

GUIDANCE NOTE ON PERFORMANCE APPRAISAL REPORT

***[Ref. Form-III to the Companies
(Cost Audit Report) Rules, 2011]***



The Institute of Cost Accountants of India

NOVEMBER 2012

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PRESIDENT



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FOREWORD

I am happy to note that the 1st edition of Guidance Note on Performance Appraisal Report (Form-III) as prescribed under the Companies (Cost Audit Report) Rules notified by Ministry of Corporate Affairs vide G.S.R 430(E) dated 3rd June 2011 is being brought out by the Professional Development Committee to guide the members of the Institute and Industry enabling them to prepare the Performance Appraisal Report as per the parameters and indicators agreed to between the Cost Auditor and the Company Management. The Expert Group constituted under the chairmanship of Shri B.B. Goyal, Adviser (Cost), Ministry of Corporate Affairs, Government of India deliberated upon performance indicators to be part of Cost Audit Report. Though it is a part of Cost Audit Report but this report is to be submitted only to Board of Directors of a Company. The objective of this guidance note is to equip the users with recommended approach to fulfill the new requirement of the Form III to the Companies (Cost Audit Report) Rules 2011. The reporting in Form-III to the Board of companies would create and enhance value for the stakeholders in an objective manner. The guidance note aims at providing a general framework and the users may adopt tools and techniques which are best suited for the company.

I acknowledge the appreciable efforts and contributions of CMA Milind Date and CMA Jagannathan, Practising Cost Accountants, CMA M. Gopalakrishnan, Immediate Past President and CMA A.S. Durgaprasad, Central Council Member of the Institute in bringing out the Guidance Note in the present form.

I thank CMA S.C. Mohanty, Vice President of the Institute, CMA Sanjay Bhargave, Chairman and other members of the Professional Development Committee for their contributions in bringing out "Guidance Note on Performance Appraisal Report" for use by members and industry.

I also thank CMA J.K. Puri, Chairman, and other members of the Technical Research Cell of the Institute for their valuable efforts and contribution in bringing out this comprehensive publication of the Institute.

I am sure that the Guidance Note will assist the cost auditors in preparation of Performance Appraisal Report as per the requirement of Company Management and also after assessing the contemporary trends of the performance management systems used by organisations of today to enable them to achieve triple bottom line (profit, people and plant) putting thrust on sustainability.



(CMA Rakesh Singh)
President

November 30, 2012
New Delhi



CMA SANJAY R. BHARGAVE
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PROFESSIONAL DEVELOPMENT COMMITTEE



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PREFACE

The Companies (Cost Audit Report) Rules, 2011 notified by the Ministry of Corporate Affairs vide GSR 430(E) dated 3rd June 2011 mandates submission of Performance Appraisal Report in Form III to the Board of Directors of the auditee company and is not required to be filed to the Central Government alongwith the Cost Audit Report. The Performance Appraisal Report is popularly referred as Form-III reporting to Board. This is a landmark in the history of companies in India, as this is the first time that a statutory prescription has been notified for an external Auditor to prepare and submit a Performance Appraisal Report to the Company Management. Performance Appraisal Report contains performance measures about the company's products, services, and the processes. Form-III reporting contains performance indicators such as knowing how well the company is doing, whether it is meeting its goals, whether its customers are satisfied, and whether appropriate actions have been taken to improve efficiency and whether improvements are necessary etc.

In most of the companies the performance analysis parameters are already in the purview of a structured management culture and the cost auditor may additionally provide an effective assurance service on selected performance indicators as desired by the management.

This Guidance Note would supplement the efforts of the Cost Auditor in preparing the effective Performance Appraisal Report. The basic objective of Performance Appraisal Report is to provide an actionable insight into costs and profitability for the management in the strategic and operational context. It inter-alia aims at satisfying the goals of management audit. It is concerned with providing the Board with information that it "should know" to take suitable actions to improve business performance.

The Performance Appraisal Report is more on principle based than format-driven. The contents of the report are to be mutually agreed between the company management and the cost auditor. Although Form III to the Companies (Cost Audit Report) Rules 2011 specifies ten areas of performance indicators, the cost auditor based on the suitability and requirement for the company may add other relevant areas or delete those not relevant to the Company.

I would like to acknowledge the appreciable efforts and contribution for preparation and bringing the Guidance Note in the present form by CMA Milind Date and CMA D. Jagannathan, Practising Cost Accountants, CMA M. Gopalakrishnan, Immediate Past President, CMA A.S. Durgaprasad, Central Council Member and also Members of PD Committee of the Institute.

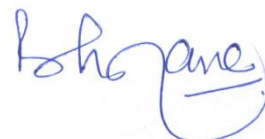
I would also like to acknowledge the contribution of CMA J.K. Puri, Chairman, and other members of Technical Research Cell enabling Professional Development Committee in bringing out this Guidance Note.

I would also like to thank all members of Professional Development Committee for their valuable contribution in preparation and for bringing out this Guidance Note.

I am also thankful to Shri J.K. Budhiraja, Director (Professional Development) and Secretary, Professional Development Committee, for the untiring efforts in finalizing this Guidance Note.

I would like to convey my sincere thanks to President CMA Rakesh Singh and Vice President CMA S.C. Mohanty of the Institute for providing guidance and able leadership in the affairs connected with the PD Committee.

I am quite hopeful that this Guidance Note will be very useful for cost accountants and industry for reporting requirement under the Form-III to the Companies (Cost Audit Report) Rules, 2011.



(CMA Sanjay R. Bhargava)
Chairman

Professional Development Committee

New Delhi
November 30, 2012

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1. PREFACE

1.1. The Ministry of Corporate Affairs vide Companies (Cost Audit Report) Rules, 2011 notified by GSR 430(E) dated 3rd June 2011 introduced “Performance Appraisal Report”. The Government has prescribed that Cost Auditors are required to prepare and submit a Performance Appraisal Report in Form III of the said notification, to the company. This is a landmark in the history of companies in India, as this is the first time that a regulatory mechanism has been notified which enables an external Auditor to prepare and submit a Performance Appraisal Report to the Company Management in addition to the assurance report. The Institute has brought out the present guidance note on Performance Appraisal Report, as required in Part III of the Cost Audit Notification dated June 3, 2011.

1.2. Performance measures help managers to create capable and matured processes. Measures are a tool to help understand, manage, and improve the performance of the organization as a whole. Effective performance measures can let us:

- Monitor performance to judge how well the company is fairing,
- Know if company management is meeting its goals.
- If appropriate actions have been taken to affect performance or improve efficiency if improvements are necessary.

There is no set number or formula to determine how many performance measures an organization should have. Tracking too many performance measures at once may cause managers to lose sight of which ones contribute directly to strategic objectives. On the other hand, having too few measures may not tell a good story about your work. Since the Performance Appraisal Report is to be submitted to the Board of Directors of the Company, the performance measures which will be appraised should be discussed with the Company Management and then finalized for analysis and reporting thereof.

This guidance is not on strategic management in companies but using strategic management process in the context of performance analysis of companies under Cost Audit provisions of the Companies Act, 1956. The guidance note is also not a prescriptive but a suggestive mode for performance analysis.

This guidance is about some of the theoretical perceptions on Strategies formulation and implementation, centering on cost implications. Understanding the theory without understanding

the ground reality is dangerous.

- 1.3.** The users of this guidance note may come across three types of companies. In the First category are those companies who operate at the global level with a robust system of strategic management processes, including detailed cost management mechanisms. In such companies, the utility of this guidance note may be limited and it would be the ingenuity of the Cost Auditor to locate areas of value-addition through the performance analysis. For such companies, most of the performance analysis parameters are already in the purview of a structured management culture and the cost auditor may additionally provide an effective assurance service on selected performance indicators as desired by the management.

The Second category of companies is the group consisting of leading domestic companies with a sight on the global market. Such companies would be receptive to any positive and meaningful recommendations from the Cost Auditor in the Performance Analysis Report. This guidance note would supplement the efforts of the Auditor in such situations, notwithstanding the fact that in ultimate analysis it is the ingenuity of the Cost Auditor to bring out the important parameters of performance that may be of interest and use to the management of the company in effectively entering/operating in global markets.

The Third category of companies is the group of domestic companies that are confined to domestic market, or even only a part of it, and includes small and medium sized companies. This guidance note largely addresses such a situation confronted by the cost auditors. The value addition provided by the profession in such a situation would strengthen the statutory role which it normally plays under the legal framework by the government.

- 1.4.** This guidance note would supplement the efforts of the Cost Auditor in all the three situations categorized above, and is the first version of guidance note on this subject. It is proposed to constantly update the guidance note on the basis of responses from the users of this guidance notes and further exposures in this area. The users are earnestly requested to send their responses, to the Institute for larger benefits.

2. PERFORMANCE ANALYSIS:

The rationale of Performance Appraisal Report (PAR)

- 2.1.** The basic objective of Performance Appraisal Report is to provide an actionable insight into costs and profitability for the management in the strategic and operational context. It aims at

discovering various drivers of costs and profitability and their impact on the selected performance variables. It would help the organisations:

- to improve profits and profitability
- to optimize resource allocation
- to optimize the product and services portfolio

2.2. The Performance Appraisal Report is to be provided only to the company under cost audit. The form III is NOT to be submitted to anyone else. In that sense, this report is a confidential and not public document. According to the rule 4 (5) of the Companies (Cost Audit Report) Rules 2011, the Performance Appraisal Report should be submitted to the Board or Audit Committee of the Board of the company.

2.3. The objective is to provide the management objective assessment of the performance of the organisation across various spectrums. It inter-alia aims at satisfying the goals of management audit. It is concerned with providing the Board with information that it “should know” to take suitable actions to improve business performance.

