



**ICMAP**

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# COST AUDIT

## BENEFITS TO INDUSTRY

### Cost Audit is different from Financial Audit

**Financial Audit** merely focuses on compliance to the Law and the reporting needs of 'Shareholders' of the company, who are wealth creators of the business. It does not evaluate a company's performance with regard to cost of production. It also does not speak about the internal strength, efficiency, and sustenance aspect of the business.

**Cost Audit** focuses on performance evaluation and the stakeholders at large. It helps improve performance and production efficiencies by detecting deviations from standards, and reasons of visible and invisible losses, inefficiencies, wastages etc. It provides answers to the questions like "to what extent the labour is efficient or whether material is being used to the optimum extent?" It speaks amply about utilisation of resources, which is vital for managing the economy.

### Cost Audit is not Punitive in Nature

**Cost audit** is suggestive in nature and derives its force from the maxim '**Prevention is better than cure**'. In fact, cost audit helps in getting early warning signals for timely remedial actions.

The cost auditor is neither conducting 'investigative audit' nor 'forensic audit', which could detect any concealment of revenue. The cost auditor's role is only to analyze the 'costs' associated with the product. A Cost auditor verifies the basic elements of cost viz. material consumption, wages of worker and overheads ensuring that production cost has been arrived at as per principles of cost accounting.

**'Cost' is a crucial parameter for competitiveness**

**Cost Audit is a pre-requisite for industry**

**Cost Accounting System builds competitiveness**

**Industry must adopt best international practices**

### Why our Industries are not Internationally Competitive?

Business sustainability depends greatly on cost and competitiveness. In a liberalized and growing economy, effective use of productive resources is the main challenge. The survival and growth of an organization depends on competitiveness and competing edge of various parameters like adaptability, technology, quality, timeliness etc. and the most important the "**Cost**".

The Pakistani industry is facing global competition and challenges. The main detriment to foster Pakistan's competitiveness in the export market is the high cost of production of our industries. With the introduction of WTO and SAFTA, it has become inevitable that Pakistani companies should not only be quality conscious but also cost-competitive. **And for that, cost audit, among other things, is a pre-requisite.**

**The industries can optimize their cost of production by adopting Cost control techniques. Cost accounting system builds competitiveness in the Industry, and helps maintain competitive cost advantage to face the global challenges.**

**Cost audit** practice was adopted in the Sub-Continent in 1967 and today a number of industries are following cost audit practices. In Pakistan, Cost audit rules are applicable in three industries viz. cement, sugar and vegetable ghee /oil, with five more sectors added recently by the government, namely chemical fertilizer, polyester fiber, petroleum refinery, thermal energy and natural gas.

The Pakistan entrepreneurs must realize the fact that survival of their industries, in today's fierce market conditions, depends greatly on their adopting best international practices, removing inefficiencies and coming out of fears and apprehensions, associated with production, labour, tax and financial reporting etc.

## Cost Audit helps management in Accurate Decision-making

The entrepreneurs should have clear understanding of both the operational cost and marginal cost for decision-making purpose. They should also bring improvement in time management system for better labour productivity and increased efficiency. Some of the important areas, where cost accounting can be of a great help to the management in making accurate decisions, are highlighted below:

**Cost accounting aids management in deciding the adequacy or inadequacy of selling prices.** In period of depressions, slumps or in competition, the management is forced to lower prices even below cost of production and sale. In such circumstances, cost accounting helps management in deciding the extent of reduction and its impact on profitability.

**Cost Accounting helps in disclosing activities, departments, products, projects and territories, which bring profits and those that are incurring losses.** Management can then take decisions on the basis of these disclosures to discontinue any unprofitable products and operations or revise their production, sales and marketing strategies.

**Cost Accounting helps in maintaining material inventory items in line with production and sale requirements.** Production may stop or sales may be affected due to shortage of material. Similarly, inventory stored in excess of the production or sales requirements will result in unnecessary investment in working capital.

**Cost Accounting helps in correct valuation of inventories of finished goods, work in process, materials and supplies, by using the book inventory method (as against physical inventory method).** In this method monthly financial statements can be prepared without having a need to take monthly physical inventories.

Cost records provide information about the manufacturing costs of different finished parts. **This helps the management to decide as to whether purchase these parts from outside suppliers or manufacture them in factory.**

Cost accounting identifies controllable and uncontrollable items in manufacturing, selling and administrative cost, at each stage of production and sale. **This helps the management focus only on those costs, which can be reduced or eliminated.**

## Cost Audit is a Management Tool for Better Control

Cost Audit is admitted internationally by business enterprises as a management tool, rather than as a cost verifying mechanism. Cost accounting techniques, which are prescriptive (e.g. budgeting, standard costing, variable costing, pricing methods like target pricing etc.), help the management in controlling costs.

