OBSERVATIONS AND ISSUES ON THE COMPANIES (COST RECORDS AND AUDIT) RULES, 2014

Ministry of Corporate Affairs (MCA) notified the Companies (Cost Records and Audit) Rules, 2014 on June 30, 2014.

Following are our observations:

1. Section 148 of the Companies Act 2013 prescribes provisions relating to maintenance of Cost Records and Cost Audit. Section 148 (1) prescribes cost accounting records have to be kept by specified class of companies engaged in the production of such goods or providing such services as may be prescribed, irrespective of Turnover and Net Worth. Section 148(2) prescribes requirement of Cost Audit based on criteria of Turnover & Net worth. In other words ONLY the nature of 'GOODS or SERVICES' is the criteria under 148(1) for prescribing the class of companies for requirement to maintain cost accounting records. It is only section 148 (2) which prescribes criteria based on Turnover / Net worth on the class of Companies mentioned in section 148 (1) for the purpose of Cost Audit.

   The Companies (Cost Records and Audit) Rules, 2014 are against the relevant provisions of the Companies Act, 2013, as far as maintenance of cost records is concerned as it lays down criteria based on Turnover and Net Worth. The Rules cannot override the basic provisions of the Act. Thus from the reading of the provisions of the Act, it appears that the criterion for prescribing cost records as well as cost audit, is "class of companies engaged in the production of such goods or providing such services as may be prescribed". Therefore the cost audit should also be prescribed for "such class of Companies" and not for such products manufactured by such class of companies.

   The scope of Section 148(1) of the Act should be wide enough to cover all manufacturing companies and service providers. For this purpose, the rationale behind erstwhile Section 209(1)(d) and Section 233B of the Companies Act 1956 may be referred to. Section 209(1)(d) provided for maintenance of Cost Records by any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account, whereas the Section 233B provided Cost Audit for the selected companies. In other words maintenance of Cost Records was mandatory for all companies and Cost Audit was prescribed for selected companies. Considering the advantages of Maintenance of Cost Records, the provisions of Section 148(1) of the Companies Act 2013 should be made applicable to any company engaged in production, processing, manufacturing or mining activities

and provision of services with certain thresh hold limits. The applicability of section 148(2) of the Companies Act 2013 may be restricted to certain class of companies.

2. **The 2014 Rules have not clearly defined the term "class of companies".** These rules have nullified the earlier framework wherein the term "class of companies" was rightly considered at the company level rather than at the product level. In this context, it may be noted that the cost accounting system cannot be implemented by any multi-product/activity company for any single product or activity in isolation. It has to be for the company as a whole enabling it to find the proper cost of each product/activity. In any organisation, there are large number of functions that render services to all products. In the absence of any composite cost accounting system installed at the company level, it would not be possible to collect & allocate or apportion costs attributable to these common cost centers. Hence, the application of any framework cannot be restricted to the limited products or activities of the company; rather if warranted, the company as a single unit need to be covered under the term "class of companies", not the specific products produced or services rendered by it. Otherwise, the data/information as sought in the prescribed formats of reporting cannot be provided. **Thus, this major ambiguity contained in the 2014 rules has effectively made them un-operational.**

3. The 2014 rules have re-introduced the old mechanism for maintenance of cost accounting records and **have incorporated cost element-wise instructions and fixed format that cannot be universally made applicable to all classes of companies; least the services sector companies.**

4. **The term "Public Interest" has not been defined.** In absence, it can be defined in many ways, such as involvement of public money [through equity, loans, deposits, fiscal incentives, tax concessions, subsidies, grants, waivers, moratoriums, free or subsidized inputs in the form of land, power, fuel, transport, & other economic benefits, etc.], employment generation, providing public services, public utilities, welfare of general public, etc. The Expert Group constituted by the MCA in its report on Cost Accounting Records Rules, Cost Audit Report Rules & Cost Accounting Standards inter-alia mentions; Public interest agenda includes minimum prices to benefit the consumer (maximize consumer surplus); ensure adequate profits are earned to finance the proper investment needs of the industry (earn at least a normal rate of return on capital employed); provide an environment conducive for new firms to enter the industry and expand competition (police anti-competitive behaviour by the dominant supplier); preserve or improve the quality of service (ensure higher profitability is not achieved by cutting services to reduce costs); identify those parts of the business which are naturally monopolistic (statutory monopolies that are not necessarily justified in terms of either economies of scale or scope); take into consideration social and environmental issues (e.g. when removing cross subsidization

of services). Prior to 1991, the public interest was sought to be served more through direct regulations that required the prior approval of government for many commercial decisions. Post-1991, in most sectors of the economy, the protection of public interest objectives rests with the laws governing competition and the regulatory regimes that have been set up for "natural" monopolies and network industries (where the production patterns of one producer are linked to that of others). **Thus, these rules are open to interpretation at the choice of the reader. Hence, there is a confusion on the applicability.**

5. Similarly, **there is no definition of "Strategic Industry"**. A Rule cannot be vague leaving room for everyone to interpret it in his/her own way. In this context one may refer to the 12th Five Year Plan document which has identified 17 different industries as strategic sectors. Most of these sectors do not find place in the 2014 rules though these were existing in the erstwhile rules as well as in the old rules in-place prior to June 2011.

