

## **Normation – A Tool**

### **Concept**

1. Estimation of fair cost/price for manufactured products is required while deciding on issues of price administration, subsidy/concession schemes, etc. The production cost of manufactured products includes cost of raw materials consumed, cost of energy like electricity, steam and other utility services, conversion cost, packing cost etc. Freight and other selling cost are included for cost of sales. Estimation of these costs incurred for production of a product for a period say a year, for a manufacturing unit gives actual cost of production/sale. Since it is not necessary that the manufacturing units have operated in a efficient manner, a pricing system based on actual cost of production/sale lacks thrust on improvement in efficiency of operation. In this context, normative cost/pricing system evolved over the years and is being extensively used by Tariff Commission (and earlier by Bureau of Industrial costs & Prices which is merged with Tariff Commission).
2. Normative price working is based on estimation of cost at acceptable level of efficiency parameters. Important parameters having bearing on cost are capacity, capacity utilisation and production level, raw material consumption, energy consumption etc. For estimating achievable efficiency parameters performance of manufacturing units is evaluated over different periods and bench marked against performance of other efficient units in the industry, international efficiency etc. Fair return on investment is also provided for arriving at normative price. Since the normative pricing is based on efficiency parameters adopted, the inefficient units need to improve their efficiencies. At the same time the manufacturing units who are able to achieve higher efficiencies will be able to retain the benefits arising out of the same. Thus normative pricing system incentivises achieving higher efficiencies. Thus giving a thrust on cost reduction and enhancing competitiveness of the industry.

## Method

- The method of estimating normative cost/price begins with the estimation of physical input/out norms (technical norms). Installed capacity, production, capacity utilisation, specific raw materials consumption, utility consumption and man/machine productivity are the major parameters impacting the cost of production of the product. The technical norms for the above parameters are worked out on the basis of actual performance of the selected units/plants over the past 3 to 5 years for estimating the normative cost of production at reasonable efficiency level.
- The technical norms are then applied on the actual cost of production/sales (costed year) of product of each selected unit for working out the normative cost of production. The actual cost of production comprises of raw material cost, conversion cost and packing cost. Freight and other cost are added in the production cost to get the cost of sales. The conversion cost comprises of power and fuel (utility cost), salary and wages, repair and maintenance, stores and spares, depreciation, factory and administrative overheads. The estimates of normative cost of production for each of the selected units/plants, takes into account the following parameters :
  - ✓ Assessment of installed capacity and capacity utilisation norms
  - ✓ Assessment of achievable normative production
  - ✓ Normative requirement of raw materials consumption
  - ✓ Normative requirement of utility consumption
  - ✓ Normative requirement of manpower productivity
  - ✓ Normative requirement of overheads
  - ✓ Updation of cost of raw materials and utility considering the latest prices of raw materials and utility, prices of imported inputs are adjusted based on current variation of rupee, whenever applicable
  - ✓ Updation of Salary and wages an annual increase is provided to take care of normal incremental effect
  - ✓ Repair and maintenance, factory and administrative overheads included in conversion cost are suitably adjusted considering fixed and variable cost.
- Normative cost of production of the product of each unit is calculated accordingly considering the above parameters.

- Normative price of the product of each unit is estimated considering normative cost of production, interest & return on capital employed:
  - ✓ Returns on capital employed comprising of net fixed assets and working capital. The net fixed asset consists of debt/loans and equity. Normally, return on capital employed is considered @12% post tax.
  - ✓ The average interest rates prevailed during the period is considered for term loan and working capital.
  
- Industry normative price is worked out
  - ✓ based on weighted average price of the product of the selected units or
  - ✓ based on efficient units after excluding inefficient units of the industry

### **Merits**

- Considered fair by an individual and /or a group.
- Determining the cost of goods/services at optimal/efficient level of inputs (manpower, material, energy and capital) and provides thrust for improvement in efficiency and enhances competitiveness of the industry.
- It helps in identifying areas for physical improvements resulting into cost reduction.
- Normative pricing methodology is a fundamental management tool that supports quality / excellence and innovation. It is in fact a continuous process of measuring one's own performance and practices against the best competitors. It is thus a bench-marking tool in competitiveness studies.
- Normative pricing balances the interest of all stakeholders while protecting consumer interest.
- It is a tool which also focuses on providing road map for improving industrial efficiency.
- Over the period this tool has passed the test of time and has become essential in the emerging complex global market scenario and cutting edge competition.