Cost Reduction in Manufacturing Companies

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Definition of Internal Audit

- Internal Auditing is an independent, objective **assurance and consulting** activity designed to <u>**add value**</u> and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Source: The Institute of Internal Auditors 1999 (IIA)

Myths of Cost Reduction

- Not a job of Internal Auditor.
- Same as Cost Audit.
- Means cutting the costs.
- Requires high level of intelligence or technical knowledge.
- Necessarily involve process re-engineering
- Requires investments
- Can be achieved by normal audit

Opportunities

- **Substitution**
- **Make or buy**
- Scrap / Waste management
- Quantification / Measurement
- Know costing of your vendor
- Vendor managed inventory
- Tax benefits / Govt. Incentives

Opportunities

- EXIM benefits (Advance Authorization / Duty Drawback / FMS)
- Under utilization of assets.
- Minimum Guarantee
- Supply Chain Management
- Dead Freight vs Penalty (Railway freight)
- Under utilization of fund limits

Scrap / Wastage

- The company was producing and selling consumer products. These products were wrapped in attractive rapper on which **month of manufacturing** and MRP were printed. Auditor found that a lot of rappers were scrapped. During inquiry he was informed that rappers are scrapped when:

a) Gap between actual dispatch of products and forecast is very high.

b) MRP of product is changed.

Auditor suggested to get rappers printed with blank space for month of manufacturing and MRP. He suggested to procure an embossing machine and stamp month of manufacturing and MRP data after the production but before dispatch of products. Amount saved was Rs. 3.50 crore p.a.

Quantification / Measurement

- The plant uses 16 compressors for handling compressed air requirements. 12 compressors were used at full load while 4 were stand by compressors. Auditor checked performance of 6 compressors for 10 days and observed that power consumption of each compressor on an average was 35 AMP @ 7.2 bar pressure. Norm given by vendor was 32 AMP @8.4 bar pressure. Auditor quantified extra power consumed due to above deviation. (Rs. 1.60 crore p.a.) Suggested to carry out detailed review of all compressors to reduce power cost.

- Management reviewed all compressors and found non functioning of flow meters, leakages in duct at few places, chocking of filters and some other technical issues. Necessary repairs were carried out. Power consumption after repairs was 32.8 AMP at 8.2 bar pressure. Cost reduced - Rs. 1.20 crore p.a.

Tax Benefits /Govt. Incentives

- As per GST Act, input credit is allowed on civil / structural work done for **foundation** of plant & machinery only. This means input credit on steel and cement used for plant and machinery is not available. Company was buying steel and cement in bulk which were issued to a contractor for all type of work. Auditor found that **GST of Rs. 20 Crore** incurred on cement and steel which was capitalized. Based on audit suggestion, company appointed a Chartered Engineer and ascertained quantity of cement and steel used for foundation work. Based on the same, input credit of **Rs. 8 crore** was claimed in GST return.

- Air tickets booking via travel agent. The company has claimed input tax credit on commission charged by travel agent. However, airlines also charge GST of 5% on economy and 8% on business class tickets. No input credit was claimed on the same as it was not visible on invoice of travel agent. Suggested to download copies of tickets from airline websites by providing PNR number. Financial Impact – **Rs. 48 lakhs p.a.**

Minimum Guarantee

- Sanctioned power capacity of the plant was 25 mega watts, which was based on average production plan. However, due to fluctuation in production (due to market conditions), peak power consumed during few days (on 15 minute basis) was 28 to 29 mega watts. MSEDCL charges penalty for exceeding demand load at 150% of normal rate. After audit suggestion, demand load was worked out after considering business plan of next year. Application filed for additional demand load of 5 mega watts. Penalty amount saved – Rs. 1.10 crore p.a.

- The company has planned to increase production capacity in near future. Hence, applied for additional water supply to Irrigation Dept. As company decided not to go for expansion project (due to logistic issues), the additional water was never used. However, company was charged Rs. 5 lakhs per month as commitment charges by Irrigation Dept. in regular bills of existing plant. Subsequently, company cancelled the second agreement and saved penalty amount of Rs. 60 lakhs p.a.