6. **Product description is very vague.** For example, Schedule-VI of the Companies Act, 2013 has already defined the terms "infrastructural projects" or "infrastructural facilities". The Companies (Cost Records and Audit) Rules 2014 include only roads, highways, railways, ports, airports, airlines and other related services, construction activities, housing & real estate development, water management, solid waste management, sanitation and sewerage systems, telecommunication services, generation, transmission & distribution of power, production, storage & distribution of petroleum and natural gas, mining and related activities, etc. **Thus, mentioning the words "Roads and other infrastructure projects" in isolation in the Companies (cost records and audit) Rules, 2014, and separately including only few other industries/sectors and leaving majority of them from that given in Schedule-VI creates confusion among all.** For clarity of all, the rules could have simply referred to the terms "infrastructural projects" or "infrastructural facilities" as defined in the Act.

7. Selection of manufacturing products/industries/sectors is not linked to the Central Excise Tariff Codes. This linkage not only makes the interpretation of applicability much simpler and universal, but also enables easy availability of data for the purpose of revenue and anti-dumping cases.

8. Cost Records cannot be maintained for few products only. These need to be maintained for a Company as a Whole.

9. Section 148 of Companies Act 2013 provides for maintenance of cost records and cost audit by such class of companies engaged in the production of such goods or providing such services, but the rules notified under this section vide Rule 3(D) prescribed maintenance of cost records and cost audit by the companies (including foreign companies other than those having only liaison offices) engaged in the

production, import and supply or trading of medical devices. Inclusion of "Import or Supply or Trading" per se is ultra vires to the Act.

10. Filing of Cost Audit Report in XBRL had given a comfort level to the industry with regard to maintaining confidentiality of the data / information which has been removed in the current Rules.

Based on the above observations and also taking into consideration Companies (Cost Records and Audit) Rules 2014, the following issues emerge:

1. **Coverage should have been more logical and properly specified. For example, no company is likely to be covered under category-A for reasons given below.** Even if covered, the company would claim exemption under the guise of not disclosing confidential details that may jeopardize security of the country. Such exemptions are already given under the financial disclosures.

    a. Machinery and mechanical appliances cannot be specific to any industry or activity. For example, bearings, power transformers, control panels or other electrical/mechanical equipments are items of general application and can be used in any sector. Hence, no company produces such items exclusively for supply to defence, space and atomic energy sectors. Therefore, if the company supplies even one item to a sector other than defence, space and atomic energy, which is a natural & commercial possibility, then the company would not fulfil the test of "exclusive supply" and will be out of the ambit of application.

    b. While on the one hand, these rules have covered many strategic & infrastructure sectors such as power, petroleum, telecom, chemicals, mining, etc., on the other hand, the inputs made by the engineering sector to these industries [or for that matter to any industrial activity] for the plant erection, operation or maintenance are not covered.

    c. Arms and ammunition is manufactured by Ordinance Factories only which are outside the ambit of Companies Act not being companies.

    d. Tanks and other armoured fighting vehicles, that are funded (investment made in the company) to the extent of ninety percent or more by the Government or Government Agencies shows an intention of covering only Government Companies. Such companies do not exist.

    e. The net worth and corresponding turnover clause rules out all companies engaged in such manufacturing and supplies.

2. **Despite MCA's intent to cover all the regulated industries, the proposed rules do not say so as the mandate of regulatory bodies referred to therein is highly restricted within the same sector.** For example, Petroleum and Natural Gas Regulatory Board do not regulate production of petroleum products or gases; or the Airport Economic Regulatory Authority do not regulate aircraft operations or civil aviation activities; or the Telecom Regulatory Authority of India do not regulate the entire value [supply] chain of telecom activities that are now controlled by different companies and majority of them fall out of the purview of TRAI. **Further, these rules have not covered number of other regulated sectors.**

3. In a multi-product or multi-service company, reference to specific product or service turnover being more than Rs. 50 crore for records and Rs. 100 crore for audit is misleading. This would imply that in a chemical company producing multiple chemicals, each of its products must satisfy the qualifying turnover. Further, for a pharmaceutical company, each drug or formulation produced in various dosage forms such as tablets, capsules, syrups, injectable, ointments, drops are considered as different products. Now even if the company has more than Rs.1000 crore turnover, it may not have any single product [dosage form] with turnover more than Rs.50 or Rs.100 crore. Similarly, Nitrogenous Fertilizer is a separate product different from Potassic, Phosphatic, Mixed or Bio Fertilizers and any such fertilizer packed in different sizes would be construed as a separate product. Even a cement producer can claim OPC, PPC & White cement as different products. This logic can also be extended to the same product having different SKUs. Therefore, **product or service specific turnover criteria as prescribed would lead to exclusion of every company otherwise intended to be covered under these clauses.**

