

MODULE**5****Cost Audit & Reporting
to Management****5.1. COST AUDIT****5.1.1. Meaning and Definition of Cost Audit**

"Audit is an attest function. It is the accreditation or validation process of examining evidence regarding a report, statement, or other assertion to determine its correspondence to established criteria. The audit of a set of financial statements reflects underlying business transactions following existing criteria for financial statement preparation".

Cost Audit is auditing of cost records to comment whether they are properly maintained so as to give a true and fair view of the cost of production, cost of sales and margin of product. The cost audit is a critical examination on maintenance of cost records to express an opinion on their adequacy, truth and fairness, compliance to cost accounting principles.

According to I.C.M.A London, "Cost audit is the verification of cost accounts and a check on the adherence to the cost accounting plan".

According to ICWAI, cost audit as, "an audit of efficiency, of minute details of expenditures while the work is in progress and not a post-mortem examination. Financial audit is a 'fait accompli'. Cost audit is mainly a preventive measure, a guide for management policy and decision, in addition to being a barometer of performance".

According to Smith and Day, "By the term 'Cost audit' is meant the detailed checking of the costing system, technique and accounts to verify their correctness and to ensure adherence to the objective of cost accounting".

5.1.2. Objectives of Cost Audit

The main objectives of cost audit are:

- 1) **Protection:** Cost audit protects the business. It ascertains and controls cost by:
 - i) Examining the correctness of cost records;
 - ii) Detecting errors, undue wastage or losses and ensuring that cost records are compiled accurately; and
 - iii) Ascertaining whether the cost accounting plan has been adhered to or not.
- 2) **Constructive Appraisal:** The success of cost audit depends on the outlook of management and scope of cost audit. The cost auditor provides constructive suggestions based on his findings from cost audit for the benefit of management and shareholders as follows:

- i) Useful information is provided to management for regular production, selecting economical methods of operation, reducing operations costs and re-formulating plans etc.
 - ii) Suggestions for modification of existing procedure, submission of returns, etc., if they are not in conformity with the modern technique and elimination of unwanted procedures.
 - iii) Suggestions for improving the return on capital employed further.
 - iv) Information regarding reliability and effectiveness of the existing procedures for taking managerial decisions.
 - v) Suggestions for necessary action if the projected expenditure is found inadequate to produce optimum results.
- 3) **Improved Productivity:** Cost audit creates cost consciousness at different levels within the organization which results in cost reduction and cost control. Moreover, cost audit improves productivity by using efficiently scarce resources, i.e., men, material, machines etc.
- 4) **Pre-Audit:** Cost auditor checks whether the expenditure has been provided for in the budget estimates and the cumulative expenditure has exceeded the budgeted provisions.

5.1.3. Types of Cost Audit

Cost audit may be conducted at the initiative of and on behalf of the following:

- 1) **Cost Audit on Behalf of Management:** Audit may be instituted by the management for its own satisfaction. The purpose of this audit is to provide management for its own satisfaction. The purpose of this audit is to provide correct and reliable cost information to management for taking managerial decisions and to ensure that the costing department is functioning according to the plan. In this audit, the cost auditor helps the management in several ways by pointing out the drawbacks of the system and suggesting ways and means to control and reduce costs. The errors are corrected and defalcations are prevented.

The Cost Auditor is appointed by the management for this audit.

- 2) **Cost Audit by the Government:** Besides the Statutory audit, the audit can be instituted by any Government – Central or State – for the following purposes:
- i) To ascertain cost of production and marketing in case of industries to whom financial assistance in the form of subsidy, grant-in-aid, lower or free rates of taxes, etc., is to be provided,
 - ii) To ascertain costs in order to fix maximum prices of products,
 - iii) To ascertain cost of contracts to be given to contractors under Cost plus contracts, and
 - iv) To fix limits of loans to be advanced by financial corporations, small scale industries, and banks to different industries, on the basis of production costs.

Cost Audit by Contractees: Where it is decided by the contractee with the contractor that the contractor would be paid the cost of the contract plus fixed percentage of profit, as in case of 'Cost-plus' contracts, the audit is instituted by the contractee to ascertain correct cost of the contract. Similarly, where a contractor appoints sub-contractors on the basis of cost and profit basis, the contractor institutes cost audit of the accounts of sub-contractors to settle payments.

Cost Audit by Tribunals: To settle labour disputes on wages, bonus, profit-sharing, etc., the Tribunals may ask for cost audit of the concerned businesses. Similarly, Income-tax Tribunals may direct cost audit for assessment of tax based on profits of a manufacturing concern.

Cost Audit by Trade Associations: In the case of concerns of similar nature costs are compared with each other under Uniform Costing or Inter-firm comparison by Trade Associations. Trade Associations want to know costs to seek concessions from the Governments in the gestation or take-off periods of certain concerns, and for that purpose, cost audit is required.

5.1.4. Cost Audit Techniques and Procedures

The techniques and procedures used by a cost accountant while conducting cost audit are similar to that used by an auditor of financial accounts. These can be summarized as follows:

- 1) **Ascertain Internal Controls:** The auditor should examine the cost accounting system and ascertain the effectiveness of internal control systems in operation with regard to the cost function. This determines the detail and depth of examination and the extent of reliance on test checking.
- 2) **Vouching:** Vouching refers to establishing correctness of cost records with the help of documentary evidences, called vouchers, supporting and substantiating these records. These vouchers may be internally or externally generated. In case of financial records externally generated vouchers are larger in number, while in case of cost records internally generated vouchers are larger in number. In vouching, the auditor does not merely seek proof that the expenditure has actually been incurred. It examines the soundness of vouchers, and ascertains that the expenditure is properly authorized, appropriately recorded and has resulted in desired value addition.

For example, a cost auditor examines that materials are issued against duly authorized Material Requisition Note, used for the purpose for which they have been issued, and surplus materials have been accounted for and supported by Material Return Note or Material Transfer Note.

- 3) **Checking and Ticking:** Cost auditor does tallying, totalling, examination of postings and cost computations. They put check-marks or tick-marks with coloured pencils or pens to indicate the work that has done. They may also put checked stamp and his signatures.

- 4) **Test Checking:** In case the cost auditor is satisfied about the soundness of internal cost control system operational in the organization, they may resort to test checking instead of detailed examination of each item. Test checking may be based on random sampling or deliberate sampling.
- 5) **Valuation and Verification:** Under cost audit, this work is particularly significant with reference to calculation of depreciation on productive assets and inventories of raw materials, work-in-progress and finished goods. Valuation and verification of inventories involves examination of records relating to production, sales and those maintained by the store-keeper.
- 6) **Working Papers:** Cost auditor should obtain and file with copies of cost manual, relevant decisions, cost codes, audit procedure followed by him and cost audit questionnaire.
- 7) **Audit Notes:** Cost auditor should maintain precise notes of all significant facts discovered by him, important clarifications sought, clarifications with which they could not be satisfied, further clarifications required, defects in the system of internal control, frauds, and policy deficiencies. Working Papers and Audit Notes help cost auditor in carrying out audit work, preparation of Cost Audit Report, and in defending himself subsequently against an allegation, if made, that they failed to discharge his duties with due skill, care and diligence.
- 8) **Questionnaires:** Cost auditor prepares questionnaires for obtaining information regarding procedures and practices relating to various types of costs incurred.
- 9) **Cost Audit Report:** The report is the culmination of cost audit. The Cost Auditor submits the report to the authority at whose order he has been appointed – Central Government or Court or the management, etc. A specimen of statutory cost audit report is given later.

5.1.5. Advantages of Cost Audit

The important advantages derived from cost audit are:

- i) **Benefits to Management**
 - i) It helps to detect errors, frauds, inconsistencies etc. This improves the morale, makes the staff more watchful and helps them to improve the accuracy in their work.
 - ii) It ensures a high degree of reliability of cost data, e.g., price fixing, decision-making, etc., which helps the management to improve the quality of cost reports.
 - iii) It highlights the weaknesses in the systems and procedures. Inefficiencies in the working of the company are brought to the notice of the management by comparing actual achievements with the target performances for corrective action.
 - iv) It improves cost accounting methods and the effectiveness of cost control and cost reduction schemes by pointing out avoidable losses.

- v) It establishes a reliable check in the valuation of closing stock and WIP.
- vi) Audited cost data is more suitable for inter-firm comparison.
- vii) It makes management by exception possible through allocation of responsibilities to individual managers.
- viii) It reduces wastes by continuous checking and reporting to management.
- ix) Budgetary control and standard costing system will be greatly facilitated.

2) Benefits to the Consumers

- i) Cost audit helps the Government to fix the fair selling price of consumer goods. Thus the consumers get the benefits of fair price for the products of the company.
- ii) Cost audit does not allow the producers to make excess profits by increasing the price at regular intervals. This helps the consumers to maintain a higher standard of living and saves them from unreasonable price hike.
- iii) It helps to reduce and control cost and make proper use of scarce resources.

