added working capital ratios etc. which leads to enterprise governance.

viii. Performance Appraisal Report: Yet another unique part of this mechanism is to have performance appraisal report under form III of report rules. There is a list of 10 indicative areas which may be covered under this report. Some areas like Manpower analysis and utilities efficiency analysis are far better than any other mandatory/ voluntary areas proposed by any mechanism. Areas like Capacity Utilization analysis will help companies understanding capacity utilization and will definitely lead to cost competitiveness. The statutory compliance calls for Performance Analysis, but this report is to be submitted only to the management of the company. It gives a free hand to the management and the Cost Auditor to identify the area and frequency of the analysis. This offers an opportunity to take a review of various key control areas from Costing Perspective. One such specific area mentioned is of IFRS. This is a new concept introduced in this mechanism. Analyzing impact of IFRS on Costing will allow the company to converge to IFRS more vigilantly so that the overall cost competitiveness of the business is not compromised.

ix. Cost Compliance Report: A compliance report is to be submitted and certified by cost accountant for companies having turnover of more than 20 Cr, net worth more than 5 Cr and companies listed in any stock exchanges or in the process of getting listed in any stock exchange. Companies in the business of processing, mining manufacturing and producing are covered under this notification issued on 3rd June 2011. Cost Compliance report is also a step towards bringing cost competitiveness in the country. Rather it covers companies having turnover more than 20Cr means smaller companies are covered under this notification. Thought there is no compulsion of audit for these companies at present, it is expected that

many of such companies striving for betterment will move to voluntary cost audit of their cost accounting records maintained as per new mechanism. Along with Compliance Report annexure giving Profit Reconciliation between Costing Profit and Financial Profit is to be given. Thus the Cost Statements has to be compiled and thus all the Costing Information gets established automatically. For This exercise will enable companies especially in SME segment to have a more structured and scientific approach towards cost thus offering opportunity to control costs and bringing in Cost Competitiveness.

4. Conclusion

Sometimes, companies prefer to have operational audits to achieve operational efficiency rather than concentrating on cost aspects of the same. Unique mechanism of cost audit recently developed in our country will help in achieving cost competitiveness for firms. Clear and concise treatment of costs is already defined in Cost Accounting Standards which is now being helped by Generally Accepted Cost Accounting Practices. All mechanism has to be taken seriously by industry, practitioners and government to achieve cost competitiveness in longer run.

5. References

1. Cost Audit Orders issued by MCA dated 3rd May 2011 and further modified by order dated 30th June 2011.
2. Cost Audit Orders issued by MCA dated 2nd May 2011.
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4. List of Cost Accounting Standards issued by ICWAI.
5. Notification for Common Record Rules i.e. Companies (Cost Accounting Record) Rules, 2011 issued on 3rd June 2011.
6. Notification for Revised Report Rules i.e. Companies (Cost Audit Report) Rules, 2011 issued on 3rd June 2011.
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