4. **Further, having an individual turnover limit of Rs. 50 crore in multi-product cases and Rs. 25 crore for single product company is contradictory.** Majority companies do not restrict their business to only one product or activity. Even if a single product manufacturing company earns 1% revenue from consulting services, it can claim to be a multi-activity company. Thus, it would be seen that the product is excluded from the ambit of application either because the company does not meet such high threshold limits or being a multi-product company, individual products are outside the ambit.

5. **Normally, the turnover is 5 times the net worth and not vice versa as has been put forth in the Rules. The prescription of high net worth and low turnover is not equitable.**

6. Further, these rules do not clearly specify in respect of which year the prescribed threshold limits of net worth and turnover are to be considered for deciding the applicability to a company.

7. The 2014 rules, in its application clause, has stated the class of companies who shall be required to include cost records in their books of account, namely companies engaged in the production of goods in strategic sectors, ***such as,*** or companies operating in areas involving public interest, ***such as.*** The word **"such as"** is meant to be illustrative and not exhaustive. The list of six types of industries given in Rule 3(A)(a) and eleven types of industries given in Rule 3(C)(a) can be taken as illustrative, inclusive and not exhaustive. It can be construed that every company engaged in the strategic sectors or serving public interest is included and the list gives only examples of such industries.

8. As regards structure of audit report, the 2014 rules have re-introduced the old concept of companies filing unit-wise, product-wise & pack/SKU-wise cost audit reports, containing very detailed, complex and highly confidential data. This will make the size of these reports running into 500-2000 pages, depending upon the product profile of each company. By this approach, the twin issues of the industry relating to complete confidentiality of company cost data and substantially high cost of compliance have been completely ignored.

9. As per section 143 (3) read with section 143 (14) of the Companies Act, 2013, the auditor conducting the cost audit is required to comply with the cost auditing standards issued by the Institute of Cost Accountants of India. **For clarification of all stakeholders, requirement of compliance with the cost accounting standards and cost auditing standards needs to be suitably incorporated in the Companies (cost records and audit) Rules, 2014.**

10. The 2014 rules do not contain clear provisions relating to cost auditors' appointment, remuneration, rotation, resignation, removal, re-appointment, period of holding of office etc. Nor they specify the compliance & monitoring mechanism with the Central Government.

11. FORM CRA 3 needs to be replaced/reviewed. Few examples of major deficiencies are briefly explained below:

    a) The entire structure has been copied from the old Cost Audit Report Rules which are totally outdated.

    b) For every Para in the Annexure, the words “Good(s)/Service(s)” have been used without considering whether it is applicable. Obviously, quantitative details, installed capacity, capacity utilisation, wastage, stock adjustment, write-offs, input of materials, etc. are not applicable at all for the service sectors. There are many other such instances across the Form.

c) The structure of this report was changed in 2011 since most of the information provided here are already available in the financial accounts and is duplication having no relevance to cost or cost accounting.

d) General Information: Annexure 1: Copied from the structure that was issued in June 2011. However, this had to be amended later on to make it compatible to XBRL Taxonomy.

e) Annexure 3: Process of Manufacture – redundant paragraph having no practical use. This is irrelevant for a service industry company.

f) Para 4 – Sales: Without reference to the Product group code (as was introduced in 2011), every company will describe its products or services in the way they please. This will not allow the data to be used for any analysis by any Regulatory body or other users. Further, there is no unit of measure provided which will lead to combination of sales figures of products recorded/sold under different unit of measures. The structure is also not compatible to XBRL filing.

g) Para 5: Quantitative Information – None of the details are applicable for a service company though mentioned in the prescribed para.

h) Para 6: Details of Major Input Materials and Para 6(A): Standard and Actual Consumption – Not applicable for service industries. For production and manufacturing companies, this represents critical data. There were many representations from industry so that such confidential information is not required to be disclosed. Giving details of raw materials exceeding 5% means the list can go to hundreds of items. The format is also not compatible to XBRL filing due to table and dimension problems.

i) Para 6(B): Cost of Imported Input Materials – Not applicable for service industries. The data is not relevant. Besides, total imports are available in financial accounts.

12. Absence of Performance Appraisal Report by the Cost Auditor will deprived the management in corrective actions for better productivity and profitability.

13. The Rules were issued on 1st July 2014. The appointment of Cost Auditor has to be made within 90 days from the beginning of the financial year. The issuance of Rules on 1st July 2014 has made them infructuous.

Conclusion:

In view of the observations and issues detailed above and large number of drafting & conceptual errors, these rules should not be made operational until these are amended suitably.

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