2.4. The Performance Appraisal Report is more on principle based than format-driven. It is clear that the contents of the report are to be mutually agreed between the company management and the cost auditor. Although some indicative areas have been specified in Form III to the Companies (Cost Audit Report) Rules 2011, the cost auditor is expected to verify the suitability for the company and then add other relevant areas or delete those not relevant to the Company.

2.5. It is also clarified that the frequency of the Performance Appraisal Report is to be mutually agreed between the company management and the cost auditor. The frequency of Performance Appraisal Report should be commensurate with the nature, size and complexity of the business of the company. Usually under the present form of corporate reporting, the BOARD OF DIRECTORS has to make an interim limited review of financial performance on a quarterly basis, immediately after the quarter is over. Ideally, the cost auditor can also consult the management and submit a quarterly Performance Appraisal Report. This will enable identification of business risks faced by the company in the immediate past and evaluate the risk mitigation measures that are planned by the Company in the subsequent period.

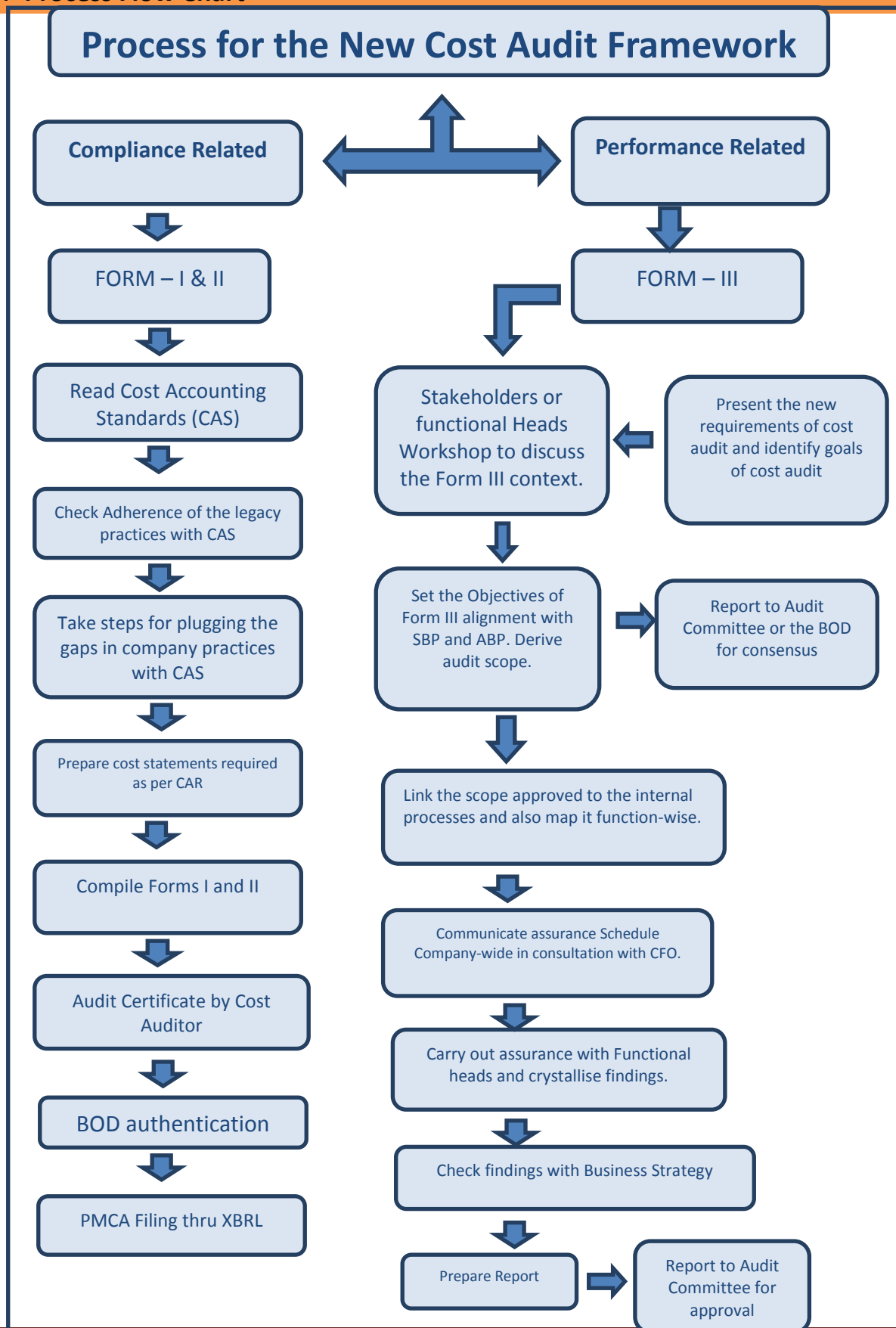
2.6. It has been clarified that there cannot be a “nil” performance appraisal report. This means that if the report is not issued or if the report is issued as “nil”, the cost audit report will be



incomplete. The cost auditor must certify in the main body of Certificate to the cost audit report (form II) that the Performance Appraisal Report has been submitted to the management. *(Refer to item number (viii) of form II – Companies (Cost Audit Report) Rules 2011.*

2.7. The Performance Appraisal Report should uncover the opportunities for improvement of performance and creation/enhancement of value of the business. The distinction between Forms I and II as a block in contrast with Form III to Cost Audit Report is presented in the form of a Process Flow below:

3. Process Flow Chart



4. Characteristics of a good Performance Appraisal Report

- 4.1.** It should be remembered that the Performance Appraisal Report is meant to be used by the company and this report is confidential.
- 4.2.** The report, being an annexure to the cost audit report, should basically lay more thrust on the cost management aspect of the business and should effectively bring out comments on how the business performance could be improved by elevating the cost performance.
- 4.3.** When commenting on or analyzing the cost performance, the cost auditor could assess the impact of changes in the costs on the profitability of the products, profitability by customers or market segments.
- 4.4.** The cost drivers that are the fulcrum of the cause and effect relationship in the cost statement, are the ones which form the first level of KPIs that are easily understood and actionable for the operational executives. The cost auditor while evaluating the KPIs can also look at the efficacy of the cost drivers. This evaluation will also enable the operational executives to relate what is being done at the shop floor to the cost statements that are the end product of the cost accounting system.
- 4.5.** It would be necessary to analyze the use of various resources to boost economy, efficiency and effectiveness of the operations. Economy indicates incurring of the least possible cost for acquiring and/or utilizing the resources, without compromising the quality. Efficiency denotes maximization of the output-input ratio. Effectiveness means achieving the desired goals. The Performance Appraisal Report should cover, at the minimum, all the three aspects of cost management.
- 4.6.** For being a valuable report, Performance Appraisal Report should portray analysis of a range of performance measures. While selecting these measures, care should be taken to include those having a material impact on the past or future performance of an organisation. These measures could change over period of time and may require to be reconsidered for inclusion to or exclusion from the Performance Appraisal Report.
- 4.7.** The following criteria may help the cost auditor to select and include the various performance measurement criteria in the Performance Appraisal Report:

- ✓ Effect on profitability

- ✓ Effect on resource utilisation
- ✓ Effect on liquidity
- ✓ Effect on risks
- ✓ Effect on quality
- ✓ Effect on competitiveness
- ✓ Effect on responsiveness to the market etc.

4.8. The Performance Appraisal Report should include non-financial performance indicators in addition to the use of traditional financial ratio analysis. The non-financial measures provide useful information about the probable future of performance of the company. E.g. a consistently good customer satisfaction index would guarantee a certain growth in business.

4.9. An ideal Performance Appraisal Report should possess the following characteristics:

- ✓ Objectivity
- ✓ Capability of being predictive value
- ✓ Comprehensiveness
- ✓ No information overload
- ✓ Coverage of strategic thrust
- ✓ Trend measures and current status
- ✓ Timeliness
- ✓ Segmented and enterprise-wide coverage

5. Suggested Mechanism for Performance Analysis

5.1 After analyzing the activities within each process, we come to the operational part of Form III of the Companies (Cost Audit Report) Rules 2011. We give below the suggested mechanism for performance analysis as follows:

5.2 In the above paragraphs, we discussed how the strategies are formulated, how they are implemented through the processes and now we come to assess the actual performance. Performance measures tell managers something important about the company's products, services, and the processes. Effective performance measures can let us:

- Monitor performance to judge how well the company is doing,
- Know if company is meeting its own set goals and if the customers are satisfied,
- Take action to affect performance or improve efficiency if improvements are necessary.

So we need to identify appropriate Performance measures so that the analyst is provided data and information necessary to make informed decisions. Performance measures provide a snapshot of current performance capabilities and track whether actual performance is getting better, staying the same, or getting worse over time. Machine hour rate is a performance measure which provides us inputs for various decisions. Capital expenditures tell about the investment of funds; we communicate the return on that investment through performance measures.

5.3 Keep the focus of the chosen performance measure on things that matter most, such as:

- Are we accomplishing our mission to analyze the performance?
- Are the processes achieving strategic goals and objectives?
- Are the customers satisfied?
- Are various processes being managed by the company properly?
- Are the output and outcomes observed result in the company being cost-efficient as the industry leader?

Narrowing the list of measures requires judgment and knowledge about the organization's systems and customers. Keep in mind that the audience who receives the information set the standard for what is relevant and important. Typically, internal audiences are interested in *process*-level measures and production *outputs*. Surveys may be measurement tools of last resort for qualitative subjects that defy attempts to measure them quantitatively, such as customer satisfaction. Survey scores can be useful to internal audiences, but usually mean little to external audiences. External audiences involved in budget and policy development are more interested in *efficiency* and *outcome (results)* measures. Because ultimate outcomes are often influenced by many factors besides a company's work, the most meaningful measures for judging effectiveness may be *immediate outcomes*.