Under utilization of assets

- Non moving inventory of spares was found at a plant location. Amount – Rs. 27 crore. Major reason was modernization of the plant, due to which spares were no longer usable. Disposing off spares as scrap would have fetched a negligible value. Based on audit suggestion, company found out other companies in same the industry who were still using old technology. Some of spares were sold to them. Balance items were sold to the vendor (from whom the same were bought) at a discount. Company realised Rs. 20 crore by selling non moving spares. Saving in interest cost - Rs. 2 crore p.a.

- Company used to have guest house at 6 locations for their travelling employees. Audit review revealed that usage of 3 guest houses is less than 20%. Cost benefit analysis revealed that cost of maintaining a guest house (rent, electricity, housekeeping, salary of attendant etc.) is higher than hotel accommodation for actual occupancy. Company closed down 3 guest houses and saved approx. Rs. 52 lakhs p.a.

Costing of the vendor

- Company has engaged a labour contractor. Contract value was worked out based on gross salaries of workers + 10% overhead charges (for arranging accommodation, conveyance and other facilities for labour and admin charges of contractor) + 10% contractor's margin + applicable taxes. This amount was divided by 12 and monthly bill was raised by the contractor. Observed that most of components of overheads are not variable but fixed or semi variable costs. Certain cost components of gross salary are either payable at year end or not payable at all (example: Bonus, Leave encashment, Gratuity etc.) Contractor was asked to divide bill in 2 parts i.e. monthly bill and reimbursements. Cost saving – Rs. 4 crore p.a.

- CHA contract was given @ Rs. 310/- per MT of export at Mumbai port. Costing of vendor revealed some cost incurred were semi variable / fixed in nature. It included survey charges, repacking charges, ground rent, documentation cost, wharfage, weighment charges, custom formalities etc. Contract was bifurcated at Rs. 210/- per MT and actual reimbursements. Cost reduced by Rs. 35/ -per MT, i.e Rs. 1.60 crore p.a.

Supply Chain Management

- Finished goods were sold via 2 routes i.e. direct dispatch from plant and via depots / CFA agents. Observed that approx. 50% of material sold via depots were more than 9 MT (i.e. full truck load). (for small customers). Apart from this, 10% material was sold to customers located within 100 km of plant. Suggested to dispatch material to these customers directly from plant. Subsequently, direct dispatches from plant increased from 6% to 57%. Cost of Depot, CFA charges, loading unloading exp. saved – Rs. 1 crore.

Vendor Managed Inventory

- Company was procuring and storing more than 5000 spares. This included motors, compressors, flanges, screws, bearings, V belts, bolts, switches etc. of various sizes. This has resulted in blockage of working capital, difficulty in record keeping, risk of obsolesce etc. Suggested to ask vendor to open a facility either inside or near the plant and have vendor managed inventory. This ensure that spares are available at short notice and release of working capital. Now, vendor is supplying the spares as and when required. Inventory of spares reduced to 1700 items and value of inventory reduced by approx. **Rs. 20 crore**.

Under utilization of fund limits

- The company had more than 30 bank accounts at various locations. Out of which, 12 current bank accounts were having minimum credit balance (aggregating to) of Rs. 6.50 crore. These bank accounts were opened for making GST payments, advance railway freight, payment of custom duties and other statutory dues. As requirement of funds in these accounts were erratic, it was difficult to predict cash flow for these bank accounts. Suggested to:
  - Reduce no. of bank accounts
  - Ask railways to accept RTGS payment instead of DD.
  - Convert some of these accounts in Cash Credit, where interest will be charged based on usage.

12 bank accounts were reduced to 3 with cash credit facility. Railways agreed for RTGS payment, which was done from bank account of Corporate. This reduced working capital by Rs. 6.50 crore.

Essentials for effective Cost Reduction

- Understanding of Business operations.
- Understanding of processes.
- Marketing skills
- Should not look like fault finding exercise. Avoid blame game
- Sharing of credit
- Follow up

Thank You