3) Benefits to the Shareholders

- i) Cost audit helps to make proper valuation of closing stock and WIP and reveals the true picture of profitability of each product *vis-à-vis* for the entire company. It also highlights whether the management is making optimum utilization of resources by eliminating inefficiencies.
- ii) It helps the shareholders to assess whether they are getting adequate return on their investment.

4) Benefits to Government

- i) When the Government enters into a cost-plus contract, cost audit helps to fix the price of the contract accurately. This helps the Government to settle the cost claims of bills under cost-plus contract quickly.
- ii) Cost audit helps the Government to fix selling prices of essential commodities accurately and thus prevents undue profiteering.
- iii) Cost audit data is considered more reliable for giving protection to certain industries in public interest.
- iv) Cost audit helps the Government to focus its attention on inefficient units and increase their productivity by taking effective measures. This improves the national income of the country.
- v) It helps the Government to settle industrial disputes regarding wages, bonus, fringe benefits, etc., through conciliation.
- vi) Accuracy in price fixation generates a healthy competition among the different units in an industry. This checks inflationary trend automatically.

5) Benefits to Statutory Financial Auditor

- i) Cost audit generates reliable data by maintaining constant internal check. Costing data, e.g., closing stocks of raw materials, WIP and finished stock, etc., is of great help to the statutory financial auditor.
- ii) It helps to prepare profit and loss account easily.

5.1.6. Cost Auditors

Cost auditor is an independent firm engaged by the client subject to the cost audit; to express an opinion on whether the company's Sheet are free of material misstatements, whether due to fraud or error.

For publicly traded companies, external auditors may also be required to express an opinion over the effectiveness of internal control over cost reporting. These are specialized person called cost accountants in India & CMA globally either cost & management accountant or certified management accountants.

Powers and Duties of Cost Auditors

The Cost Auditor is vested with the same powers and duties in relation to the cost audit conducted by him as a statutory auditor (financial audit) has in terms of Section 227(1) of the Companies Act [Section 223B(4)]. The report should be presented to the Central Government in the prescribed form and within the period fixed for the purpose. A copy of such report should be forwarded to the company.

Under Section 227(1), every auditor of a company shall:

- 1) Have the right to gain access at all times to the books, accounts and vouchers of the company wherever kept;
- 2) Be entitled to require from the officers of the company whatever information and explanation he thinks necessary for performing his duties as an auditor.

5.1.7. Cost Audit Report

Under Section 233B of the Companies Act, the cost auditor has to submit his report to the Central Government in the prescribed form and simultaneously send a copy of the report to the company. The company has to furnish to the Central Government full information and explanations on every reservation or qualification contained in the cost audit report, within 30 days from the date of receipt of the copy of the report. After considering the report and the information and explanations furnished by the company on the cost auditor's reservations or qualifications, the Central Government can also call for further information and explanations from the company to be furnished within specified time.

The Central Government can also direct the company to circulate to its members, alongwith the notice of the annual general meeting to be held for the first time after the submission of the cost audit report, the whole or such portions of the cost audit report as it may specify in this behalf.

5.1.7.1. Cost Audit (Report) Rules, 2001

Cost Auditor is required to submit his report after completing his audit. The Central Government has issued Cost Audit (Report) Rules, 2001 amendable from time to time, which specify the form of the report to be made by the Cost Auditor. The important provisions in this regard are as follows:

- 1) **Application:** These rules shall apply to every company in respect of which an audit of the cost accounting records has been ordered by the Central Government under Sub-section (1) of Section 233B of the Act. The cost audit report submitted on or after 1st October 2002, irrespective of the financial year of the company to which it relates, shall be in the form prescribed under these rules.
- 2) **Contents of the Report:** Cost Auditor should examine the cost records thoroughly and should express his independent opinion on the matters as the Cost Audit (Report) Rules prescribe. He should also express his comments on certain material issues under the head "Auditor's Observations and Conclusion" in the 'Annexure' part of the report.
- 3) **Submission of Report:** Every Cost Auditor who performs audit of the cost accounts and records of the company shall submit the report (a hard copy and a soft copy) alongwith auditor's observations and suggestions, annexure, and proforma to the Central Government in the prescribed form (including annexures) and at the same time forward a copy of the report to the company.
- 4) **Time Limit for Submission of Report:** The Cost Auditor shall forward his report to the Central Government and to the concerned company within one hundred and eighty days from the close of the company's financial year to which the cost audit report relates.
- 5) **Power of the Cost Auditor:** The company and every officer thereof, shall make available to the Cost Auditor within one hundred and thirty five days from the close of the financial year of the company, all such accounting records, cost statements, other books and documents, annexure and proforma to the report, duly completed, that would be required for conducting the cost audit, and shall render necessary assistance to the Cost Auditor so as to enable him complete the audit and submit his report within the time limit specified by the Act.
- 6) **Authentication of the Annexure to the Cost Audit Report:** The Board of Directors shall approve the annexure and proforma prescribed to the cost audit report before submitting the same to the Central Government by the Auditor. The company secretary and atleast one director on behalf of the company shall also sign the annexure and proforma, duly signed by the Cost Auditor. In the absence of company secretary in the company, the same shall be signed by atleast two directors.
- 7) **Penalties:**
 - i) If default is made by any Cost Auditor in complying with the provisions as regards form of and time limit for submission of audit report, he shall be punishable with fine, which may extend to ₹5,000.

- ii) If a company contravenes the provisions as regards furnishing within the prescribed time the Cost Auditor cost accounting records and authentication of annexure and proforma to the cost audit report, the company and every officer thereof, who is at default, shall, subject to the provisions of Section 233B of the Act, be punishable with fine which may extend to ₹5,000.

5.1.7.2. Contents of the Report of Cost Audit

Following are the contents of the cost audit report:

- 1) The cost auditor should report if a large quantity of raw materials were stocked and which remained unutilised for a long time and thus locking up of the working capital of the company.
- 2) He should report if the machines and labour remained idle during the year because of the shortage of raw materials.
- 3) He should report whether the cost records maintained by the company were adequate for the purpose of audit.
- 4) He should report whether the broad policy laid down by the management was faithfully followed.
- 5) His report should concentrate more on the cost of production, comparative profitability and operating efficiency of different lines in which the company is engaged rather than the routine statistical or financial information.
- 6) He should report if there has been a rise in the cost of production compared with the previous year. He should analyse the causes of such rise which might have been due to lapses or negligence on the part of the management or because of rise in the price of raw materials of labour cost or reasons beyond the control of the management, e.g., imposition of import duty on raw materials, if used in production, etc.
- 7) He should report if there has been any wastage during the process of manufacture and how could it be avoided.
- 8) He should mention the areas in which it is possible to reduce the cost of production.
- 9) He should report whether or not the cost statement reveals a true and fair view of the cost of production. He should see whether the cost accounts maintained by the company are correct or not and whether the policy laid down by the management has been or has not been followed.

5.1.7.3. Form to the Cost Audit Report

Schedule [See 2(e) and rule 4] Form of Cost Audit Report

[See rule 2(c) and rule 4]

I/We having been appointed as Cost Auditor(s), under Section 233B of the Companies Act, 1956, (1 of 1956) of (mention name of the company) having its registered office at (mention registered office address of the company) (hereinafter referred to as the company), have examined the books of accounts prescribed under clause (d) of sub-section (1) of Section 209 of the said Act, and other relevant records for the year ended (mention the financial year) relating to (mention name of the product) maintained by

the company and report, subject to my/our comments under the heading Auditor's Observations and Conclusions' contained in the Annexure to this report, that:

- 1) I/We have/have not obtained all the information and explanations which to the best of my/our knowledge and belief were necessary for the purpose of this audit.
- 2) Proper cost accounting records as required under clause (d) of sub-section (1) of Section 209 of the Companies Act, 1956 have/have not been kept by the company.
- 3) Proper returns adequate for the purpose of my/our Cost Audit have/have not been received from branches not visited by me/us.
- 4) The said books and records give/do not give the information required by the Companies Act, 1956 (1 of 1956) in the manner so required.
- 5) In my/our opinion, the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, processing, manufacturing or mining activities, as the case may be, and marketing of the product under reference.
- 6) The cost statements in respect of product under reference as specified in the Annexures/Proformae of Schedules I and II of the Cost Accounting Records (.....) Rules duly audited by me/us are/are not kept in the company.

The matters contained in the Annexure and Proforma to this report form part of this report, which is also subject to my/our observations made therein.

Dated this date of 19 at

(Mention name of the place of signing this report),
Cost Auditor(s)

Note:

- 1) Delete inapplicable words.
- 2) Specify the title of Cost Accounting Records Rules made under clause (d) of sub-section (1) of Section 209 of the Companies Act, 1956 which are applicable to the product of the company.