5.4 Try to avoid common mistakes in writing about selected performance measures:

- Should not include explanations of why the measure is important or how the data is collected. Those comments belong to in operational details, footnotes, or unpublished notes.
- Avoid jargon and acronyms in performance measure titles, so readers who are not subject matter experts can understand what is being measured.



Don't word performance measures as objectives. Objective statements include words such as "increase" or "decrease," which imply change. Objective statements are not performance measures, although performance measures can tell us whether we are meeting our objectives.

6. EIGHT STEPS APPROACH SUGGESTED FOR PERFORMANCE APPRAISAL REPORT- Form III

In conclusion we present below eight steps involved in the preparation of the Performance Analysis Report for being submitted to the Board or Audit Committee of the company:

Preliminary discussion with the Management of the company to apprise them of the scope of Form III of the Companies (Cost Audit Report) Rules 2011, with specific reference to the company.

- 6.1.** Identify and understand the key strategies of the company, both prescriptive and emergent strategies included.
- 6.2.** Choose strategies that have more visible expressions in costs data maintained by the company.
- 6.3.** Identify the activities that were impacted by the strategies selected and also implemented during the year of cost audit.
- 6.4.** Analyze the cost implications of those activities and link it with the expected results of the strategies.
- 6.5.** Present the evaluation, in a table or any other easily comprehensible format like histogram, chart, graph etc.
- 6.6.** Give explanatory notes for the terms used, calculations made, and assumption behind the evaluations.
- 6.7.** Finalize the finding after a discussion with the concerned operating executives and then with the management of the company.



7. General Guidance on the first time preparation of Performance Appraisal Report

7.1. The Performance Appraisal Report being the part and parcel of the cost audit report, it would apply in all the cases where Companies (Cost Audit Report) Rules, 2011 apply with effect from 1st April 2011.

7.2. Before preparing the Performance Appraisal Report for the first relevant year, the following approach is recommended to be adopted by the cost auditor:

- The cost auditor first must clearly understand the nature of business operations of the company, its segmentation, the environment within which the company operates. It is essential to list the various business drivers and then prioritize according to the importance of each one of them. For this purpose, it will be useful to relate to the definitions of “manufacturing activity”, “mining activity”, “processing activity”, “product” and “production activity” as mentioned in the rule 2 of the “Companies (Cost Accounting Records) Rules 2011. This will provide immense insight for the cost auditor to understand the nature of business and then build the Performance Appraisal Report around it.
- The organization’s reporting structure is a crucial consideration. The responsibility centers recognised as investment centers, profit centers or cost centers should be correctly understood as the performance metrics for each of them would be different.
- The business drivers could, inter alia, include product life cycle stage, technology, customer preferences, market developments etc. This will enable the cost auditor to understand the variables that impact the performance of the company.
- It is recommended that the cost auditor collects and analyses the competitor information. Using this he could add value to the Performance Appraisal Report by clearly bringing out the comparative analysis of performance parameters.
- The cost auditor should, by having a series of discussions with the senior management, understand the existing MIS reports of the company and the objectives thereof. It is necessary understand how these reports help the management to make decisions for short term and long term.
- It is necessary to get agreed between the cost auditor and the company management the contents of the Performance Appraisal Report and the frequency of the issue which could

be half-yearly or yearly depending upon the need. More frequent reporting may not be feasible. The cost auditor should concentrate on financial as well as non-financial performance indicators. The selection of Key performance indicators (KPIs) for a highly diversified company may be difficult and should be done based on the economic relevance of each business in the overall performance.

- It would be better to provide the comparative figures for the previous one or two years as may be required in consultation with the management. The preparation time for the first report may be a little longer as the information may have to be collected and analysed for more than one reporting period.
- The cost auditor could summarize the plan in order to have clarity. A suggestive format of the plan is given in the Appendix- A

7.3. Once the terms of Performance Appraisal Report are agreed upon as above, the cost auditor should ensure that the company has the underlying information system which could throw up the data required for the preparation of Performance Appraisal Report. In case, the existing system is insufficient, the cost auditor could hold discussions with the IT head of the company.

7.4. The cost auditor is recommended to have a personal hearing from the head or member of the audit company and discuss the Performance Appraisal Report templates with them. The templates of Performance Appraisal Report could then be finalised.

7.5. The cost auditor should make a presentation to the general management team and the members of audit committee. This presentation should highlight the performance metrics selected for the Performance Appraisal Report, the logic of selecting them, and the way they would help the company to review its performance. The cost auditor should then present his independent evaluation of performance of the company. It should not only be diagnostic assessment, but should also include suggestions for improvements.

7.6. The suggestions for improvement could stem from comparing the performance vis-à-vis competition or any other benchmark selected (whether internal or external).

7.7. The Performance Appraisal Report should not contain only number crunching, but have meaningful conclusions drawn from the relationships that exist between various performance criteria.

7.8. The cost auditor must maintain proper record of all the information gathered from the company for the purpose of compiling the report. *(Please note this information is required for carrying out the cost audit work as well).* The record may be maintained to include:

- The company organisation structure with divisions, departments, SBUs, products and services handled etc.
- Details of information collected
- Source of the information – whether from the IT system or internal documents, board minutes, any other internal correspondence
- Basic assumptions like risk perception of the management, discount rates used in various calculations, the methods of inventory valuation, overheads allocation, absorption rate calculations etc.

8. General guidance on Performance Appraisal Report for subsequent years

8.1. Handling of the Performance Appraisal Report for subsequent years may seem to be simple. However, the cost auditor must exercise proper care to ensure that the Performance Appraisal Report is relevant and serves the objectives of the management and the audit committee. The cost auditor should revisit various aspects of the previous report and dwell upon the rationale thereof.

8.2. Depending upon the satisfaction of the Board or the members of Audit committee, the cost auditor should choose to continue reporting on the same parameters or may elect to alter some of them in consultation with the management.

8.3. For every subsequent year, it is necessary to question the basis of preparing and submitting the Performance Appraisal Report. If substantial changes have occurred in the business during the year (like merger or demerger, introduction of a new products, new markets, discontinuation of a product line, new technological development, or such other material changes), the cost auditor should make suitable changes in the contents and format of the Performance Appraisal Report.

8.4. It would be pertinent to highlight the effect of such changes on the overall performance of an organisation and also how these factors could potentially drive the future performance of the company.

8.5. The cost auditor should comment on the feedback on the previous year's Performance Appraisal Report. There may suggestion made in the previous year on which the management may have agreed to act upon. The Performance Appraisal Report should comment on the actions taken by the management and the outcome thereof. This is essential to ensure no issue remains open.

8.6. The Performance Appraisal Report would also highlight the success achieved as a result of suggestions made in the Performance Appraisal Report of the previous year/s. It is required to officially document the usefulness of the Performance Appraisal Report for the organisation.

9. Guidance on indicative contents of the Performance Appraisal Report

9.1. The form III of the Companies (Cost Audit Report) Rules 2011 has provided an indicative list of the contents. The critical parameters that have to be concentrated upon may differ from industry to industry and within the business amongst the business segments. Some KPIs may also be not figuring in the indicative list also. The cost auditor has to use his judgment in shifting between the chaff and grain and arrive at Performance Appraisal Report indicators that add value to the Company. This guidance note aims at providing the approach for each of those areas.

9.2. This approach would enable the cost auditor to include in the report

- The opinions and observations and
- Suggestions for improvement

9.3. The word "opinion" denotes "a view point". The cost auditor is expected give his/her viewpoint about "how something or someone has performed" during the reporting period. In addition, the cost auditor is expected to put a remark as an observation. This needs to be based on a critical assessment of the performance metrics. This may include quantitative and/or qualitative assessment of various performance indicators chosen for reporting. It is recommended that the cost auditor should establish an observed relationship between two or more parameters and the outcome thereof. This may mean cause-effect observations.

9.4. Based on the view point and remarks, the cost auditor should put forward suggestions or recommendations for improvement. The cost auditor may develop certain ratios in relation to the chosen metrics and then elucidate the analysis by comparing these ratios with the set benchmarks.

9.5. For each of the indicative area given in the form III, the guidance aims at providing the following:

- Meaning and Coverage of the area
- Performance measures related to the area
- Cost auditor's checklist

9.6. The guidance note covers the following indicative areas:

- i) Capacity Utilization Analysis
- ii) Productivity/Efficiency Analysis
- iii) Utilities/Energy Efficiency Analysis
- iv) Key-Costs & Contribution Analysis
- v) Product/Service Profitability Analysis
- vi) Market/Customer Profitability Analysis
- vii) Working Capital & Inventory Management Analysis
- viii) Manpower Analysis
- ix) Impact of IFRS on the Cost Structure, Cash-Flows and Profitability
- x) Application of Management Accounting Tools

9.7. For these and any other performance measures elected for inclusion in the Performance Appraisal Report, the cost auditor should also include wherever appropriate the following:

- Horizontal and vertical analysis of quantitative figures
- Trend analysis of performance parameters reflecting 3-10 years' figures
- Qualitative comments with interpretations of the cost auditor
- Comparison with external benchmarks such as industry average

10. Capacity Utilisation Analysis

- 10.1.** The basic quantitative information on capacity is covered in the Para 4 – Quantitative Information to the annexure to the cost audit report. However, this information is only indicative and does not provide analytical review. Capacity is usually expressed in terms of the final cost unit and where not so possible in terms of machine hours, people hours etc.
- 10.2.** The concept of capacity is highly subjective. While on one hand it denotes the availability of resources, it would also mean the maximum rate at which the company can produce goods or services. Capacity does have considerable impact on the profitability. The cost auditor should assess this impact by analyzing and relating the impact of capacity costs on profitability.
- 10.3.** The cost auditor should collect information of theoretical capacity, practical capacity, normal capacity and budgeted capacity for the period under review. Although the information may be available for all machinery & equipment, the cost auditor should identify the “constraint” that would limit the capacity of the entire organisation or product or a certain geographical area.
- 10.4.** The cost auditor should assess various capacity limits for better analysis and reporting. All these have costs and could affect profitability. These are:
- Internal physical capacity – machinery & equipment
 - External physical capacity – subcontracting and leasing
 - The capacity of manpower bandwidth at all levels
 - The financial capacity
- 10.5.** When comparing the actual production with the capacity, the cost auditor should identify and analyze the reasons for variation due to controllable and uncontrollable causes. It would help to concentrate on material impact caused due to idle time, break-downs, lack of power, lack of material, lack of demand. It would be advisable to compute the cost impact of these.
- 10.6.** Most of the capacity related information is available with the production and industrial engineering departments. The cost auditor should also refer to the CENVAT records for actual production data.