**Cost Accounting provides an effective check on the use of materials and supplies by each department, job, unit of production or service.** This eliminates or reduces misappropriations, embezzlements, deterioration, and losses from defective, spoiled, scrap and out of date materials and supplies.

**Cost accounting helps the management to compare the current cost of labour per job or operation with some previously incurred or determined cost,** thus measuring the efficiency or inefficiency of the labour force and assigning the work to employees best suited for it.

Entrepreneurs must understand both operational and marginal costs

Decision to fix realistic Selling Prices

Decision to revise production and sales strategies

Decision to keep proper inventory as per requirements

Decision on correct valuation of inventories

Decision to manufacture or purchase from Outside Supplier

Decision to reduce controllable costs

Control of Material and Supplies

Control of Labour Costs

## Cost Audit is Oriented towards Corporate Governance

In present economic scenario, the companies focus on good Corporate Governance and practices, for improving their image in the eyes of shareholders and other stakeholders.

The prospective investors and shareholders look for efficient utilization of resources, which can display the real strength of the Company in true sense and create “**value creation for stakeholders**”. **Cost Audit helps industry by giving direction for continuous improvement.**

## Cost Audit has a vital role in Consumer Protection

The consumers, in a liberal economy, are vulnerable to practices such as monopoly or predatory pricing. Curbing these practices requires a harmonized and authentic cost database. What is market driven price? If all the players are charging excessive / exorbitant prices, can we justify such price as a market driven price? We have witnessed the prices of Cement in our country, which are decided by forming cartels. **Cost Audit helps to detect such practices for protection of consumers' rights.**

### Major Benefits to National Economy

- Ensures optimum utilization of economic resources
- Brings economic competitiveness
- Safeguards against economic exploitation
- Brings down inflation due to reduced costs
- Better planning and price control by government
- Balances factors of production in industries
- Improves profitability of industries

### Cost Audit helps Industry to prepare Advanced Budget Plans

**Cost Budgeting is a preventive device for the Industry to rectify inefficiencies before they creep into the business operations or as they occur from day to day.** A cost accounting system helps the industry in preparation of various budget plans in advance of actual production and sale of goods. These budgets include budgeted statement of profits, budgeted cost of plant improvements, budgeted cost of production, budgeted cash receipts and payments, and so forth. These budgets show the plans of the management for future periods and they reflect the expected results of these plans.

### Zero-based Budgeting

Cost and Management Accountants can assist the entrepreneurs in adopting zero-based budgeting technique, which could help them in efficient resource allocation, improved operations through cost effective ways and detecting inflated expenses, for which the managers need to provide full justification.

### Major Benefits to the Industry

- Enhances operational efficiency of industry.
- Improves productivity and profitability of industry
- Highlights wastages, losses and inefficiencies
- Reduces raw materials consumption/ obsolescence / wastage.
- Ensures efficient management of resources
- Identifies idleness in capacity utilization.
- Provides clue to industry to divert resources into productive and remunerative channels.
- Detects standards of efficiency of management
- Helps compare actual and expected results
- Enhances trust of investors, financial analysts, banks, insurance companies and government.
- Helps to plan, operate and control stocks.
- Helps to evaluate production processes and performance of respective units.
- Helps in proper pricing of goods thus enhancing the trust of customers.
- Provides a base for systems audit, operational audit and energy audit etc. by the management.
- Detects errors, frauds and misappropriations
- Cost audit is not too expensive to conduct as it involves only payment to cost auditor.
- Increases competitiveness in the local and international market by still remaining profitable.

## Multi-Dimensional Application of Cost Audit in Global Economic Scenario

One can observe a shift in the focus of cost audit in the present global economic scenario. The foundation of cost audit system is solid and deep rooted, whereas its structure keeps on changing with the economic scenario. The tool of Cost Audit mechanism is multi-faceted, with universal application and ever-expanding utility, bringing long-term benefits for the industry.

Some new areas where cost audit can contribute immensely are as under:

### Anti Dumping and Counter Veiling duties:

**The provisions relating to anti dumping laws are of special significance in the context of cost accounting.** The determination of normal value, domestic price, quantum of injury etc. all requires cost information. Manufacturers in the developed world are so well equipped with data that they obtain speedy relief under WTO while benefiting from the lack of data available in developing countries.

**In Anti-Dumping cases, the International Dispute Resolution Authority accepts the authenticated cost data from the Cost Audit records, maintained by the companies.**

**An in-built cost accounting system could be a great support to the industry itself in order to check dumping as well as to provide inputs in cases of alleged dumping in legitimate exports.**

If our industries maintain cost accounting system, they can file and fight a large number of Anti Dumping cases against the foreign importers.