5.2. MANAGEMENT AUDIT

5.2.1. Meaning and Definition of Management Audit

The overall or part of checking an organisation's transaction is called management audit. It comprises of scrutinising of effectiveness of the managers with the companies and professional standards; the correctness of management data, the performance quality and all the suggestions about improvement.

The organised and unbiased examination along with the examination and review of management overall performance is known as management audit. It is a type of review mechanism of the overall performance of management.

According to William P. Leonard, "The management audit may be defined as a comprehensive and constructive examination of an organization structure of a company and its plans and objectives, its means of operation and its use of human and physical facilities".

According to Churchil and Cyert, "Management audit is performed with the object of examining the efficacy of the information control system, management and management procedures towards the achievement of enterprises goals".

According to CIMA Terminology, "Management audit is an objective and independent appraisal of the effectiveness of managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weakness within an organization and to recommend ways to rectify these weaknesses".

Hence, management audit focuses on the estimation and assessment of the control and information system in the overall or at some part of organisation. It has increased its area to appraise in detail the system and sub-systems, procedures, job separation, authorisation, accountability, quality of personnel and information generation, etc.

5.2.2. Objectives of Management Audit

The main objective of management audit is to enhance the overall effectiveness of the organisation. To achieve this objective management audit performs the activities of recognising the weak areas of internal control system and of advising the ways to improve the performance. The other objectives of management audit are as follows:

- 1) To make sure that all the resources (including human resources) are used optimally.
- 2) To identify the flaws and shortcomings of company policies, objectives, procedures, and plans.
- 3) To recommend better methods available for production and operations.
- 4) To indicate the deficiencies in structure and internal control system of the organisation and to suggest the methods for improving them.
- 5) To assist the management by informing them to know about the threats that are likely to happen and also by advising the methods to avoid them.
- 6) To recognise the problems in advance and propose suitable methods to resolve them promptly.
- 7) To evaluate the performance of managers at all the levels.
- 8) To highlight the activities and decisions which are not in accordance with the objectives of the company.
- 9) To make sure that employees of all the levels clearly understand the objectives of the organisation.
- 10) To assess all the plans, policies, objectives, etc., of the organisation.
- 11) To assess the organisational structure, i.e., what duties are assigned to whom, how the authority is allocated to employees, etc.
- 12) To help in the process of assessment of all the available resources,

5.2.3. Scope of Management Audit

Management audit is a very wide topic and has almost no limitations. Objectives of a business determine the areas that are to be reviewed through the management audit. Management audit has the following scope:

- 1) It assesses whether the objectives of the organisation are practical, suitable, and compliable or not.
- 2) It reviews the company image among the general public, among its employees, and among the other players of the industry.
- 3) It analyses that what kind of returns are investors getting against their investment in the company, i.e., very low, satisfactory, high, or very high.
- 4) It also helps in maintaining good relationship with all the stakeholders of the company, i.e., shareholders, customers, managers, workers, etc.
- 5) It also examines the rate of returns and ratio of operating returns on several capital projects of the company.
- 6) It evaluates the objectives and efficiency of all the levels of management, i.e., top, middle, and lower.
- 7) It also encompasses the financial policies and control system pertaining to different functional areas of the company, such as, production, marketing and sales, distribution, etc.

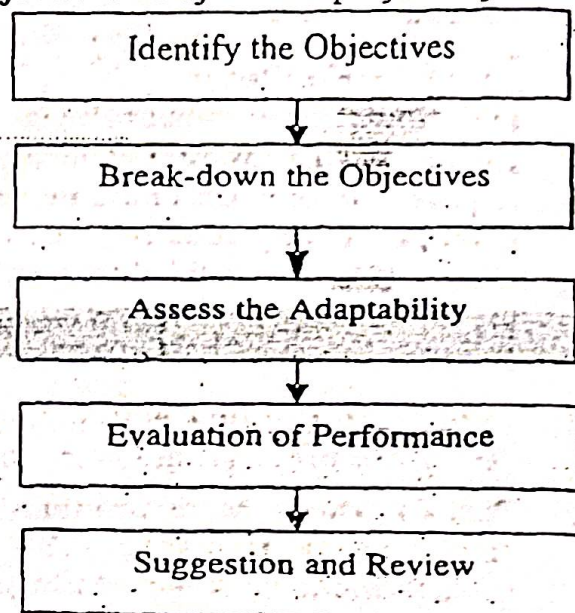
5.2.4. Difference between Cost Audit and Management Audit

Cost Audit	Management Audit
1) Cost audit validates the cost and expenditure related information in order to evaluate the internal efficiency of the organisation.	Management audit not only examines the internal efficiency but it also works in order to foster good relations among the organisation and its external environment.
2) During cost auditing, the information related to cost accounting is inspected.	During management auditing, the objectives and activities of the management is reviewed.
3) Cost audit should be carried out by a person who is equipped with the necessary knowledge to carry out a cost audit.	Management audit should be conducted by a person who is well acquainted with the concepts of production planning and control, management control, etc.
4) All the organisations are legally bound to conduct a cost audit compulsorily.	Management audit is an optional practice that may or may not be conducted by an organisation.
5) Cost auditing is carried on yearly basis and report is submitted every year.	Management audit is very vast topic and encompasses almost all the activities of the management.
6) Cost audit can only be done by a cost accountant or a chartered accountant; provided that he is not a member of the organisation under audit.	Management audit can be done by any person who is capable to do it, until and unless he is a member of the organisation under audit.
7) The concerned authority has fixed a time limit within which the report of cost audit should be submitted.	Management audit is not governed by any statute; hence, no time limit is fixed to submit the audit report.

5.2.5. Steps in Management Audit Process

The essential steps of the management audit are:

- 1) **Identifying the Organisational Objectives:** Objectives play a key role in management audit process, hence, identifying the exact objectives is important for carrying out with management auditing.
- 2) **Break-down the Objectives:** The bigger the size of an organisation, bigger will be its objective. So it's important to break down objectives into detailed targets and plans.
- 3) **Assess the Adaptability:** Evaluating the adaptability of the organisation structure for achieving the targets effectively it is important to judge how adaptable the organisation structure is because the attainment of goal and implementation of plan is to be carried out by organisational structure only.
- 4) **Evaluation of Performance:** The evaluation of the performance is of utmost importance to make sure whether each functional area is contributing its maximum so that the targets are met in time.
- 5) **Suggestions and Reviews:** The suggestions and reviews should be given to improve the efficiency and effectiveness. This step is considered to be the main step of management audit to ensure that management functions with pre-decided targets.



Steps in Management Audit Process

5.2.6. Advantages of Management Audit

Management audit has become a widespread practice as of now. Every developing organisation carries management audit on discretionary basis because of its number of advantages. Few of the advantages are mentioned below:

- 1) Management audit makes easy for the organisation to set fundamental guidelines and determine goals and strategies.
- 2) Management audit assist in configuration of organisational structure for executing its predetermined goals.
- 3) Management audit works for the purpose of achievement of the long term goals, it also assists in developing a practical and easily attainable strategy for organisation.
- 4) It works for regular and continuous working of the organisation; it helps in drafting plan and policies.

- 5) Management audit helps in drafting and evaluating management information system (MIS) for quick decision making.
- 6) It helps organisation to grow powerful, management audit helps in examining the strength, weakness, opportunity and threats of the organisation.

5.2.7. Problems Associated with Management Audit

Management audit that involves within itself the operational audit, performance audit and propriety audit, experiences few operational problems. Below mentioned are few of such problems experienced by management audit:

- 1) **Disputes among Line and Staff Authorities:** The work is performed by the line managers while the staff managers direct and recommend. Management auditor's instruction could give rise to a dispute among line and staff authorities.
- 2) **Resistance to Change:** The change is sometimes opposed, therefore, it takes a lot of time to convince people to welcome and transform to the change.
- 3) **Fear of Criticism:** The management audit often proves to be a fear of criticism in the minds of staff, as it could lead to penalty, downsizing of employee, etc.

5.3. REPORTING TO MANAGEMENT

5.3.1. Meaning and Definition of Report

The origin of the word 'report' comes from Latin language word 'reportare'. The word 'reportare' means 'carry back'. Hence, the word 'report' signifies the narration of an occasion carried back to person or persons to witness the event. In general, report includes memorandums, news items and letters.

In formal sense, a report is described as a "statement describing what has happened". It can also be used for "describing a state of affairs". In the business world, there are many events which require the presentation of 'report'. A report gives an elaborate account of an event or a situation. It also shows various steps taken as well as the findings or results of an investigation. A report should be informative. It should show the findings, conclusions and recommendations. It also describes various actions needed to be taken.

According to Raymond V. Lesikar and John D. Pettit, "A business report is an orderly, objective communication of factual information that serves some business purpose".

Report writing is a form of written communication. These reports are an important tool used to fulfil the need of communication in organisation. The reports are helpful in making various decisions in the organisation. The nature and type of the organisation determine the quantum of communication required through reports. Such quantum also depends on the difficulty of the problem, the preparation and demonstration of the content.