10.7. The cost auditor should comment on how the company responds to the variations in product demand by adjusting its capacity. This should be done with respect the cost impact.

10.8. The capacity performance measures could be:

- Capacity ratios to measure utilisation
- Identify bottlenecks & their impact on costs
- Ability to serve markets by creating short term capacity
- Analysis of throughput per hour of constraint capacity resource and return per hour at this resource (could be done decomposing the Throughput Accounting ratios)
- Committed capacity costs by process and managed capacity costs by process
- Impact of wastages on capacity utilisation

10.9. The cost auditor's checklist would include processing of information gathered from sources like:

- Technical documents pertaining to the equipment
- Production planning reports
- Interviews with managers responsible
- Wastage and down-time reports
- Benchmarking exercises done, if any
- External sources providing suggestive capacity reporting formats like CAM-I publications (Consortium for Advanced Manufacturing – International)

10.10. Suggested additional references

- Cost Accounting Standard (CAS- 2) – Capacity Determination issued by the Institute of Cost Accountants of India



- CAM-I capacity model developed by Consortium for Advanced Manufacturing – International, Texas
- Capacity Utilisation Bottleneck Efficiency System (CUBES) model
- SEMATECH's approach to Overall Equipment Effectiveness (OEE)
- Theory of constraints model (TOC)
- Balanced Score Card – by Robert Kaplan
- AA1000APS (Principles)
- AA1000AS (Assurance)
- AA1000SES (Stakeholder Engagement)

11. Productivity and Efficiency Analysis

11.1. Productivity involves variables of input resources and the output. Measuring, identifying and isolating the different input resources and analyzing their contribution to produce goods and services and their effect on costs and profitability is imperative for improving business performance. It should be noted carefully that productivity is a measure of efficiency per unit of output, whereas efficiency is generally measured in totality.

11.2. The cost auditor could understand and analyse the whole chain of input-processing-output. This analysis, while traditional and very basic, would help cost auditor to comment upon the performance of the organisation across products or product groups. It is necessary for the cost auditor to understand the input ingredients for each product, product group, customer etc.

11.3. Para 6 and Para 8 to the cost audit report provide some basic information about the input costs and their relation with the output. The cost auditor should further analyse these areas to identify causes of good performance and areas that need improvements.

11.4. The considerations in measuring productivity and efficiency performance could be:

- Performance of input factors such as material, people, tools, equipment, processes, management, capital funds etc.

- The output factors could be units produced and sold, number of customers served, reduced costs, improved responsiveness etc.
- It's not just the productivity, but the improvement (or lack of it) in it that must be measured. This could be done by identifying whether the company is able to
 - ✓ Achieve more output with same input
 - ✓ Achieve same output with less input
 - ✓ Achieve much more output with relatively less increased input
 - ✓ Achieve slightly less output with much less input
- For each selected area, the cost auditor should identify whether the improvement is permanent or temporary and report on the same. The recommended approach for the organisation should be focusing on the sustainable improvements. Care should be taken to identify and report potential manipulations.
- Alongside the productivity or efficiency ratios, the cost auditor should also analyse and report on the effect of the same on quality. The cost auditor should isolate quality of various inputs and their effect of the output.
- The performance measures in respect of this area could be:
 - ✓ Inputs utilised (material, man, machine, capital etc) per unit of output or output obtained per unit of an input variable
 - ✓ Wastages as percentage of input
 - ✓ Indices could be developed for Single Factor Productivity (SFP), Multi-Factor Productivity (MFP), Total Factor Productivity (TFT)
 - ✓ Inter-relationships in various productivity measures e.g. output per man-hour may have increase, but if it is accompanied by higher wastage per man hour, then there is no real benefit

11.5. The cost auditors checklist would include, inter alia, the following:

- The Bill of Material (BOM) for each product
- The standard cost card, if any
- Internal reports on consumption, wastages per unit of input to capture actual data
- Production scheduling and plans to measure labour & machine time productivity
- External benchmarking such as industry norms, best practices data etc. used by the company or generated by cost auditor for analysis

11.6. Suggested additional references:

- Publications by the Indian Productivity Council
- Industry association reports like Indian Machine tool manufacturers, Society for Indian Automobile Manufacturers, etc. to get the data on Industry averages for benchmarking

12. Utilities and Energy Efficiency Analysis

12.1. This is an extended analysis of single factor productivity in respect of the utilities and energy inputs acquired and consumed by the company. The importance of conservation of non-renewable energy needs no emphasis.

12.2. The utilities are resources that are used in the process of conversion of material and other components into a finished product, but these resources do not form part of the physical unit of the product. In manufacturing industries, utilities and energy form a substantial part of the conversion cost.

12.3. The broad headings under which the utilities and energy performance could be categorized are Power, steam, electricity, compressed air, water, etc. These utilities are consumed in the production process or in environment protection initiatives. The use of utilities for administrative functions may be found in terms of lighting, cooling, ventilation, heating refrigeration etc. The cost auditor should evaluate the impact from cost angle as well as from the viewpoint of conservation of energy. It is essential to check if there are any statutory norms prescribed for the company.

- 12.4.** The cost auditor should gather information on whether the company falls under the energy intensive industries as per the schedule attached to the Energy Conservation Act 2001. These industries include Aluminum, fertilizers, steel, cement, paper and pulp, sugar, textile, chemicals, petrochemicals, gas crackers, etc.
- 12.5.** For external benchmarking, it may be useful to refer to the practices followed by companies which are accredited by the Bureau of Energy Efficiency formed under the Energy Conservation Act 2001.
- 12.6.** The performance appraisal parameters for energy and utilities would include the consumption of fuel for generating energy and then the use of the energy thus produced per unit of final product. The performance parameters could include the following:
- Energy generated per unit of fuel consumed or fuel consumed per unit of energy generated. This could be applied for power, steam, electricity, water etc.
 - Measurement of improvement in power factor (denoting reduction in the KVA demand charges)
 - The cost of generating energy per unit and the cost of consuming the energy per unit of the finished product would be the critical part of the analysis.
 - Trend analysis of energy costs as percentage of total production costs is a good indicator of performance

13. Key Costs And Contribution Analysis

- 13.1.** The thrust here should not be only on computation of numbers or percentages for various product groups under consideration. The cost auditor should check the reasonableness of the contribution by benchmarking with the industry average wherever applicable.
- 13.2.** Financial performance is the major element of the performance management. This analysis involves assessment of major items of cost, their relationship with the volume of production and impact on the profitability. Para 6 -Annexure to the cost audit report provides information (for each product group) on operating ratios for the current and previous years. These ratios are computed as proportion of individual cost elements to the cost of sales.

- 13.3.** The cost auditor could provide analysis of the cost information by highlighting any significant variation therein during the reporting period. These variations are caused by non-recurring, onetime costs that may vitiate the ratios. Suggestions to avoid such variations may be provided in the report. This could be having long term rate contracts, supplier agreements, consumption controls etc.
- 13.4.** The cost information should include comparison of actual cost performance with the standards or budgets as the case may be. If the company is using target costs, the cost auditor could identify the cost gap and recommend the ways to reduce the same. The report should provide a commentary on variance analysis. The process followed by the organisation for investigation and correction of variances should be commented upon.
- 13.5.** In addition to these, it would be necessary to enlighten the company management with an in depth analysis of contribution earned by each product group. The contribution analysis may be given an absolute amount per unit of the finished product or in terms of percentage of sales i.e. the PV ratio. The cost auditor can add value by pointing out contribution earned per unit of the key constraint resource.
- 13.6.** The contribution analysis should also be extended to include the break-even analysis and the margin of safety at the current volumes. It may be necessary for the cost auditor to scientifically split the costs into fixed and variable elements. This split should be validated every year to find out structural changes if any. It will help to include inter-firm comparison for the same.
- 13.7.** The cost auditor should report on evaluation of use of the contribution analysis data by the management for decisions like pricing, accepting or rejecting an order, make or buy etc.
- 13.8. The checklist for the cost auditor could include reference to**
- Sales and production records
 - Reconciliation with CENVAT records
 - Price lists and discount structure policy
 - Product cost statements
 - Operational budgets

