

‘COST AUDIT’ IS NEED OF HOUR IN BANKING SECTOR

Abstract

Conducting a Cost Audit in a Bank supports effective Cost Management, which is vital for setting service prices, boosting profitability, and enhancing corporate governance. A reliable Cost Accounting System is crucial for a bank to accurately price its products and services, as it provides essential information for key managerial decisions.

Cost Audits enable comparisons across different branches or central processing centres or departments, helping to identify and resolve inefficiencies. They assist Banks in detecting and eliminating waste and operational weaknesses, leading to better resource use and increased profitability, key factors for maintaining competitiveness in today’s market.

Furthermore, Cost Audits offer insights into the profitability of specific products or services, aiding management in making well-informed decisions about their offerings. They also enhance a Bank’s Risk Management by providing dependable Cost Data necessary for strategic planning.

With precise and verified Cost Information, Bank Leaders can make improved decisions regarding pricing, resource allocation, and growth. Additionally, Cost Audits encourage transparency and accountability by ensuring stakeholders have access to clear and accurate cost details, thereby building trust among investors, management, and regulators.

In our country, Cost Audits are legally required for certain industries. Even where not mandatory, conducting Cost Audits helps banks comply with relevant regulations and guidelines.



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Although there is no formal, compulsory Cost Accounting System mandated by specific Reserve Bank of India (RBI) regulations for all Indian Banks, the

challenging financial environment, marked by rising operational costs and shrinking net interest margins, is motivating Banks, especially Public Sector Banks (PSBs), to voluntarily adopt and enhance their Internal Cost Management and Cost Accounting Practices. While implementing robust Costing Systems benefits performance management in Indian Banks, statutory Cost Audits are currently not required for the Banking Sector in India.

Current Situation and Reasons for Adoption:

Indian Banks face significant financial challenges such as rising operational expenses, an increasing cost-to-income ratio, shrinking net interest margins, and heightened competition, all of which negatively impact their profitability. These issues drive banks to implement improved cost control measures.

Cost to Income Ratio of Public Sector Banks (For the FY 2021 to 2025)

Sl. No.	Name of the Bank	2021	2022	2023	2024	2025
01	Bank of Baroda	49.21%	49.24%	47.72%	47.71%	47.94%

02	Bank of India	51.34%	54.48%	51.08%	51.73%	50.84%
03	Bank of Maharashtra	47.37%	44.26%	39.14%	37.55%	38.37%
04	Canara Bank	49.55%	46.16%	44.79%	47.04%	47.27%
05	Central Bank of India	59.70%	58.27%	56.35%	58.18%	58.87%
06	Indian Bank	48.55%	46.21%	44.20%	45.92%	44.77%
07	Indian Overseas Bank	48.54%	48.61%	51.94%	56.32%	47.14%
08	Punjab & Sind Bank	75.61%	63.16%	62.95%	72.16%	61.23%
09	Punjab National Bank	47.82%	49.38%	51.69%	53.37%	54.59%
10	UCO Bank	53.40%	49.89%	55.94%	59.74%	56.99%
11	Union Bank of India	46.02%	45.74%	46.27%	46.42%	45.48%
Average of 11 PSBs		49.57%	48.83%	48.41%	49.70%	49.15%
12	State Bank of India	53.60%	57.91%	53.87%	55.66%	51.64
Average of 12 PSBs		51.13%	52.31%	50.45%	51.98%	50.09

(Source: IBA Data)

Voluntary Adoption: Banks are increasingly focusing on cost reduction efforts and developing internal cost management systems to enhance efficiency and remain competitive.

Internal Decision-Making: Cost accounting, a subset of management accounting, provides detailed cost information crucial for internal decisions like optimizing pricing, evaluating product mixes, and improving overall operations.

Regulatory and Industry Support: The Institute of Cost Accountants of India (ICMAI) has recommended mandatory cost accounting and audits for banks to better manage non-performing assets (NPAs) and uphold financial discipline. While not compulsory for all, the value of enhanced cost information is widely recognized.

CAMELS Framework: The CAMELS rating system used by regulators to assess bank performance includes factors such as management efficiency and earnings, which rely on effective internal cost control and analysis.

Key Areas of Application in Banks apply cost accounting principles across various internal functions, including:

Profit Center Analysis: Identifying profit centers

like corporate banking, retail banking, and treasury operations, and determining their specific costs and revenues.

Product/Service Costing: Calculating the true cost of various products and services (e.g., loans, mobile banking, ATM services) to optimize pricing and resource allocation.