5.3.2. Meaning and Definition of Management Reporting

The system of communication in an organisation is known as Management reporting system. It generally involves written communication. The system helps in proper dissemination of information to different levels of management to aid the process of decision making. Here the term 'information' encompasses data which has been processed for a particular purpose. Thus, the system of presenting information to the management is known as management reporting.

According to Kohler, Reporting refers to "A body of information organised for presentation or transmission to others. It often includes interpretations, recommendations and findings with supporting evidence in the form of other reports".

According to Dr. Maheshwari, "Management reporting system is an organised method of providing each manager with all the data and only those data which he needs for his decisions, when he needs them and in a form which aids his understanding and stimulates his action".

5.3.3. Objectives of Reporting

Following are the objectives of reporting:

- 1) **Evaluating Executive Performance:** Reporting is helpful in the process of proper evaluation of executive performance. It also shows various areas of improving the performance.
- 2) **Helps Dealing with Changes:** The organisations work in a dynamic environment. Reporting helps in keeping track of various changes in different variables. The organisation can change itself in response to changes in its environment to reap the benefits.
- 3) **Offers Information:** The reports are an excellent source of information. It provides data about various organisational activities, plans, progress and challenges. These are important for planning process.
- 4) **Supports Control Process:** The reports help in control purpose as they ensure smooth communication of performance of the employees to the owner.
- 5) **Better Coordination:** The reports are helpful in ensuring better coordination among the top level and lower level employees in the organisation.
- 6) **Contact:** The reports are also helpful in creating and maintaining touch with clients, government and creditors.
- 7) **Record Keeping:** The events are recorded in the report for the purpose of providing references and aids in the process of decision making.
- 8) **Suggests Course of Action:** Reports are useful for the purpose of convincing various users of the report to different courses of action.

5.3.4. Purpose of Reporting

Following are the main uses of reports:

- 1) **Communication:** The reports are mainly used for facilitating smooth communication.
- 2) **Record Keeping:** It also helps in keeping records which may be useful for providing present and future references.
- 3) **Legal Requirements:** According to the applicable laws, the firms are required to prepare and submit the reports to various authorities. As an example, Companies Act 2016, requires the submission of annual reports which are also provided to the shareholders of the company.
- 4) **Decision Making:** The management report serves the process of decision making.
- 5) **Improving Public Relations:** Reports help in generating goodwill as these can be used for giving information to the public.
- 6) **Performance Measurement:** Reports are important for recording employee performance. This helps in the process of performance measurement such as performance appraisal.
- 7) **Control:** It helps in exercising control over various functions of the business.
- 8) **Feedback:** Reports help the lower management levels in providing feedback to the management in the form of reactions on decisions taken by the management.
- 9) **Wider Contact with Users:** Reports help in maintaining the contacts with various parties such as consumers, customers and public.

5.3.5. Requisites of a Good Report

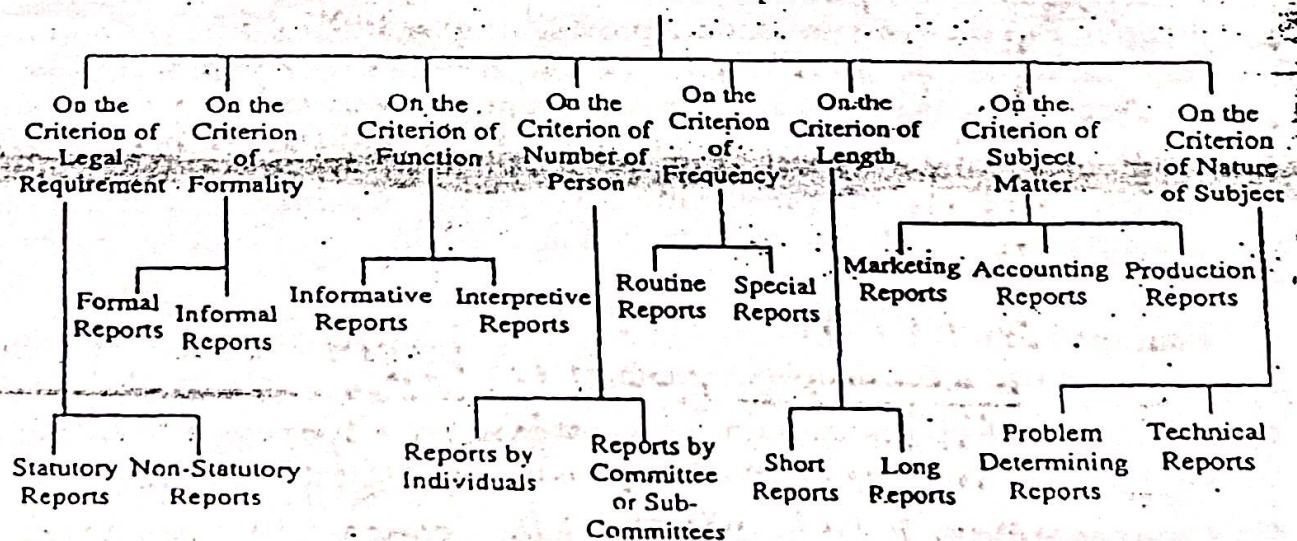
Main features of an efficient reporting system are as follows:

- 1) **Proper Form:** A report should provide deep analysis and have proper title and heading. A good report further has requisite sub-headings and paragraphs for easy reading and referencing.
- 2) **Contents:** A good report should be simple in its form. There should be a logical process of the presentation. The visual aids may be used for better presentation of the information. Visual aids include diagrams, charts and other figures.
- 3) **Promptness:** The reports should be prepared and submitted in time, so that users can use it for decisions making.
- 4) **Accuracy:** Reports should provide accurate information. This entails taking proper care while compiling a report according to guidelines.
- 5) **Comparability:** An effective report offers comparability. It ensures that the information contained in the report can be used for the purpose of comparison. This is a convenient way to find deviations and take relevant action. It helps in the process of controlling.

- 6) **Consistency:** Consistency is important as it facilitates comparison. It can be achieved by following uniform principles for the purpose of collection, classification and presenting information.
- 7) **Relevancy:** The reports should contain relevant information. This increases the usability of the reports. The irrelevant data leads to wastage of resources and may cause faulty decisions.
- 8) **Simplicity:** The reports should be simple in their format and presentation. It should minimise the use of technical jargon and complicated figures and doubling of work.
- 9) **Flexibility:** The reports should be flexible so that it can be changed in accordance to the change in circumstances and requirements.
- 10) **Cost-Benefit Analysis:** The costs associated with making reports should be less than the commensurate benefits arising out of them.
- 11) **Principles of Exception:** The reports should follow principle of management by exception because the management has very less time and effort. The reports should be designed in such a way that important matters are highlighted.
- 12) **Controllability:** Reports are required to be directed to a defined department or centre. It is important for the purpose of designing content of the report. The factors should be classified into uncontrollable and controllable category. The employees should not be held accountable for uncontrollable factors. The corrective action should be taken for uncontrollable factors in the report.

5.3.6. Classifications of Report

Classifications of Report



- 1) **On the Criterion of Legal Requirement:** In this regard the reports can be categorised as below:
 - i) **Statutory Reports:** These reports are prepared according to the applicable laws. For example, the reports submitted to the registrar of companies prepared by Director or Secretary.

- ii) **Non-Statutory Reports:** The various formal reports are not legally required but are created to help management in planning, designing policies and other decision making purposes.

On the Criterion of Formality: Following are the main types of reports classified on the basis of formality:

- i) **Formal Reports:** The reports which are required to be prepared as per the set format are known as formal report. These reports are circulated using prescribed channels.

- ii) **Informal Reports:** These reports have informal structure. Their format is designed as per the needs of the users in the organisation. The main use of these reports is to provide information, offer reporting of events or to check the evolvement of operations. They can be informative or recommendatory report. They are prepared in the form of person-to-person communication or as a letter.

3) **On the Criterion of Functions:** Following are the main types of reports according to this criterion.

- i) **Informational Reports:** These reports contain only the data collected in a systematic manner. These reports are not designed to provide recommendations and are only intended to aid management in the decision making process by providing relevant information as it is.

- ii) **Interpretive Report:** These type of reports not only contain data but also provide recommendations. This report also analyses the data. It is also called recommendation or recommendatory report.

4) **On the Criterion of Number of People:** Following are the main classifications in this regard:

- i) **Reports By Individual Persons:** The reports are prepared and submitted by different managerial personnel like company secretary, the Auditor, etc. The reports only contain information pertaining to their respective departments or divisions.

- ii) **Reports by Committees or Sub-Committees:** These reports deal with the matters which are relevant to more than a single department. These reports tend to be more important and require attention of more than just one person. Such reports generally follow formal styling.