14. Product/Service Profitability Analysis

- 14.1.** The unit product or service profits are driven by two major components viz. cost per unit and selling price per unit. The cost auditor should analyse if the business belongs to the sellers' market or buyers' market. This would facilitate the assessment of impact of changes in selling prices and changes in costs on the profitability or otherwise of the products or services. While the selling price is a single number, the cost is the sum total of different elements. The cost auditor must ensure that the basis use to allocate indirect costs is consistently adopted by the company.
- 14.2.** In case of services, the unit of measurement is very important and hence carefully selected. Further, due to the diverse nature of services, it is essential to exercise care in analyzing the profitability thereof especially when the services provided are not standard. Many times, there is a combined contract for sale of product along with the service & maintenance contract. In such cases, the cost auditor should bifurcate the sales and costs for each portion and then compute and comment on their respective profitability.
- 14.3.** Care should be taken in splitting the joint costs in case of joint products and by products. The method adopted for separation of costs should be checked to ensure correctness and consistency.
- 14.4.** It would help to separately identify the costs of production, selling & marketing and handling customer services.
- 14.5.** The cost auditor is expected to provide a thorough evaluation to bring out the products and/or services that are contributing more or less to the overall company performance. For convenience purpose, the products and/or services could be classified in groups with similar risk-return profiles. This classification may be different from the 'product groups' in the cost audit report annexures.
- 14.6.** The analysis should separately appraise profitability of newly introduced products or services and also their proportion to the total profits of the organisation. The cost auditor should incorporate the profitability analysis of products discontinued during the period.
- 14.7.** The term "profitability" should be taken with an extended meaning to include, apart from the concept of accounting profit, the ROI analysis as well. It would be useful to analyse profitability of products/services in domestic and export market. Care should be taken to isolate reasons for



the changes in the profitability percentages. Similarly, if significant, profitability on sales to the related parties may be separately highlighted.

14.8. The report should specifically highlight the top five and the bottom five products. This will help the company to understand which products or services are contributing to the performance and which are ones that are non-performing. Based on this the suitable corrective actions may be suggested.

14.9. The checklist for the cost auditor could include reference to

- Sales and production records
- Reconciliation with CENVAT records
- Price lists and discount structure policy
- Product cost statements
- Operational budgets

15. Market / Customer Profitability

15.1. Certain industries focus on limited markets and customer types, while the others are broad based. The management may choose to understand its position in the different markets and different customers it serves.

15.2. The cost auditor should observe the segmentation method adopted by the company for analysing its profitability. The objective is to take suitable action for the segments that are not performing as per desired targets by introducing campaigns or to pull out of those segments that are no longer attractive.

15.3. The markets could be segmented on the basis of geographical locations such as domestic & international, zones or regions. They can also be segmented based on customers, e.g. OEMs, institutional, dealers, aftermarket, retail etc. These are normally termed as channels of distribution. Sales and supplies to Government, related parties could also be used for analysis.

15.4. The challenge in all the above named method of segmentation lies in the computation of costs for each of them. The cost auditor should carefully evaluate the allocation of costs to the different channels, especially marketing & campaigning costs.

- 15.5.** While analysing the profitability, the amount of turnover should not be ignored. There could be cases of improved profitability and dropping turnover levels for the different segments. The cost auditor should perform trend analysis to judge the performance in such cases and recommend suitable measures.
- 15.6.** A life cycle approach would provide better insight into the market or customer profitability analysis. Hence, the cost auditor could analyse the costs of acquiring the market or customer, costs involved in servicing and maintaining them and also costs involved in evaluating the potential thereof through market research. Example of how to look at “Cost per unit” when there are multiple customers and orders vary from quantities to deliveries. A Customer places the PO for X quantity to be delivered in four batches. Another customer places PO for Y quantity which is higher than Customer X, but delivery in equal number every month, which incidentally falls short of the minimum batch size. Here customer X, even though the quantity is lesser than customer Y, is economical to produce the required quantity as it costs less per item compared to Y.
- 15.7.** This aspect of the report should specifically highlight the top five and the bottom five markets and/or customer/customer categories. This will help the company to understand the most profitable markets and customers/customer categories and also the ones that are consuming resources but not yielding profits.
- 15.8.** In addition to the study of profitability, the cost auditor could comment on the risks associated with the markets and customers. This risk could be “concentration risk”, e.g. overdependence on a few customers or selling in one market only. The other risk may be related to defaults by customers. The analysis of bad debt history would help the analysis.
- 15.9.** The checklist for evaluation of performance in this area could be based on the study of
- Market and customer-wise sales and cost reports
 - The marketing campaigns undertaken by the company
 - Date on new markets or new customers added during the year



16. Working Capital And Inventory Management Analysis

- 16.1.** This part of the report should point out the efficiencies in operations through management of different components of working capital. The cost auditor should identify all the elements of working capital for each product group and evaluate the adequacy or otherwise thereof.
- 16.2.** In case of multi-unit operations, the working capital and inventory management is centralized, with sub limits fixed for each manufacturing locations. While the working capital assessment is done for the Company as a whole, the key factor which influences the working capital requirement of each unit have to be kept in mind and evaluated.
- 16.3.** On the whole, the cost auditor should critically examine the working capital policy of the company. The total working capital could be analysed into permanent and fluctuating components. It is necessary to check whether the funding of these components is consistent with the period of requirement.
- 16.4.** Working capital decision is handling of the conflict between liquidity and profitability. The cost auditor could provide an independent assessment of how it is being currently handled and how it can be improved.
- 16.5.** The analysis of working capital can be done using the traditional measures of ratios like current ratio, quick ratio, turnover ratios, number of days in operating cycle etc. These ratios could be computed for each product group separately. Analysis of the operating cycle of the company would be immensely useful.
- 16.6.** For manufacturing industries, inventory is the major portion of the current assets. The cost auditor should evaluate the inventory management policy which would include, inter alia, procurement policy, stocking policy, inventory valuation method, inventory records and physical verification procedures. Benchmarking of the policy pursued by the company with the industry averages will enhance the value of performance report.
- 16.7.** It will be appropriate to analyse the inventory into its components such as raw material and stores, work in progress and finished goods. For each of these categories, system of inventory control should be evaluated using tools like ABC or VAT or FSND analysis, EOQ technique, JIT system etc. The cost auditor should comment upon the quality of inventory asset using the inventory aging reports.

16.8. Another important component of working capital is receivables. Analysis of receivables is important for internal perspective (working capital management) and external perspective (customer management) as well. The cost auditor should peruse through the policy of the company regarding credit evaluation of customers, setting up of credit terms and credit limits, discount policy, collection & delinquency procedures etc.

16.9. Trade credit from suppliers is the most crucial spontaneous source of working capital funding. The performance in respect of this could be critical for operational efficiencies and liquidity of the company. The cost auditor could analyse the supplier-wise performance in respect of on time supply, quality issues, pricing, etc.

16.10. Observations about other components of working capital and trends therein could be noteworthy. These components may be loans and advances, other receivables and payables etc. the criteria for analysis here should be to find whether excessive amount is blocked in these areas. Cash management can be included in the analysis.

16.11. It will be helpful to include the observations on cost of working capital funding. These costs may include the interest paid on cash credit and loans, cost of using factoring services, cost of collection efforts, costs involved in cash management, cost of inventory carrying etc. These costs may be explicit or implicit. Reasonable assumptions could be made for computing the implicit costs. The total cost of managing working capital as a percentage of total working capital invested may be a very useful performance indicator.

16.12. The cost auditor's checklist could include the reference to the following:

- Records related to inventory of RM, WIP and FG, stock discrepancy reports
- Inventory aging reports, reports on treatment of non-moving items
- Reports on receivables – aging, timely collection, bad debt etc.
- Terms and conditions of working capital funds such as bank credit, loans etc.

17. Manpower Analysis

17.1. The depth of analysis of manpower could depend upon the proportion of manpower cost to the total cost of product or service. The performance criteria for this area will mainly be related to

the costs and efficiency or productivity. Again, benchmarking with the similar organisations would be helpful.

17.2. The costs may be categorized into the cost of recruitment, cost of maintaining the manpower and the cost of separations. Recruitments costs may include position advertisements, commission paid to recruitment agencies, participation in job fairs or campus recruitment etc. The maintenance costs may be the training & development costs, facilities provided over & above the monetary benefits etc. The separation costs would mostly be implicit costs. These costs as a percentage of the total salaries and wages would provide an insight into the quality of manpower management. These costs could be further broken up as per the hierarchies of people. The time taken to recruit important positions may affect the performance adversely.

17.3. The factor returns from the manpower is in terms of growth in production and productivity, enhancement of skills and knowledge of the organisation. The cost auditor should analyse the figures of manpower productivity, idle time, overtime worked, absenteeism etc. These factors could be compared with the respective outputs such as increased production, increased sales etc. The criteria such as sales per person achieved, production per man hour etc. will add value to the Performance Appraisal Report.

17.4. The Performance Appraisal Report may include comments and observations about the employee learning and growth opportunities and their linkage with the improvement in overall performance of the organisation.