### Free Trade Agreement:

The domestic cost of product is the base for incorporating any item during the process of negotiations under Free Trade Agreement (FTA) signed by Pakistan with other countries. **The costs of items covered under Cost audit can be used by government for taking proper decision.**

### Transfer Pricing:

The Multinational companies have their prominent presence in Pakistan and they frequently transfer resources among associate concerns / inter units operating in different parts of globe. This transaction has a great impact on their profitability vis-à-vis tax liability. **The Cost Auditors can play a role in providing a system of check on such transfer pricing mechanisms.**

### Predatory Pricing:

For enhancing market share, the dominant players may opt for a price lesser than the cost, to eliminate the competitors. This, in long run, is detrimental to the common consumers. **The Cost auditor can help the Competition Commission in cases filed against predatory pricing.**

### ICMAP Professionals can help Industry in preparing Rescue Plans for Reviving the Sick / Idle / Non-performing Industrial Units

The revival of sick industry is of immense importance in the present and future scenario. The Cost Auditors can offer their expertise in preparing rescue plans for those sick / idle and non-performing industries units, which are working below capacity due to mismanagement or faulty planning. These professionals can help such units in overcoming their problems, achieving efficiencies and improving production capacity.

**THE TEXTILE-SPINNING SECTOR**, in particular, is presently in a deep crisis, with a large number of units either being sick or working at marginal level. Irrespective of few textile units, which can be considered healthy, others are giving average production. The textile sector can utilize the services of ICMAP professionals as Consultants, in diagnosing the reasons of sickness or idleness of sick textile units and putting them in operation with their consultation.

### Cost Audit Success Stories in Cement and Sugar Industries

#### ..... Cement Industry

<b>Actions taken by Cement Industry On the advice of Cost Auditors</b>	<b>Accruing benefits to Industry Because of Cost Audit</b>
Switch-over was made from furnace-firing to Coal-firing system	<ul style="list-style-type: none"> <li>- Substantial reduction in fuel costs.</li> <li>- Reduction in manufacturing costs by about 15%</li> </ul>
High burstage rate (over 1%) of paper bags taken up with manufacturers	<ul style="list-style-type: none"> <li>- Paper bags quality was improved.</li> <li>- Burstage rate reduced by more than half.</li> </ul>
Obsolete and slow-moving items of stores / spares tackled properly	<ul style="list-style-type: none"> <li>- Improvement in cash flows</li> <li>- Blockade of funds checked.</li> </ul>
Comparisons made of actual production of each unit with its rated capacity, budget and previous year's position	<ul style="list-style-type: none"> <li>- Variances in production were identified</li> <li>- Corrective actions taken to improve production</li> </ul>
Transmission losses in electricity checked, and captive power generation units installed	<ul style="list-style-type: none"> <li>- Cheaper electricity was produced</li> <li>- Cost of power supply was reduced.</li> </ul>

#### ..... Sugar Industry

The sugar industry has also immensely benefited from cost audit, especially in cost reduction

<b>Actions taken by Sugar Industry On the advice of Cost Auditors</b>	<b>Accruing benefits to Industry Because of Cost Audit</b>
Yield comparisons were made.	<ul style="list-style-type: none"> <li>- Pilferage, wastage and process problems reduced.</li> <li>- Raw material, WIP, Finished goods valuations improved.</li> </ul>
Refineries were installed by some sugar units to further process molasses and bagasse (earlier sold at nominal prices)	<ul style="list-style-type: none"> <li>- Better and profitable utilization of molasses and bagasse</li> <li>- Some sugar mills now produce alcohol and chipboards.</li> </ul>

### Scope of Service of Cost and Management Accountants

- Audit of Cost Accounts - under Section 258 of Companies Ordinance, 1984 read with the Companies (Audit of Cost Accounts) Rules, 1998
- Special Audit of sales tax records under Section 32A of Sales Tax Act, 1990
- Audit of Sales Tax Refund Claims under Section 32 A of Sales Tax Act, 1990
- Audit of Records of Registered Persons under Federal Excise Act, 2005
- Certify Audited Accounts of Non-Profit Organizations (NPOs) under Rule 211 of Income Tax Rules, 2002
- Certify accounts of Borrowers - under Prudential Regulation of State Bank of Pakistan.
- Certify accounts of Leasing companies under Leasing Companies Rules, 2000
- Appointment as Sales Tax Electronic Intermediary under Sales Tax Electronic Intermediaries Rules, 2006
- Appointment as Inspectors by SECP under Section 263 and 265 of Companies Ordinance 1984

For More Details ..... *Research Department*

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