5) **On the Criterion of Frequency:** Using this criterion, following are the main types of reports:

- i) **Routine Reports:** These reports are prepared in their format and are filed on regular basis. They are also known as ordinary reports and are transferred regularly from different departments to the management. These reports are meant to provide relevant information to the management. Annual reports and monthly reports are examples of this kind of reports. It records the day to day and current information.

- ii) **Special Reports:** Such reports are prepared to provide information about specific events. A report about the feasibility of introducing a new product, strike is an example. These reports are concerned with non-recurring issues.

6) **On the Criterion of Length:** Following are the main classifications in this regard:

- i) **Short Reports:** Such reports deal with well-defined issues and generally are limited in their scope. The methodology used for such reports is easy and simple. The length of short reports is generally close to five pages.
- ii) **Long Reports:** These reports provide deep analysis and are focused on important issues. Long reports tend to be more comprehensive in their approach than the short report.

7) **On the Criterion of Subject Matter:** Following are the main types under this criterion:

- i) **Marketing Report:** This report deals with explanation of various components of supply chain such as customers, suppliers and competitors market demand and various sales, etc.
- ii) **Accounting Reports:** These reports provide information about financial state of the business including its assets and liabilities. It also provides data about expenses and revenues. There are different formats for different accounting information. All the reports give useful information to the user.
- iii) **Production Reports:** These reports provide information from employees to managerial staff. It helps management in evaluating performance of the employee and the work units. It reports about the quantity and units of production during specific time.

8) **On the Criterion of Nature of Subject:** Following are the main types based on this criterion:

- i) **Problem Determining Reports:** These reports endeavour to find the root cause of different issues. These reports also determine whether a problem exists at all or not.
- ii) **Technical Reports:** These reports present information for specific subjects. These may or may not have comments.

5.3.7. Structure of Report

Following are the main features of a report:

- 1) **Title Page:** Title page contains the title as well as subjects contained in the report. It also defines the name of the author, submission date and the receiver of the report.
- 2) **Table of Contents:** All the sections are mentioned here along with the sub-sections with respective page numbers.
- 3) **Executive Summary or Abstract:** The main points and results of the reports are summarised here. This may be omitted from short reports.
- 4) **Introduction:** The background and scope of the report is mentioned under this head:
 - i) **Objective:** The aims and objectives of the report are specified here. It also shows terms of reference, purpose of the report and context. It may also show the details of the organisation asking the report and all the questions which they are hoping to be answered.

- ii) **Methodology:** This section defines the method of collecting data and the way it will be used. Sometimes, the reasons behind choosing a particular methodology may be explained. It covers information about the topic, a summary content and the limitation of the project.
- 5) **Body of the Report:** It is the main part of the report. It procures explanations and possible solutions to the problems. This part presents the findings categorised in various sections and sub-sections. Different sections as well as the sub-sections should be suitably numbered and should be given titles and headings. Following are the critical elements in the body of the report.
 - i) **Literature Review:** The body of the report should include literature review.
 - ii) **Method:** It describes various actions undertaken and the reasons behind them.
 - iii) **What You Found:** It includes various findings like quantitative and qualitative data, outcomes and observations are stated here.
 - iv) **Discussion:** It describes various deductions and their relevance to previous findings. These results are presented relative to applicable theoretical framework. Appropriate references should be provided.
- 6) **Conclusion:** This part sums up all the major points taken into consideration for reaching the conclusions. All the key points of the study are summarised in it. This part should not contain anything new.
- 7) **Recommendations:** The possible solutions to the problem should be enumerated here. The recommendations should be presented and discussed. The recommendations are optional.
- 8) **Bibliography:** This part shows all the books, journals, articles and websites, etc. referred for writing the report.
- 9) **Glossary:** This part includes the terms which are used in the body of report. The important terms are detailed in glossary portion.
- 10) **Appendix:** This is placed at the conclusion of the report. Various relevant pieces of information, which were too elaborate to be posted in the body section of the report, should be placed here. Different types of information should be placed under different appendix. These appendixes may be referred to in the report.

Basic and Subsidiary Parts of Report

Basic Parts	Subsidiary Parts
1) Executive Summary	1) Cover
2) Introduction	2) Title Page
3) Discussion	3) Table of Contents
4) Recommendation	4) Bibliography/References
5) Appendix	5) Glossary

The subsidiary parts mentioned at number 3, 4 and 5 are only included in long and formal reports. For short reports, headings replace the cover and title pages.

5.4. SEGMENT REPORTING

5.4.1. Introduction

Segment reporting refers to the disclosure of information about an enterprise's operation in different industries, its foreign operations and export sales, and its major customers. Reporting on each segment of the business has become a necessity over the recent years to communicate to the users of financial statements about the operating performance of each segment of the business for better analysis and understanding of the enterprise's performance including its performance in dissimilar and diversified activities.

As business organisations have become more complex over the years, and the conglomerate form of organisation has become more popular, it has become necessary to concede that financial statements which present the full scope of an enterprise's operations have declined markedly in utility. While it is certainly possible to access the overall financial health of the entity using such financial reports, it is much more difficult to evaluate management's operating and financial strategies, particularly with regard to its emphasis on specific lines of business. It is due to this that segment reporting has been emphasised.

The objective of presenting information by segments is to provide users of financial statements with information on the relative size, profit, contribution, and growth trend of the different industries and different geographical areas in which diversified enterprise operates to enable them to make more informed judgements about the enterprise as a whole.

5.4.2. Objectives of Segment Reporting

The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

- 1) Better understand the performance of the enterprise;
- 2) Better assess the risks and returns of the enterprise; and
- 3) Make more informed judgements about the enterprise as a whole.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas – often called segment information – is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

5.4.3. Users of Segment Reporting

Users of segment reporting are as follows:

Investors: They are fascinated to acquaint themselves about segment reporting on profitability, risk, growth, and return on various segments. This helps the investors to assess the future prospects of the enterprise.

Employees: They are concerned in the performance of diversified products and services and diversified geographical localities. Besides, they are engrossed to evaluate the future prospects of the enterprise. They are curious from the aspect of wage negotiations and job security.

Internal Management: They utilise segment reporting for decision-making. Management is interested to evaluate individual product and its performance to appraise its profitability. Besides, geographical area-wise performance is judged. Based on the performance, the management decides whether to continue or drop the product.

Government Agencies: At country as well as world levels are more interested about product-wise and geographical area-wise performance of an enterprise relating to quantity, quality and balance of payments.

Customers: They are fascinated to assess the quality, supply and availability of products at a reasonable price to enable themselves to acquire and consume.

5.4.4. Terms Used in Segment Reporting

The following terms are used in this Standard with the meanings specified:

- 1) **Business Segment:** This is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments.
- 2) **Geographical Segment:** This is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.
- 3) **Reportable Segment:** This is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard.
- 4) **Enterprise Revenue:** This is revenue from sales to external customers as reported in the statement of profit and loss.
- 5) **Segment Revenue:** This is the aggregate of:
 - i) The portion of enterprise revenue that is directly attributable to a segment;
 - ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment; and
 - iii) Revenue from transactions with other segments of the enterprise.

6) **Segment Result:** This is segment revenue less segment expense.

7) **Segment Assets:** These are those operating assets that are employed by the segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, segment assets include the related receivables, loans, investments, or other interest or dividend generating assets. Segment assets do not include income tax assets. Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

8) **Segment Liabilities:** These are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities. Segment liabilities do not include income tax liabilities.

9) **Segment Accounting Policies:** These are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting.

5.5. COST REDUCTION

5.5.1. Meaning of Cost Reduction

Cost reduction is planned, positive approach to reducing expenditure. Cost reduction exercises are planned campaigns to cut expenditure. It is a continuous process with the object of getting a more or less permanent benefit.

Cost reduction is defined by CIMA, London as "the achievement of real and permanent reduction in the unit cost of good manufactured or services rendered without impairing their suitability for use intended".

Thus, the cost reduction is, therefore, the term used for planned and positive approach to the improvement of efficiency. It can be viewed in many ways, such as increasing productivity, elimination of waste, improvement in product design, better technology and techniques, incentive schemes, new layouts and better methods, etc. If the cost reductions are not based on sound reasons, like improved methods, then very quickly the costs will grow back to their original size.

5.5.2. Features of Cost Reduction

Features of cost reduction are as follows:

- 1) **Cost Reduction must be Real;** Said, through increase in productivity, change in product design, improvement in technology, etc.

Cost Reduction must be Permanent: Temporary reductions in cost due to windfalls, change in tax rates, changes in market prices, etc., do not come in the purview of cost reduction.

Cost Reduction must not Impair: The suitability of products or services for the intended use. In other words, cost reduction should not be at the cost of essential characteristics of the products or services.

5.3. Scope of Cost Reduction

Following are the areas or scope of cost reduction:

Product Design: The design of the product provides the greatest scope for cost reduction. Product design being the first step in production, if cost reduction can be made at design stage, then it is likely that the benefits can be availed to the maximum.