17.5. The cost auditor's checklist for this content area may be:

- Details of number of recruitments done, number of people left, the labour turnover ratios
- The data on idle time, absenteeism
- Manpower productivity reports
- Use of temporary or casual labour
- Turnover at the higher level of management
- Training and developmental programmes and the feedback thereon

18. Impact of IFRS on the Cost Structure, Cash Flows and Profitability

- 18.1.** The new era of accounting standards has started in India after India committed to converge to the IFRS. The Ministry of Corporate Affairs had notified 35 new Ind AS in 2011. The timeline for the adoption of these new standards is not yet given. The date has been postponed in view of pending the suitable amendments required to be done in the other enactments.
- 18.2.** However, it will be useful for the cost auditor to run through the effects that the new standards may have on the organisations in the new era. The cost auditor should get acquainted with the requirements of the new standards and the differences as compared to the existing standards.
- 18.3.** In the Performance Appraisal Report, the cost auditor may point out the impact of IFRS on the existing cost structure, cash flows, and profitability. It may be noted that the new standards provide a principle based framework in place of rule based standards, and as such the companies may need to assess the effect of their actions and choices made for accounting.
- 18.4.** The five main elements of financial statements are assets, liabilities, equity, income and expenses. The IFRS provide for recognition, measurement and disclosure criteria for these elements. In cases, where the measurement criteria change, there will be an impact on the costs. The changed recognition criteria may impact the profitability and cash flows of the company.
- 18.5.** The most important effect on valuation will happen through the adoption of “fair value” concept in measuring various assets and liabilities. The cost auditor must enumerate the cases where use of fair value is mandatory or permitted as management’s choice. It should be noted that any change in the fair value as on the reporting date has to be taken to the profit and loss a/c.
- 18.6.** It may not be possible to split the effect of new standards on individual product or product group costs and profitability. It could be assessed for the organisation as a whole.
- 18.7.** These effects arise due to the balance sheet orientation of IFRS rather than the P & L smoothing practices followed by companies. Given below is an illustrative list of areas where major impact would be arising out of the IFRS provisions related to:
- **Revenue recognition** – companies may have to defer part or whole of their revenues
 - **Inventory valuation** – explicit rejection of LIFO method could change the inventory costs and thus profitability



- **Property, plant and equipment** – recognition of assets and depreciation may change, provisions on revaluation of assets are noteworthy
- **Financial instruments** – accounting for hedges and FOREX may result in profits or losses to be recognised or derecognized
- **Construction contracts** – there could be changes in contract revenues and profit measurement thereon
- **Impairment of assets** – recognition of provisions may impact profitability
- **Intangible assets** – certain existing assets may have to be derecognized
- **Business combinations** – some costs of M & A cannot be capitalized

18.8. The impact of changeover has been explained in the Ind AS 101 – first time adoption. It may be noted that the impact based on this standard would be in the first year in which the new standards are applied. In the first financial statements, the adjustments will have to be made in the retained earnings, subject to some exceptions and exemptions. This standard may require an entity to

- (a) Recognise all assets and liabilities whose recognition is required by Ind AS
- (b) Not to recognise items as assets or liabilities if Ind AS do not permit such recognition;
- (c) Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under Ind AS and
- (d) Apply Ind ASs in measuring all recognised assets and liabilities

18.9. The Performance Appraisal Report should include comments of the potential changes for the understanding of the Board and Audit Committee members. The cost auditor could provide them an insight to the likely changes in the cost structure. This content area is an important aspect to be covered till the new standards are not adopted. In subsequent years, it may lose its relevance.

19. Other areas that could be covered in the Performance Appraisal Report

19.1. As stated in the note to the form III, the above named areas are only indicative. It should, however, be noted that these are very comprehensive and could cover most of the aspects of enterprise performance. However, depending upon the specific characteristics of the industry

within which a company operates, the performance criteria should be chosen and included in the Performance Appraisal Report. It may be necessary to drop one or more of the above on the basis of their relative importance (or the lack of it) for the organisation.

19.2. Some additional areas of performance assessment actually may not directly comment upon the current or past performance but the likely future performance. The cost auditor should make use of the non-financial measures of performance that signal the direction in which the future performance is being driven. The various non-financial measures are listed in the appendix B.

19.3. Another set of parameters could company specific. The companies may track performance using parameters such as EVA and therefore the assessment will have to be done to meet the specific requirement.

19.4. The listed companies clearly bring out business specific factors that may affect their performance going forward. This is usually given in the “management discussion and analysis” in the annual reports. The cost auditor should benchmark these with companies in the same industry and provide observation thereon.

19.5. Risk Management: The Performance Appraisal Report should include the risk analysis that may affect the future performance. These could be macro variables causing variations like the economic indicators of India such as industrial growth trends, Government policy on commerce and trade, interest rates, international growth etc. The risks facing the business could arise out of technological changes, entry of competition, stages of product life cycle, FOREX rate movements, shifts in customer preferences, credit risks, etc. The cost auditor should

- Identify the sources of various risks
- Assess the potential downside or upside effect thereof
- Comment whether the risks are worth taking or suggest the acceptable range
- Recommend risk mitigation tools and techniques to be used
- Evaluate the effect of the existing risk mitigation tools used by the company

19.6. Environment and Sustainability: The Performance Appraisal Report could provide insight into how effectively the company is following policies on CSR, environment and sustainability. The importance of economic, social and environmental performance hardly needs any justification. The CSR index could be formulated to reflect performance in respect of socially responsible

products, socially responsible processes and socially responsible employee relationships. The index could comprise of spending by the company on these as a percentage of turnover. Similarly, the economic benefits from the environmental & sustainability initiatives could be indexed to the costs of such initiatives and reported.

19.7. Quality Performance: Quality is another important performance area. The cost auditor could include analysis of quality performance of the company. The quality performance could be assessed by relating the quality costs incurred versus the benefits achieved by reduction in customer complaints or increase in customer satisfaction index. The quality costs should be reported as prevention costs, appraisal costs, internal failure costs and external failure costs. It will be useful to analyse the changes in the composition of total quality costs and their impact on the sales and profits, e.g. higher spending on prevention would mean less costs on external failures, which in turn would reduce customer complaints and could bring in higher sales. Such analysis would provide good value for the user of the Performance Appraisal Report.

19.8. R & D Performance: The future performance of companies would depend upon their success of the R & D initiatives. The cost auditor could provide a useful lead in this respect by including analysis of the R & D costs. The analysis may include, inter alia, the percentage of successful research initiatives, the turnaround time taken for development, the response time taken for changes in designs due to customer requirement etc. Total expenditure on R & D initiatives as a percentage of sales turnover may be a good indicator of the technology leadership status of the company.

19.9. Business Process Performance: The cost auditor could evaluate various processes followed by the company and incorporate valuable assessment in the Performance Appraisal Report. The processes could be evaluated on the criteria like speed, accuracy, empowerment, hurdles, facilitation etc. The process performance would have a bearing on costs and profitability of the organisation. Transparent and ethical business processes would enhance the corporate image of the company and hence the cost auditor could bring out clearly how far the existing processes need to be modified. The cost auditor could suggest best practice adoption approach from the benchmarked processes of the industry. This data is usually available in the published case studies. It would be appropriate to highlight the processes that should be re-engineered.

19.10. Human Resource Accounting: This is an extended analysis of total human resource costs, both explicit and implicit, which are capitalised at an appropriate discount rate. This value of human capital is reflection of the enhanced value that an organisation could create by owning the

human asset. The cost auditor could observe the value of human asset and link it to the returns. This is an upcoming performance measurement criterion.

19.11. Value Added Analysis: The performance of a company could be measured in terms of the value based approach. The value added is measured as an absolute value created by the business and the distribution thereof to the employees and other providers of capital. The growth in the value added over a period of time could be observed and commented upon.

19.12. Performance of Intangible Assets: The business may have internally developed intangible assets. In financial accounting these are generally not capitalised. It is possible to use value based approach. The value created by the intangibles could be computed as excess returns earned by the company over the industry average. This excess is supposed to be earned due to the presence of intangible assets like brand.

19.13. Stakeholder Performance Analysis: This would mean analysing various performance parameters for the different stakeholders. The performance for shareholders could be denoted by EPS growth, the stock price performance, market capitalization, dividend growth, EVA etc. The lenders' parameters would be interest coverage and debt-service cover ratios. The suppliers would look for business growth, and on time payments. Customers expect on time delivery, proper pre and post sales service, and reasonable prices. These are performance metrics could be included in the Performance Appraisal Report.

20. Management Accounting tools

20.1. The performance measurement involves collection of information, analysing the same by establishing the inter-relations between them, interpreting the results and then arriving at meaningful conclusion. The collection of information depends upon various sources of data and other reports for various systems used by the organisation.

20.2. The data input is generally made in the accounting system used by the company e.g. the ERP systems. Most of the ERP systems facilitate input and capturing of even the non-financial data which can be then processed to produce desired reports. There is a lot of information to be accessed from outside of the ERP system. The cost auditor should identify such sources within and outside of the organisation and use information drawn from the same.

20.3. The management accounting tools could be used to analyse the performance with different purposes. The cost auditor should verify the tools and techniques used by the company and



comment on appropriateness and adequacy thereof. The cost auditor could recommend more appropriate management accounting tool.

20.4. The following table shows various management accounting tools that are used to serve different objectives:

Purpose	Management Accounting tool
Control	Budgetary control, standard costing, variance analysis
Cost computation	Full(absorption) Costing, Job, batch, process or contract costing Activity based costing, Time Driven ABC
Cost reduction	Total Quality management, Quality costing, Kaizen costing, Lean manufacturing, Value Analysis and Value Engineering, Six Sigma
Pricing and decision making	Target costing, Life cycle costing, Throughput accounting, Variable or marginal costing
Total performance management	Balanced Scorecard, Performance Prism, Performance pyramid, Business Objects, Business Intelligence

20.5. The cost auditor should be acquainted with the intricacies of these and such other tools and what it takes to successfully implement and use them. The success of Performance Appraisal Report would depend upon not how many performance measure are considered, but upon how they are evaluated and assessed with the help of various management accounting tools.