Overhead Allocation: Using methods such as activity-based costing (ABC) to more accurately assign overhead costs to particular activities and products.

Performance Evaluation: Utilizing cost data to evaluate the performance of branches, departments, and employees.

Risk Management: Employing cost information to assess project feasibility and manage risks related to lending and other operations.

Although comprehensive statutory requirements for cost accounting are not mandated for all banking operations under the Companies Act, 2013 (which applies mainly to certain manufacturing and service sectors based on turnover), implementing robust internal cost accounting systems is strategically vital for Indian Banks in today's challenging economic and competitive landscape. Increasing financial pressures strongly support the adoption

of advanced cost management practices to ensure long-term profitability and stability.

Need for Implementing Cost Accounting Systems & Cost Audit in Indian Banks: The main reason banks are exempt from mandatory Cost Audits is that they are already subject to strict financial supervision and comprehensive audit requirements imposed by their regulatory authority, the Reserve Bank of India (RBI). This strong regulatory framework, which includes risk-based internal audits, concurrent audits, and detailed financial reporting standards is deemed sufficient to ensure transparency and accountability, making an additional separate cost audit unnecessary. Although a statutory cost audit under the Companies Act is not mandatory, banks undergo various other audits that, together with effective internal costing systems, establish a solid governance structure:

Financial Audit: This required an external audit to confirms that the bank's financial statements (such as the balance sheet and profit and loss account) accurately reflect its financial status and comply with accounting standards.

Internal Audit / Risk-Based Internal Audit: Banks have strong internal audit mechanisms, often focused on risk, which assess operational efficiency, risk management, and compliance with internal policies and regulations. Reliable costing data can significantly enhance the quality of these audits.

Regulatory Audits: The RBI conducts regular inspections and audits to verify banks' adherence to banking regulations, capital adequacy norms (like Basel III), asset quality, and risk controls.

Management Audit: This audit reviews the effectiveness of all operational functions from planning to execution, a process greatly improved by precise cost and performance information.

In the banking sector, conducting a "Cost Audit" is most beneficial in departments that heavily impact the Bank's profitability and efficiency, especially where costs are complex, irregular, or variable. Such audits can evaluate cost-effectiveness and optimize operations in key cost centers including:

- Lending.
- Deposit Accounts.

- Banking Operations.
- Central Processing Centers.
- Technology Department, among others.

Costing Systems and their benefits in Indian Banks: Implementing formal costing methods, such as Activity-Based Costing (ABC), in banks results in multiple advantages:

- ① **Informed Decision-Making.** Access to detailed cost data enables management to understand the true expenses associated with each product or service (like various loan categories or digital banking offerings) and customer group, facilitating improved strategic and operational decisions.
- ② **Cost Control and Efficiency.** These systems help banks identify inefficiencies, manage costs, particularly increasing operational and infrastructure expenses and make better use of resources.
- ③ **Pricing Strategy.** Accurate cost calculation allows banks to establish competitive yet profitable pricing for their products and services.
- ④ **Performance Evaluation.** Costing systems provide a reliable basis for evaluating the performance of different departments, branches, and business units.
- ⑤ **Strategic Planning.** The insights derived support effective planning, budgeting, and forecasting, ensuring that business outcomes align with strategic goals.

Cost Accounting principles are highly valuable and frequently used internally by banks to enhance management effectiveness and benefit stakeholders.

- ⑥ **For Management.** Cost data enables banks to analyse profitability across various services or products (such as loans, credit cards, wealth management), control internal costs, detect inefficiencies, make informed pricing decisions, and optimize resource allocation.
- ⑦ **For Customers.** Efficient cost management can result in more competitive and fair pricing of services (like interest rates and

transaction fees), as banks gain a clearer understanding of the actual costs involved.

- ◎ For Shareholders. Improved internal cost control and operational efficiency can boost a bank's overall profitability and competitiveness, leading to better returns for shareholders. Additionally, rigorous financial audits provide assurance regarding the bank's financial health and regulatory compliance.
- ◎ For Regulators / Government. The comprehensive financial reporting and auditing frameworks already in place supply the Reserve Bank of India (RBI) and government authorities with essential data for policymaking and monitoring the sector's financial stability.