There are two basic points that should be kept in mind while effecting cost reduction in product design:

- i) The product should perform all the functions for which it is intended, and
- ii) The product should retain its 'esteem' or 'aesthetic' value. This is in the case of many products which have the shape or other characteristic which pleases the eye.

Improvement in product design may result in cost reduction as illustrated below:

- i) **Material Cost:** Change in design of the product may result in saving in material cost. Economical substitution for existing material may also be considered. For example, in manufacturing kitchen utensils, brass may be substituted by cheaper alloys. In curtain rings, metal may be substituted by plastic.
- ii) **Labour Cost:** Improvement in design may result in reduced operating time.
- iii) **Factory Overhead:** Reduced operating time not only helps in saving in labour cost but also in factory overhead.
- iv) **Packing and Transportation:** Compact design of a product results in reduced cost of packing and transportation. Cost of tools, jigs and fixtures can be reduced through design improvement.

2) **Organization:** Cost reduction may also be achieved by improving factory organization in the form of clear-cut lines of authority and responsibility, well-defined channels of communications, co-ordination and co-operation between various executives, etc.

3) **Production:** A cost reduction programme should make a study of sequence of operations to find out the best one, to use the most suitable machines for the work, to use jigs and fixtures to reduce operating time, to reduce idle time, to reduce scrap by the use of better quality tools, to provide better working conditions conducive to efficiency, etc.

- 4) **Administration:** Items under this head include savings affected by modifying the range of cash discounts to customers, introducing mechanical and electronic aids to office routine, modifying internal and external communication system, etc.
- 5) **Marketing:** In this function, costs can be reduced by revising the methods of remuneration of salesmen, re-arrange territorial responsibilities of sales representatives, modifying current methods of advertising, improving product design and production quality so as to reduce after sales service, economizing channels of distribution, improving packing, etc.
- 6) **Finance:** A cost reduction programme should aim at securing capital at economical cost, employing capital to give maximum return and eliminating over and under capitalization and wasteful use of capital, etc.

5.5.4. Importance of Cost Reduction

Cost reduction is important owing to the under-noted reasons:

- 1) It leads to an improvement in the competitive capabilities of a firm and thereby ensures its survival, growth and prosperity.
- 2) It leads to optimum utilization of the resources of the firm.
- 3) It ensures reasonable prices to consumers by not passing on the inefficiency of the business itself.
- 4) It assists in the preservation of the nation's scarce resources.
- 5) By keeping the prices charged to the consumers under control, it helps the government in controlling inflation.

5.5.5. Difficulties in Cost Reduction

Difficulties in cost reduction are as follows:

- 1) Resistance by employees to pressure to reduce costs, usually because the nature and purpose of the campaign has not been properly explained to them, and they feel threatened by the change;
- 2) They may be confined to a small area of the business (e.g., to one department) with the result that costs are reduced in one cost centre only to reappear as an extra cost in another cost centre;
- 3) Efforts to cut material and labour cost may erode confidence in established system for estimating material usage and labour productivity standards;
- 4) Cost reduction campaigns are often introduced as a rushed, desperate measure instead of a carefully organized exercise.

5.5.6. Tools and Techniques for Cost Reduction

Tools and Techniques for cost reduction are as follows:

- 1) **Standard Costing:** Standard Costing provides stability in the costing of standard products. Management's decision-making is enhanced by simulation tools that allow to analyze the effects of material or labour rate changes. This helps with pricing decisions and also helps to identify areas that have potential for cost reduction.

Budgetary Control: Budgetary control is the most widely used tool for planning and monitoring organizational activities. Importantly, the budgets are inextricably linked with strategy formulation, cost analysis and performance management. It is crucial to interpret how costs behave so that realistic budgets and plans can be produced, and appropriate financial and non-financial resources can be made available to the business.

3) **Inventory Control:** Inventory control is concerned with minimizing the total cost of inventory. The three main factors in inventory control decision-making process are:

- i) The cost of holding the stock (e.g., based on the interest rate).
- ii) The cost of placing an order (e.g., for raw material stocks) or the set-up cost of production.
- iii) The cost of shortage, i.e., what is lost if the stock is insufficient to meet all demands.

4) **ABC Classification:** The ABC classification system is to grouping items according to annual sales volume, in an attempt to identify the small number of items that will account for most of the sales volume and that are the most important ones to control for effective inventory management.

5) **Re-Order Point:** The inventory level R in which an order is placed where $R = D \times L$, D = demand rate (demand rate period (day, week, etc.)), and L = lead time.

6) **Safety Stock:** Remaining inventory between the times that an order is placed and when new stock is received. If there are not enough inventories then a shortage may occur.

Safety stock is a hedge against running out of inventory. It is an extra inventory to take care on unexpected events. It is often called buffer stock. The absence of inventory is called a shortage.

7) **Operational Research:** A new multi-disciplinary approach to problem-solving, called Operations Research was developed. This was a quantitative approach basically concerned with the efficient allocation and control of resources. Multi-disciplinary operations research groups, largely initiated and founded by government and quasi-governmental organizations, were formed.

8) **Production Planning and Control:** Production planning and control can be viewed as the nervous system of the production operation. This function aims at efficient utilization of material resources, people and facilities in any undertaking through planning, co-ordination and controlling the production activities that transform the raw material into finished products or components as a most optimal manner. All the activities in the manufacturing or production cycle must be planned, co-ordinated, organized and controlled to its objectives.

- 9) **Statistical Quality Control:** It is desirable that the process itself is adjusted in such a way that the number of defectives remain within acceptable limits. This is based on preventive principles. In such a situation, we can even dispense with inspection of individual components/products so long as we are assured that the defectives will not exceed pre-determined value within a specified confidence level. The method used for this purpose is called Statistical Quality Control (SQC). Control charts are used for this purpose.

Statistical Quality Control is the application of statistical techniques to accept or reject products already produced, or to control the process and, therefore, product quality while the part is being made. While the latter is called process control, the former is named acceptance sampling. Statistical quality control is the application of statistical techniques to determine how far the product conforms to the standards of quality and precision and to what extent its quality deviates from the standard quality. The purpose of statistical quality control is to discover and correct only those force which are responsible for variations outside the stable pattern. The standard quality is pre-determined through careful research and investigation.

- 10) **Value Analysis:** Value Analysis or Value Engineering (VE) is a systematic method to improve the "value" of goods or products and services by using an examination of function. Value, as defined, is the ratio of function to cost. Value can therefore be increased by either improving the function or reducing the cost. It is a primary tenet of value engineering that basic functions be preserved and not be reduced as a consequence of pursuing value improvements. Value analysis is a systematic effort to improve upon cost and/or performance of products (services), either purchased or produced. It examines the materials, processes, information systems, and the flow of materials involved.
- 11) **Job Evaluation and Merit Rating:** Job evaluation technique which seeks to show in a reasonably objective manner the relative worth of jobs. It attempts to do this by analyzing the content of each job under various categories, e.g., training required, degree of responsibility, working conditions, types of decisions involved and so on, and giving a point score for each factor. The total of the points' scores for each job is then used to establish the ranking of one job to another and, by reference to pay scales, the normal salary for the job.

Unlike job evaluation, Merit Rating is concerned with the individual employee. It seeks to rate an employee's performance to assist in determining whether a person should receive a merit award, promotion, demotion, etc. It does this by considering the performance and attributes of an employee under various categories, e.g., initiative, attendance, accuracy, willingness, etc.; and giving a number of points for each factor. Merit rating under various guise is frequently encountered in staff appraisal schemes, particularly in larger firms, and is considered to be of value in providing a reasonably standardized basis to the difficult task of individual appraisal.

- (12) **Market Research:** Purchasing and supply (market) research refers to the systematic study of all relevant factors which may affect supply and demand of goods and services, for the purpose of securing the company's current and future requirements.

Purchasing (market) research is used first of all to support purchasing policies and decision-making; it must generate data and alternatives on which the buyer and/or management can base better purchasing decisions. Purchasing research can have both an external and an internal focus. Examples of purchasing policies are supplier studies, supply market studies and materials cost and price analyses. Examples of decision making are analysis of the company's purchasing portfolio and analysis of the costs that may be related to holding inventory and the quality costs of incoming materials.

5.6. COST CONTROL

5.6.1. Meaning and Definition of Cost Control

Over a period of time, cost control has acquired much more importance than mere cost ascertainment. Bigger the size of a business, greater is the importance of cost control.

The Chartered Institute of Management Accountants, London defines cost control as "the regulation by executive action of the cost of operating an undertaking particularly where such action is guided by cost accounting". Cost control, thus involve:

- 1) Regulation, i.e., significantly influencing the cost of operating the undertaking;
- 2) The regulation is not automatic but due to conscious effort by the executive;
- 3) The area of cost control are brought to the notice of the executive;
- 4) The strategic points of executive interference are pre-determined and the responsibility is fixed on individual executives; and
- 5) Cost control operates as an essential component of the system of cost accounting and is achieved by comparing actual performance with the pre-determined level of achievement. Cost control is exercised through setting targets, budgets, norms or standards and ascertaining deviations from these for initiating corrective action.