Planning for the Performance Appraisal Report

Key Performance Indicators (KPIs) are simply the variables, independent or interdependent, in respect of which the goals can be set and performance measured to assess whether it is in furtherance of the enterprise objectives. Hence, for evaluation of performance the selection of KPIs must be chosen correctly in tune with the objectives. The KPI measurement should not be a static computation, but always needs to be compared with a benchmark set. The KPIs could be:

- a) **Quantitative** – these can be financial or non-financial
- b) **Qualitative** – these are often lead indicators i.e. they influence future performance
- c) **Actionable** – those which can be influenced by enterprise actions or controllable
- d) **Trending** – those which need to be assessed over a period of time to observe whether they are improving or not

At the outset, based on the initial discussion with the management, a proper checklist may be drawn in the following format for planning the Performance Appraisal Report:

KPI (performance measure) Also indicate if strategic or operational	Type of KPI (whether quantitative or qualitative)	Functional areas affected by KPI	Persons/ departments responsible	Measurement criteria	Comparison with (budget, standard, external benchmark etc)

Depending upon merit of each case, the cost auditor could factor in other things such as source of the information, measurement frequency, time periods to be covered, etc. This will facilitate clarity of understanding and once the cost auditor gets the management's nod on these basic elements, the Performance Appraisal Report can certainly be a value adding proposition for the company.



Appendix B

Suggestive list of KPIs

Performance area	KPI	Measurement
Financial performance	<i>Turnover</i>	Segmental revenue to total revenue %
		Segmental turnover growth %
		Total turnover growth %
		Growth % in new product sales
		New product sales as % of total sales
		Customer-wise sales
		Top 5 customers, bottom 5 customers' sales
	<i>Margins</i>	Gross margin % on total sales
		Gross margin % on segmental sales
		Gross margin % on new products
		Customer-wise Gross margin %
	<i>Costs</i>	Element-wise cost % to total turnover and segmental turnover
		Cost composition – nature-wise, variability structure, functional split
	<i>Returns</i>	ROI on product groups
		ROI on geographical segments
		ROI on new products
		ROI on new markets
		ROCE
		Value added to total income



Performance area	KPI	Measurement
		Earnings per share (EPS) Dividend per share (DPS) Retention ratio Price-Earnings (PE) ratio Market price per share
	Balance sheet	Current ratio, quick ratio Asset turnover (current and fixed assets) Growth in assets Capital expenditure % to total assets Debt-equity ratio Debt to total capital employed
Productivity & Efficiency	Material	Material cost % to total cost Material wastage as % to total input Contribution per unit of material used
	Labour	Production per man hour Production per employee Employee cost % to sales Idle hours % to total available hours
	Machine	Production per machine hour Growth in machine capacity utilisation Machine downtime ratio Break-down hours
Manufacturing performance	Operating	Material turnover



Performance area	KPI	Measurement
	<i>cycles</i>	WIP turnover Finished goods turnover
Customer performance	<i>Complaints</i>	% of customer complaints to total orders Response time to resolve a complaint Customer-wise number of complaints Number of complaints repeated
	<i>Development</i>	Business growth % over 3 years
	<i>Risks</i>	Payment defaults Delinquencies Payment delays
	<i>Retention and satisfaction</i>	Customer retained over 3 years Customer satisfaction index On time order execution % Correct documentation % Customer orders delivered in full % Average time spent on customer relation
	<i>Overall</i>	Order-to-cash cycle days
Supplier performance	<i>Delivery</i>	On time supplies Supply of full quantity
	<i>Quality</i>	% of rejections
	<i>Cost</i>	Price reductions agreed – cost effect Price escalations given – cost effect



Performance area	KPI	Measurement
	<i>Overall</i>	Supplier satisfaction index Accuracy of forecasts shared



Additional references for cost auditor

1. Annual reports of the companies for current year and past years
2. Guidance given by companies to stock markets
3. Written Policy documents of the company
4. Company web-sites
5. Web-sites of industry associations
6. Macro-economic data from RBI, Ministry of finance and commerce & industry etc.
7. Management accounting tools and techniques – reference books and hand books
8. Cost accounting standards issued by the ICAI
9. Accounting standards and Ind AS issued by the Institute of Chartered Accountants of India
10. Generally accepted cost accounting principles (CAGAP) published by ICAI
11. Stock market information on prices, market capitalisation, market returns
12. Minutes of board meeting to the extent relevant
13. Personal meetings with the CEO/MD of the organisation and members of the audit committee and the Board
14. The cost accounting policy of the company
15. The cost accounting system of the company – costing methods
16. The CENVAT and VAT records maintained by the company
17. The monthly MIS reports – concentrate only on exceptional reports

White Paper on MANAGEMENT CONCEPTS IMPACTING CURRENT PERFORMANCE FRAMEWORK:

1.1. Strategies can be seen as the process of building on or stretching a company's resources and competencies to create opportunities for the company to benefit from them. It means identifying existing resources and competencies and using them to create opportunities in the market. Strategies may require major and comprehensive resources changes for the company. This would be in terms of the extent to which resources can be obtained and controlled to develop strategies for the future.

Strategies do affect operational decisions. Operational aspects of the company need to conform to the strategies to achieve the goals of the strategies. Also, only at the operational levels the strategic advantages are achieved. Performance Analysis report as discussed in this Guidance note, takes this view of linkage between strategy formulations and operational dimensions. Strategy will be affected by the values and perceptions of people around the company who have power in and around the company, like investors, shareholders, consumers, suppliers and the regulatory authorities.

Strategies formulated in a company can be grouped into three levels: The Corporate Level, The Product Group Level and the operational level. All the three levels, it must be emphasized, are closely inter-related. In this guidance note we focus more on the Operational levels and Product group levels, notwithstanding the significance of the Corporate Level strategies on these two levels of strategies. While the Products group level strategies largely concentrate on gaining/maintaining Competitive advantages, the operational level strategies focus on processes and resources allocation. Strategies implemented, have a wide range of implications including cost implications. A Cost Auditor should focus on the cost implications of strategic decisions and their implementation, not losing the sight of other implications. Familiarity with the strategic management process will be an essential requisite for this focus .

1.2. Strategic Management Process:

Strategy and strategic management are significant aspects of company's decision making process in a specific political and cultural context and the performance analysis would include a rational

assessment of the strategies and implementation thereof. However, the Para III of the Cost Audit Report Rules, 2011, would also deal with those aspects of company's performance which have cost implications in a strategic context. While it is true that the notifications of June 3, 2011, prescribing Para III, do not restrict to operational performance analysis with cost implications only, this guidance note is based on the premise that the Cost Auditor's role in performance appraisal report can be extended to strategic areas expressible in terms of cost impacts. There is a sufficient scope for reporting on overall performance, because of the recent thrusts in companies on resource-led strategies which tend to have significant cost implications.

1.3. Strategic Management is concerned with:

Strategic Analysis>Strategic choices>Strategic Implementation

All the above three segments are inter-related. Performance Analysis is evaluation of the results of the implemented strategies, in the context of strategies chosen after Strategic Analysis. Hence the Cost Auditor preparing the Performance Appraisal Report should be well versed with this cycle in the company under audit. The guidance note takes this perspective and presents a brief description of the Strategic Management process for the practicing members to appreciate the theoretical context behind the appraisal process.

Strategic Analysis:



1.4. The strategic management process is concerned with the issue of positioning the company in the context of its environment, competitive and others. For example, a small company may be engaged in finding a niche' in the emerging competitive market. The Strategic management process is also involved in finding ways to extend the company to a perceived future position with

higher levels of competitive advantage. One of the important factors on which success of company is dependent, is the strategic capability of the company which is based on judicious use of resources to build competencies and achieve core competencies. We also know that the core area of analysis under Cost Audit is the study of the Resources of the company. The cost audit, in a way, attempts to assess the inherent strengths of the resources of the company in the contexts of the strategies of the company as well as in comparison to other users of similar resources. The appraisal of the resources of the company, in terms of its competencies and efficiency, will be a significant input for the Management. Hence, the Performance Appraisal, primarily, should focus on the resources of the company both in terms of usage in strategies' implementation as well as in terms of the outcomes of its usage. It would also include an appraisal as to the uniqueness of the resources of the company that adds to its competitive advantage.

1.5. Resources

Resources of any company may be grouped:

(a) Physical resources:

Queries should be raised as to the nature of these resources, such as age/condition/capabilities, and the location of the resources to the extent of their usefulness in contributing to the competitive advantage of the company. Capacity utilization, a performance indicator, analysis is a good example to appreciate the meaning of physical resources' performance. Input-output ratio, machine hour rate are some of the factors that may throw light on the usage of physical resources.

(b) Human Resources:

Skill base of this resource, under each category, its conformity with the strategies are important areas of analysis and evaluation. Similarly, the adaptability of the human resources to the strategies formulated, needs to be examined while evaluating the operational processes as well as their outcomes.

(c) Financial Resources:

Financial Resources are the money available to a business for spending in the form of cash, liquid securities and credit lines. Simply put Financial Resources represent the money that is available for a person or organization to spend. Before going into business, an entrepreneur needs to secure sufficient financial resources in order to be able to operate efficiently and sufficiently well to promote success

Companies often need funding for starting or continuing business operations. Small businesses typically need start-up funds, while medium and larger companies may need funding to expand operations or purchase competitors. Different types of funding are usually available based on the company's size and needs. Companies may choose to use traditional funding sources such as banks and equity investors or apply for government grants or venture capital funds. Each funding type offers different advantages to companies with different costs associated with them.

Corporate financial management plays a cardinal role in organizational decision-making processes, enabling companies to manage risks adeptly, administer liquidity ratios and increase profit indicators. Central to corporate strategies are management accounting procedures that organizations select in the short- and long-terms.

(d) Intangible Resources:

Performance analysis should also take into account the intangibles as this is gaining in importance in determining or shaping competitive advantage. For example, capacity utilization of machine and processes are increased often to improve the brand image and not for any focused Sales growth. In such cases, the capacity utilization enhanced is a pointer to the brand image strategy in place and not to be confused with sales growth. The performance analysis should include audit of all the resources of the company that support its strategies, including resources like network of contacts or customers.

