

STRATEGIC COST MANAGEMENT AND PERFORMANCE EVALUATION

Preface to the Notes

This notes has been prepared for the benefit and use of CA Final students. Other Professional Course students can also use the material for respective topics of their syllabus. Being notes, the topics have been condensed and are presented in a synopsis manner. Yet, they cover the complete issues involved in respective topics and give the reader good understanding of the subject. This has been prepared for the ease of students preparing for Examinations. The issues have been explained in simple language supported by examples as well. If students desire to have more in-depth knowledge on any topic(s) then they need to refer relevant Text Books.

This paper of the CA Final course had substantial change in the contents and syllabus as compared to the erstwhile Advanced Management Accounting. There is a marked shift from more of the earlier Figure Work to Theory and Figure work in current syllabus. The syllabus has included more of the practical aspects of Management Accounting and Performance Evaluation with Case Studies. To answer practical cases, a student needs to have:

- Thorough understanding of the Theory;
- Application of theoretical knowledge to Practical business scenarios for solutions: and
- Figure work analysis.

In this part, only theory has been considered.

I hope this notes will be of good use to students.

Readers are requested to mail suggestions and feed back to ram_pv@rocketmail.com for improving the contents.

Good wishes and Happy Reading
P V Ram

CHAPTER 5: Cost Management for Specific Sector

Broad Contents of the Chapter are:

1. Costing in Power Sector
2. Costing in Agriculture Sector
3. Costing in I T Sector

Costing in Power Sector:

Thermal Power Plants are the main sources of electricity in India. Other sources of electricity are Hydro electricity, Solar Power, Wind Power, Nuclear Power etc.

Power industries are **Highly Capital Intensive** with long gestation periods (3 to 5 years) before revenue streams start flowing in. Their operating periods are also large spanning over 25 years also.

Coal is the main input for thermal plants and most of the power plants in India are coal based plants. Desired quantity of coal of the right quality happens to be a crucial factor. Shortage of right coal is acute and forcing many of the plants to import coal / lignite.

Distribution of Electricity is a Complex Network involving Power Plants, Grid, Substations, Transformers, Power Lines etc. Most of the Grids are interconnected for reliability and commercial purposes.

Features of Power Sector:

- a. Limited number of Suppliers of Electricity
- b. Tariff is based on rationality of the cost incurred at various points of operation.
- c. Stakeholders are existing and future consumers, industries, Government, Regulators, Investors etc.
- d. Growing demand of Electricity
- e. Flexible Cost Allocation
- f. Distribution loss and inefficiency gaps
- g. Undisciplined Consumer
- h. Continuous network between Generators, Transmitters, and Consumers
- i. Most of the Producers are Public Sector Undertakings regulated by Government
- j. Subsidies offered

Application of Cost Management Techniques:

- a. Developing a Flexible Cost Allocation System
- b. Analysing Distribution loss and inefficiency Gap
- c. Multi Dimensional Cost Calculations
- d. Power Factor Analysis and reporting (PF is the ratio of the real

power that works and the power that is supplied to an AC circuit. This varies from 0 to 1. There will not be any PF in case of DC circuits as there will be no Frequency)

Costing in Agriculture Sector:

The Value Chain of Agriculture Sector is as below:

Farmer **to** Consolidator **to** Trader **to** Commission Agent **to** Whole Saler **to** Retailer **to** Consumer

Features: The features of Agriculture industry in India are as below:

- a. **Fragmented Structure:** This sector in India is unorganized and fragmented. The regulations are also ineffective leading to the farmer getting exploited with very low margins.
- b. **Non Understanding of Costs and prices by Farmers:** Most of the farmers are uneducated and do not know or understand the Cost Management.
- c. **Understand to work Collaboratively:** The farmers must be open to Innovation and Cost Management and Contracting techniques. Though there is scope for cost reduction, benefits of Cost Reduction are not getting transferred to the Farmer. They are being enjoyed by rest of the participants of the Value Chain.
- d. **Imbalance in Power Distribution:** With the fragmentation and unorganized nature of the industry, Power bargaining lies in the hands of Wholesalers (who buy from Farmers) and Retailers (who sells to the consumer.) This is leading to the exploitation of Farmers.

Cost Management: Cost Management for Agriculture focuses on all the activities that are internal and external to the Value Chain for Cost Reduction and Cost Control. For this purpose Activity Based Costing technique appears to most suitable. ABC suggests in a better manner how the indirect costs associated with agriculture are allocated / apportioned. Large scale enterprises engaged in Agriculture activities with high capital investment need efficient use of technology to carry operations viably. ABC has the following advantages:

- Adjustable Costing Technique
- Faster and more Accurate
- Enables to carry a detailed Analysis

Costing in I T Sector:

Expenses incurred on I T by MNCs' presents lot of challenges for Cost Management. This is mainly because of the complexity of the operating structure and the difficulty in applying cost allocation models. Most organisations develop centralised I T Departments which may be treated as cost centers for allocating the costs of Business Units. Further, with

the availability of Cloud Computing Services, large and small organisations are opting for Cloud Computing Services in lieu of having separate independent I T Departments. This is making the I T departments to fight hard for their existence and make relevance for the organisation. To take a call on this, organisations are evaluating through **4D(imensional) I T Cost Optimisation Framework** as below:

Defining Organisation Vision: The I T requirements and consumption of an organisation need to be in line with the Vision and Long Term Objectives. These are to be framed involving the key stakeholders' viz., CEO, CFO, Directors etc. Depending on the amount involved, appropriate Cost Accounting Model is to be adopted. The model needs to be flexible and also not too complex to implement and maintain. The organisation may go for direct allocation of overheads or the refined way of allocation through ABC based on Cost Drivers.

Documentation of Current State (i.e. As is Study): The current state of the I T Department in the organisation needs to be Documented to identify the gaps and potential weaknesses and potential areas for automation.

Delineation of Target Business Architecture: Once the current state of the IT architecture has been documented, the next step is to develop the target business architecture for the purpose of addressing the gaps and limitations identified. This forms the crux of the IT cost management framework.

Build Vs. Buy: This is the last step of the process which requires lot of Brainstorming and Research considering the view of all the Stakeholders.