5.6.2. Features of Cost Control

Features of cost control are as follows:

- 1) **Cost Accounting:** Cost accounting is feasible only when an organization has an effective cost accounting system to provide relevant information. Costs should be categorized into controllable and non-controllable. The organization is divided into responsibility centers. Every executive is made responsible for the performance of the centre directly under his control.

- 2) **Cost Planning:** Cost control aims at achieving the cost targets. So, an organization should have a proper planning or budgeting system. The targets should be set after taking into consideration all relevant factors. The targets need to be feasible and capable of being achieved.
- 3) **Cost Reporting:** Proper management reporting system is necessary for perfect monitoring. It must be in-built in the organization to have a continuous basis of information about the actual and predetermined costs of different products or services to the concerned levels of management.
- 4) **Corrective Action:** On observing the variances, the management must identify the causes of variances and take appropriate remedial measures.

5.6.3. Advantages of Cost Control

The advantages of cost control are mainly as follows:

- 1) Achieving the expected return on capital employed by maximising or optimizing profit,
- 2) Increase in productivity of the available resources,
- 3) Reasonable price of the customers,
- 4) Continued employment and job opportunity for the workers,
- 5) Economic use of limited resources of production,
- 6) Increased credit worthiness, and
- 7) Prosperity and economic stability of the industry.

5.6.4. Techniques of Cost Control

Cost control is exercised through the techniques of budgeting and standard costing:

- 1) **Budgetary Control:** It involves the following steps:
 - i) Establishment of budgets relating to responsibilities of executives to the requirements of a policy.
 - ii) Comparison of actual values with the budgeted value on continuous basis.
 - iii) Ascertainment of variances along with their causes.
 - iv) Devising and taking suitable corrective measures.

Budgets may be prepared for various activities like Production, Marketing, Capital Expenditure and Cash, etc.

- 2) **Standard Costing:** It involves the following steps:
 - i) Techniques of evolution and fixation of standards for the elements of cost.
 - ii) Comparison of actual costs with standard costs.
 - iii) Ascertainment of variances along with their causes and points of incidence.
 - iv) Devising and taking suitable corrective measures.
 - v) Evaluation of standards of different elements of cost, if necessary.

It is observed from the foregoing that standard costing is basically concerned with cost aspects of a business and so it is intensive, while the budgetary control is concerned with the operation of the business as a whole and hence it is extensive.

Further, budgetary control is a prerequisite for successful operation of the standard costing system in the organization. Thus, both the techniques are necessary for cost control purposes.

The cost control is the function of keeping costs within prescribed limits. It is based on the principle of predetermination of costs and achieving these cost levels so that inefficiencies and wastages may be reduced. Budgetary Control and Standard Costing are the two most used techniques of cost control.

The other techniques of cost control are the followings:

- 1) Ratio analysis.
- 2) Intra-firm and inter-firm comparisons.
- 3) **Material Control:** Control on purchase, handling and investment in materials.
- 4) **Labour Control:** Control on labour cost including labour time, productivity and remuneration.
- 5) **Overhead Control:** Control on production, administrative and selling and distribution overheads.
- 6) Control on capital expenditure.
- 7) Control Ratios.
- 8) Efficient reporting.

5.6.5. Difference between Cost Control & Cost Reduction

Cost Control	Cost Reduction
1) Cost control process involves: <ol style="list-style-type: none"> i) Setting targets and standards, ii) Ascertaining actual performance, iii) Comparing actual performance with targets, iv) Investigating the variances, and v) Taking corrective action. 	Cost reduction is not concerned with setting targets and standards and maintaining performance according to standards. Cost reduction is the final result in the cost control process.
2) Cost control aims at achieving standards, i.e., cost targets. It assumes existence of standards.	Cost reduction aims at improving the standards. It challenges standards and assumes existence of concealed potential savings in the standards.

3) It follows a conservative procedure and lacks dynamic approach.	It is continuous, dynamic and innovative in nature, looking always for measures and alternative to reduce costs.
4) It is a preventive function.	It is a corrective function.
5) In cost control, costs are optimized before they are incurred.	In cost reduction, there is always assumed a scope for reducing the incurred costs under controlled conditions.
6) It is generally applicable to items which have standards.	This is applicable to every activity of the business.
7) It contains guidelines and directive of management as to how to do a thing.	It adds thinking and analysis to action at all levels of management.

5.7. TARGET COSTING

5.7.1. Meaning and Definition of Target Costing

It is a pricing method and has been defined as "a cost management tool for reducing the overall cost of a product over its entire life-cycle with the help of production, engineering, research and design".

According to Cooper, "Target Costing is a disciplined process for determining and realizing a total cost at which a proposed product with specified functionality must be produced to generate the desired profitability at its anticipated selling price in the future".

According to CIMA, target cost is "a product cost estimate derived from a competitive market price". In the context of pricing in competitive environment, it is used to reduce cost through continuous improvement and replacement of technologies and processes. This is what according to management; the cost should be viewing the competitive market prices. These costs are generated externally based on analysis of the cost structure of the leading competitors in the industry".

5.7.2. Features of Target Costing

Following are the main features of target costing:

- 1) Target costing is a market driven process.
- 2) It is calculated by subtracting the desired profit margin from the target price.
- 3) The target cost is an independent variable and should not be affected by design decisions.
- 4) It is a simple yet powerful process to affect the profitability of the business.
- 5) It can be easily embedded in current processes.
- 6) It is a logical process for achieving targets.
- 7) Target costing integrates economic objectives and technical knowledge.

5.7.3. Principles of Target Costing

Target costing can best be described as a systematic process of cost management and profit planning. The six key principles of target costing are:

- 1) **Price-Led Costing:** Market prices are used to determine allowable – or target – costs. Target costs are calculated using a formula similar to the following:

$$\text{Market Price} - \text{Required Profit Margin} = \text{Target Cost}$$

- 2) **Focus on Customers:** Customer requirements for quality, cost, and time are simultaneously incorporated in product and process decisions and guide cost analysis. The value (to the customer) of any features and functionality built into the product must be greater than the cost of providing those features and functionality.
- 3) **Focus on Design:** Cost control is emphasized at the product and process design stage. Therefore, engineering changes must occur before production begins, resulting in lower costs and reduced “time-to-market” for new products.
- 4) **Cross-Functional Involvement:** Cross-functional product and process teams are responsible for the entire product from initial concept through final production.
- 5) **Value-Chain Involvement:** All members of the value chain, e.g., suppliers, distributors, service providers, and customers are included in the target costing process.
- 6) **Life-Cycle Orientation:** Total life-cycle costs are minimized for both the producer and the customer. Life-cycle costs include purchase price, operating costs, maintenance, and distribution costs.

5.7.4. Objectives of Target Costing

Following are the main objectives of target costing:

- 1) The fundamental objective of the process is to promote proactive cost management, planning and cost reduction.
- 2) It helps in identifying the costs, which the product must be manufactured as if it is to earn its profit margin at its expected target selling price.
- 3) Target costing breaks down the target cost down to its component level and determining the efficient way to supply them.
- 4) It helps managers to make comprehensive plans regarding product costs and decisions, implementation well ahead in time.
- 5) It is a comprehensive process to plan, manage and reduce costs.
- 6) Target costing helps to understand the markets and its competition. It also helps in making trade-off analysis.

Target costing gives attention to the needs of customers with regard to quality, cost and quantity which results in increased in profit margin.

5.7.5. Advantages of Target Costing

Following are the main advantages of target costing:

- 1) **Proper Delivery:** Target costing system delivers the optimal value proposition to customers.
- 2) **Minimizing Complexity:** This system helps in reducing product line complexity, lowering costs.
- 3) **Selecting Appropriate Technologies:** Appropriate product and process technologies are required to keep costs low.
- 4) **Lowering Design Mix Late in the Process:** Target costing adopts the opposite path to the traditional way of creating a new product. By involving product design late in the process of product creation, it reduces the possibility of designing a product which cannot be marketed due to high price or any other such reason.
- 5) **Create Competitive Future:** It helps in creating more competitive company by designing and producing products which are more marketable.
- 6) **Eliminating Cost Overruns:** This system sets cost target which helps in reducing the chances of cost overruns. It also makes the design team know that exceeding the target may lead to a reduction in profit margin or the gross rejection of the product.

5.7.6. Disadvantages of Target Costing

Following are the main disadvantages of target costing:

- 1) **Misuse of the System:** This system may be misused by producers to squeeze profit margins of suppliers by demanding materials at the lowest possible cost. This distracts the producers from the real target of the technique.
- 2) **Stress on the Design Team:** The system emphasizes on keeping costs below the target cost. This may cause uncertainty for the design team about the approval of the product.
- 3) **Takes Long Time:** Product development time is increased as the product undergoes several changes to reduce the costs and achieve the target.
- 4) **Too Many Opinions:** Since design team consists of people from various departments with diverging agenda, it may be difficult to reach consensus.