The cost auditor will do well to identify resources that are critical in underpinning the company's strategies. That is, which are the resources on which the successful performance of the strategies, implemented, depends?

1.6. Competencies

Difference in performance over time in the same company or differences in performances of different companies in same industry, cannot be explained only by the differences in their resources base, but also need to be examined in the manner in which the resources have been deployed. Resources deployed in various cost centres would indicate the competencies of the company in activities within a cost centre. These are the competencies that help the company in gaining or strengthening its competitive advantage. Competencies are those which are the strengths of the company in using its resources. They are difficult to be imitated by competitors. The bases of competencies of company could be any or all of the following:

a) Cost efficiency; b) Value addition:

The Performance Analysis process should examine the above factors in identifying the core competencies (those that are unique to the company) of the company and their comparisons through appropriate benchmarks. This is an area of professional expertise of the cost auditor.

Core competencies (cost efficiency being an important one) in different activities contribute to the competitive advantage of the company. Identifying the core competence of the company in various activities/cost centres and providing performance appraisal of them, periodically, is within the scope of the Performance Appraisal Report. Creating and managing these core competencies provides leverage and levels of performance that are difficult to imitate by competitors, and hence the competitive advantage to the company.

1.7. Value Chain:

It needs to be appreciated that many company attempts to gain competitive advantage by appropriately linking its own activities with those of the suppliers, channels or customers. Vertical-integration, quality controls on inputs from suppliers, total quality management strategies, controlling distributors' performance through training/financing etc., collaborative arrangements etc. are some of the ways in which company's own activities are beneficially linked to other organizations. This provides an avenue for reporting under performance analysis report. What has been the cost of such coordinating strategies and how much of competitive advantage of the company has improved or strengthened at present level? If such linkages with other companies are established as a matter policy, every year, then performance as to the cost efficiency in such coordinating/cooperating linkages can be an area for appraisal for the Cost Auditor.

1.8. Benchmarking

A company's capabilities (resulting from core competencies) are to be assessed, ultimately, in relative terms. Items like capacity utilization at a given level Sales value, contribution ratio, investments in green initiatives, contributions to social responsibilities, are of no use unless juxtapositioning them with other companies' similar data. Such an attempt is usually known as Benchmarking. It is important to note that benchmarking technique, both internal and external to the company, would be an important tool for reporting on the performance appraisal by the Cost Auditor. While historical comparisons are important, they may be limited in their potential to draw conclusions. Hence, comparison with outside organizations for each or group of activities may be advantageous in analyzing the real performance. It is always a welcome input for the top management of the company, when an external assurance professional provides a comparative analysis of the company's performance with

that of best practices in the Industry. Having mentioned the relevance of Benchmarking under Performance Appraisal Report, it must be stated in clear terms that it is a challenging task for the Cost Auditor and it would require good amount of hard work to get appropriate benchmarks and use them effectively. In the initial years, historical data comparisons, input-output data available in public domain may be used and slowly graduate to higher levels of benchmarks acquired through specific in-depth studies undertaken by the cost auditor. It must be mentioned that it is necessary for the Cost Auditor to identify areas for benchmarking, after a detailed consultation with the Management of the Company. Many companies do have a system of collating Benchmark data and using them for internal analysis. It is also important to note that benchmarks can be for individual activities, group of activities, processes, outcomes including final products/services.

2. PROCESS MAPPING AS A TOOL IN PERFORMANCE MANAGEMENT AND EVALUATION.

2.1. Definition of “process”: “A collection of interrelated work tasks, Initiated in response to an event.” The objective of a process is to achieve the specific result as expected by its customer. A process can be made up of processes, often called sub-processes. Process mapping is to understand the activities of the company, in the background of strategies formulated and implemented by the company at all levels. To evaluate performance it is necessary to understand the processes in the company, as they constitute the area of performance analysis. Each process is understood by what is known as process mapping. Processes involve more than one person/equipment, coordinated effort is required. Tasks involve one person/equipment. Two versions of a process map are common:

- > **As-is**: the current state of the process;
- > **To-be**: the goal state of the process;

2.2. Likely results of process mapping:

Increased understanding of process, Increase consensus about the process, increased visibility into the process (Those who assume they know the process, without having mapped it, will probably find surprises when they map the process).

2.3. Steps-wise approach for Process Mapping:

1. Observe process
2. Document your observations
3. Identify all process steps & Align all the steps horizontally

4. List the parameters that can change a product characteristic at each step (machine settings, supplies)

5. *Identify VA and NVA steps:*

5.1 Value Adding (VA) steps have the following characteristics:

- a. Something the customer would be willing to pay for
- b. Transforms the product or service (shape, smell, color)

5.2 Non Value-Added (NVA) steps are classified as:

a. NVA Necessary:

- Activities that your customers do not want to pay for (it does not increase value in their eyes) but are required by the company for some reason: Accounting, legal, Rework, multiple signatures & copies, counting, handling, inspecting, set-up, downtime, transporting, moving, delaying, storage.
- Is task required by law or regulation?
- Does task reduce financial/liability risk?
- Does task support financial requirements?
- Does process break down if task is removed?

b. NVA Unnecessary (waste): (rework, delays, idle)

6. **List Process Inputs and Outputs:** Each step in a process may be understood in terms of a common logic: *INPUTS >>>>TASK >>>>>OUTPUTS*.

Inputs: all necessary parameters to complete a step in a Process (Human Resources, Machine, Measurement, Method, Material including Utilities and Nature)

Task: Activities converting inputs into outputs.

Outputs: End-products; parameters that are measurable or assessable

7. **Inputs & outputs can be identified by:**

Brainstorming; Work instructions; Operators experience; Industry standards; Engineering knowledge; scientific theory

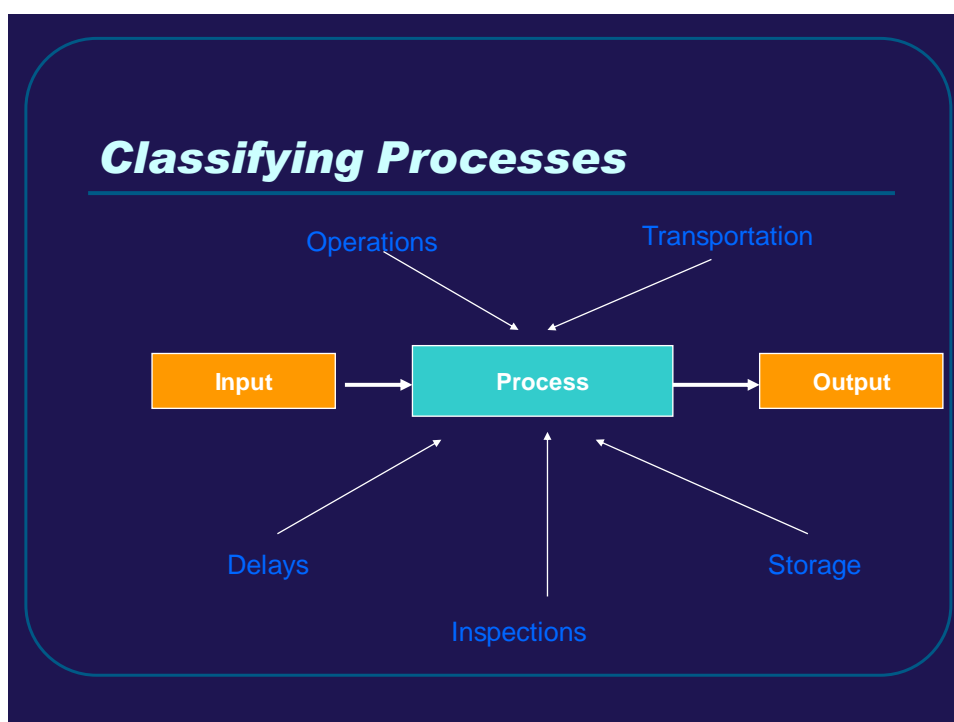
8. Classify inputs into the following categories:

- Uncontrollable factors in the process
- **Controllable Factors** - Process factors that can be changed to see the effect on product characteristics.
- **Standard Operating Procedures** - A procedure is used to define and run those factors.
- **Critical Factors** – Important factors that determines the outcome. (Availability of specific input, at times, become so critical that even product mix is determined by computing contributing per such input)

9. Link desired customer value to process: Time ; Cost; Quality; Flexibility; Sustainability;

10. Measure The Process

- Show total time as VA and NVA percentages for the entire process.
- Analyze the NVA steps, investigate time wasted.
- Calculate Cycle Time – *total time elapsed to run all the steps in a process to complete a part and start the next one.*
- Calculate Flow Time – *total scheduled time to complete a part*



For the benefit of the readers, we list out the possible benefits of process mapping:

- Understanding of the process flow
- Find where/what/when/who/how waste is being created
- Define elements of cycle time
- Eliminate or combine steps
- Improve process flow
- Re-layout the process
- Reduce variation, cycle times, rework, waste and manpower
- Allocate resources better
- Process Mapping may also help in focusing to eliminate waste, like:
 - a. Unnecessary motions, steps
 - b. High volume of inventory, overstock
 - c. Overproduction
 - d. Transporting
 - e. Waiting, idle, queuing
 - f. Defects, scrap
 - g. Under-utilization of resources (people, equipment)

It is important to point out here that Process flow as mapped in the above Ten steps, may undergo change due to:

- Raw materials
- Product (output) design
- Job design
- Processing steps used
- Management control information
- Equipment or tools
- Suppliers

The above elaborate articulation of Process Mapping is to enable the Cost Auditors familiarize themselves with the role of process mapping as a vital tool in the performance analysis.