1. Core Banking Functions:

- a. **Lending and Credit Division:** Cost audits help identify the actual expenses involved in various lending activities, including loan processing and recovery.
 - ◎ *Cost of Funds:* The audit reviews costs associated with raising funds for lending through deposits, money markets, refinance facilities, and other borrowings.
 - ◎ *Loan Processing and Disbursement:* Analysis uncovers inefficiencies in the time and resources spent on application handling, documentation, and credit assessments.
 - ◎ *Management of Non-performing Assets (NPAs):* Cost audits examine the significant expenses related to recovery efforts, legal fees, and administrative overhead for bad loans.
- b. **Deposit and Account Services:** Understanding the true cost of managing customer deposits and accounts is essential for profitability.
 - ◎ *Cost-to-Serve (CTS) Analysis:* A cost audit identifies the expenses involved in servicing different types of accounts, highlighting the most profitable customer

segments.

- ◎ *Low-Cost Deposits (CASA):* The audit evaluates the effectiveness of initiatives aimed at attracting low-cost current and savings account deposits, which are vital for the bank's net interest margin (NIM).
- c. **Branch Network and Delivery Channels:** As banks move toward digitalization, cost audits assess the efficiency of both physical branches and digital platforms.
 - ◎ *Branch Operations:* Audits evaluate costs related to rent, staffing, and utilities to determine the profitability of individual branches or the entire network.
 - ◎ *Digital Channels:* Cost audits measure the efficiency and return on investment (ROI) of alternative delivery methods such as mobile banking, internet banking, cash deposit machines, call centers, and ATMs.

2. Support Functions and Key Strategic Areas:

- a. **Information Technology (IT) Department:** Since banks rely heavily on technology, the IT Department serves as a major cost center and is well-suited for efficiency audits.
 - ◎ *Technology Investments and Cost Audits:* These audits evaluate the cost-effectiveness of investments in emerging technologies such as cloud computing, artificial intelligence (AI), and data analytics.
 - ◎ *System Maintenance and Support:* Audits in this area help identify potential savings related to software licenses, hardware maintenance, and IT support services.
 - ◎ *Process Automation:* Assessing the return on investment (ROI) of automation projects ensures they successfully reduce costs and boost productivity.
- b. **Human Resources (HR) Department:** Personnel expenses constitute a large portion of bank costs, making HR a vital focus for cost audits.

- *Workforce Optimization:* Audits can reveal opportunities to restructure roles, eliminate redundant processes, and enhance employee productivity without relying on unsustainable actions like layoffs.
- *Training and Development:* Cost audits evaluate the ROI of training programs and their effects on employee productivity and retention.

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Cost Audit is crucial for Banks due to increasing Operating Expenses and Overheads, ensuring Independent Verification, improved Cost Management, Greater Efficiency, Precise Pricing, Stronger Governance, and Higher profitability

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- c. Procurement and Vendor Management:** Sourcing goods and services is a crucial area for cost optimization through auditing.
- *Vendor Consolidation:* Audits can uncover chances to cut costs by streamlining vendor relationships and negotiating more favorable bulk contracts.
- *Process Automation:* Audits assess how effectively procurement, invoicing, and compliance processes are automated to reduce administrative expenses.

3. Risk Management and Compliance:

- a. Internal and Regulatory Compliance:** As a regulated sector, the banking industry must adhere to a wide range of regulatory requirements.
- *Compliance Costs:* Cost audits can evaluate the expenses associated with regulatory compliance and help ensure these costs are managed efficiently.
- *Fraud Detection:* Audits can assess the effectiveness of fraud detection and prevention systems to reduce financial losses.

b. Asset Liability Management (ALM): This area deals with a bank's funding and investment strategies, focusing on controlling costs. Cost audits can verify that a bank is:

- Matching the maturity schedules of assets and liabilities to maintain stable funding costs.
- Diversifying its funding sources to optimize the overall cost structure.

Conclusion:

Although Indian Banks are not required by the Companies Act to undergo a specific

statutory Cost Audit, applying cost management principles is essential for their efficiency and profitability. By integrating internal costing systems with the existing thorough audit and regulatory frameworks, banks maintain strong financial stability and good governance. The Institute of Cost Accountants of India (ICMAI) has proposed making Cost Audits mandatory for the banking and insurance sectors to enhance transparency and accountability. As the Banking Industry becomes more strategic, implementing robust cost accounting systems and conducting audits will remain crucial for improving operational efficiency, financial management, and corporate governance. While a separate mandatory Cost Audit is not currently legally required for Indian Banks, the fundamental principles and advantages of effective Costing Systems are highly relevant and widely adopted internally to boost performance and create value for stakeholders. MA

References

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