5.8. BALANCED SCORECARD

5.8.1. Meaning & Definition of Balanced Scorecard

In the early 19th century, balanced scorecard was introduced by Robert Kaplan and David Norton as a technique of performance evaluation. It helps to evaluate the performance of the organisation from diverse viewpoints. The reason behind such views is that managers are largely identifying the need of evaluating other facets of organisational performance in order to measure their

value-creating activities. Currently, the balanced scorecard has adopted a new approach. According to this approach, it is a broad system of performance evaluation that provides a balance between non-conventional financial methods and operational methods.

In the recent years, balance scorecard has been able to define itself as a best technique for strategic control. It acts a basis for the firms to validate they have launched the financial and strategic controls for their performance evaluation. It is considered most suitable for business-level strategies and can also be applied to corporate-level strategies.

According to Kaplan and Norton, "The balanced scorecard retains traditional financial measures. But financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology and innovation"

According to David Chaudron, Balanced scorecard is defined as:

- 1) A way of measuring organisational, business unit or department success.
- 2) A way of balancing long-term and short-term actions.
- 3) A way of balancing different measures of success such as – financial, customer, internal operations, human resource systems and development.
- 4) A way of tying strategy to measures to action.

5.8.2. Features of Balanced Scorecard

The features of balanced scorecard are as follows:

- 1) Balanced scorecard is a management tool focusing on both financial and non-financial goals of an organisation.
- 2) Balanced scorecard is a system of aggregating financial and non-financial measures of performance in one single card.
- 3) Balanced scorecard includes performance measures of four perspectives – financial, customer, internal business processes and learning and growth (innovation).
- 4) It need not be restricted to four perspectives; more may be added. The social responsibility and environmental performances are two possible perspectives suggested by I.M. Pandey. The other is human resources accounting.
- 5) Balanced scorecard focuses on the link between business processes, decisions and results.
- 6) Balanced scorecard is considered as a device to guide strategy, formulation, implementation and communication.
- 7) Balanced scorecard helps in tracking the performance and providing quick feedback for control and evaluation.
- 8) Balanced scorecard aligns with strategy leading to better communication and motivation which causes better performance.

5.8.3. Purpose of Balanced Scorecard

The purpose of balance scored card are as follows:

- 1) **For Strategy Communication and Clarification:** Members of management utilise the balanced scorecard for transforming the strategic goals into measureable targets.
- 2) **For Communicating Organisational Objectives:** With the help of balanced scorecard, the macro objectives of the organisation are changed into operational objectives, and are successfully communicated to all employees of the organisation.
- 3) **For Detecting and Aligning Strategic Objectives:** With the help of balanced scorecard, strategic objectives are effectively aligned with organisational departments or teams.
- 4) **For Aligning Unit and Individual Goals:** With the help of balanced scorecard, the goals of the department/team are effectively aligned with those of the individuals.
- 5) **For having Periodic Performance Reviews:** With the help of balanced scorecard, it is possible to have performance related feedback from organisational strategies and plans. This performance feedback is very important for developing or modifying the strategy implemented in the organisation.

5.8.4. Four Perspectives of Balanced Scorecard

There are four main perspectives to develop a balance scorecard. They are as follows:

- 1) **Financial Perspective:** Kaplan and Norton always considered the traditional need for financial data but gave priority to on-time and accurate financial data. Managers also follow the same criteria in case to finance and try to arrange it as soon as possible. Frequently, there is excess financial data for handling and processing. Therefore, it is required to centralise and automate data processing through establishment of a corporate database. But with the increasing stress on finance leads to "unbalanced" situation in comparison with other viewpoints. Thus, there is a necessity to involve surplus financial data like cost-benefit data, risk assessment, etc.
- 2) **Customer Perspective:** With the changing philosophies of management it is realised that customers are of utmost importance to the company. It is very essential to attain customer satisfaction. The indicators which define that customers are not satisfied can be: they will shift to other suppliers which are more capable to satisfy their required needs.

As a consequence, this may lead to future decline even if the company at present is earning profits. For distinguishing customers on different basis, can be in terms of types of customers and types of processes used for developing a product or service.

- 3) **Business Process Perspective:** This perspective is also known as internal business processes. This process helps the managers to assess the position of the business and whether the products and services offered by the company are able to satisfy the customers or not. Hence, the balance scorecard is mainly designed by the person who has in-depth knowledge about the process and not by the outsiders.
- 4) **Learning and Growth Perspective:** This perspective is associated with the individual and corporate self-improvement, which involves corporate cultural attitude and employee training. In a knowledge-based organisation, people/ workers are the main source of knowledge. It is essential for such knowledge workers to keep on learning about the changing occurring in the business environment. Managers can use the scorecard to measure the funds required for training of such people. Learning and growth perspective is considered as a crucial aspect of the organisation for their success.

According to Kaplan and Norton, learning is much more important than training. This process comprises of tutors, guides and mentors from the organisation and it also enables the workers to seek help of them if they come across any problem. It also uses technological tools known as the "high performance work systems" which is called by Baldrige.

Table 5.1: Strategic Controls and Financial Controls in a Balanced Scorecard Framework

Perspectives	Criteria
Financial	1) Cashflow, 2) Return on equity, and 3) Return on assets.
Customer	1) Valuation of ability to determine needs of the customers, 2) Effectiveness of customer service practices, 3) Proportion of repeat business, and 4) Quality of communications with customers.
Internal Business Processes	1) Asset utilisation improvements, 2) Advancement in employee self-confidence, and 3) Variations in turnover rates.
Learning and Growth	1) Developments in the ability to innovate, 2) Number of new products compared to competitors', and 3) Rise in employees' skills.

5.8.5. Advantages of Balanced Scorecard

Following are the advantages of balanced scorecard:

- 1) **Consensus on the Strategy at Executive Level:** A balanced scorecard is developed after a lot of brainstorming at the Board or Top level. At this level, discussion about the vision and core values of organisations is done. Therefore, every person can get aligned to the main objective and top

executives can identify the growth strategies clearly. It determines the priorities for the organisation thereby making the senior executives capable of visualizing the future more clearly.

- 2) **Communicates Strategy to the Organisation:** The steps needed to be undertaken by the organisation for achieving the goals are specified with the help of a balanced scorecard. It also specifies the working of the strategy and sets the priorities by ensuring a proper balance between different internal and external constraints. Thus, it facilitates leadership and makes the selected strategy valuable.
- 3) **Translates Strategy into Meaningful Goals:** The preparation of a balanced scorecard is done by identifying the specific goals and targets. This enables the organisation to plan about the activities to be undertaken to ensure the achievement of goals. Thus, by clearly defining the priorities and activities to be done eventually everyone is encouraged to focus on goal achievement.
- 4) **Employees Identify Themselves with Goals:** Since every employee is assigned a specific goal while preparing a balanced scorecard, therefore, every employee can easily determine their contribution to the success and growth of the organization. Employees should be clearly explained about the balanced scorecard at each probable opportunity as it will facilitate them to understand how their achievements are influencing the future of organisation. This develops a feeling of affinity in them and encourages them to be aligned with the vision and mission of the organisation.
- 5) **Personal Targets Linked to Strategy:** The goals identified by the balanced scorecard can be achieved only by the continuous contribution of many employees and process owners. The employees usually keep on stretching their assignment. Therefore, it is important to define a definite timeline for completing the assignment. However, sometimes the defining of timeline is not sufficient and it is important to link the strategy with the personal objectives of employees. This linking can be facilitated through balanced scorecard.

5.8.6. Disadvantages of Balanced Scorecard

Along with having several advantages and uses, balanced score card also possesses some disadvantages, which are as follows:

- 1) **Does not Provide Recommendations:** Balanced scorecard is responsible for describing the overall performance of the organisation, but it does not provide recommendations for solving inconsistencies in the strategy. Thus it cannot be used as a tool for strategic recommendations.
- 2) **Resistance from Employees:** Top management as well as other employees may oppose the implementation of balanced scorecard. The major factor behind this resistance is the perception that employee performances are not valued. Some of the employees see it as extra load of executive work.

- 3) **Not Fully Efficient:** Balanced scorecard is not inclusive of all financial activities, it becomes comprehensive when incorporated with an accounting system. Therefore, it cannot give a complete performance evaluation of a company.
- 4) **Takes Time:** The strategic system of the balanced scorecard is a lengthy process and consumes a lot of time. Consequently, it requires continuous reinforcement to successfully end the process.
- 5) **Can Show Low Profit:** If a company has a low initial cost then using a balanced scorecard will always assess the company as no profit making company and it would be a waste time and money. Thus, companies' using this method must have a high initial cost and time duration.